Testimony of

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The Private Mortgage Market Investment Act

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INTRODUCTION

Good Morning Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange that invests in mortgage credit risk. I appreciate the opportunity to testify on the draft legislation entitled "The Private Mortgage Market Investment Act."

OVERVIEW

Mr. Chairman, I first want to commend you for introducing this legislation. You have obviously put a great deal of time and effort into understanding the structural problems of the secondary mortgage market, and have now drafted comprehensive legislation to address those problems. While the fact finding part of the legislative process will continue, it is very encouraging to see the drafting process get underway.

There are two equally important impediments to the redevelopment of a robust private MBS market. The first is structural deficiencies in the mortgage securitization process that impede investor confidence, and the second is extensive government subsidies that crowd out the private sector.

Before I move to the main part of my testimony, let me say something briefly about the overreach of government subsidies. While they may have been necessary at the peak of the market crisis, the subsidies can now be scaled back without dire consequences. This was proven when the GSE and FHA conforming loan limits were reduced on October 1. There was a smooth transition in the market to the new lower limits. All the warnings of borrowers getting shut out of the market or getting charged 300 basis points higher interest for a loan, have proven to be wrong. Borrowers above the new conforming loan limit are getting loans and the current spread over a conforming GSE mortgage has averaged less than half a percent.

I understand that the Senate has recently adopted an amendment to an appropriations bill that would extend the higher loan limits yet again, even after they have already been reduced without dire consequence. I urge the Committee to reject that amendment.

The legislation you have introduced, addresses many of the structural deficiencies in the housing finance process that caused problems and that continue at this time to deter investor confidence. This is very important. Without investor confidence and willingness to take on mortgage credit risk, there will not be a broad resurgence in the private MBS market. Investors in a Ginnie Mae or a GSE mortgage security are not buying mortgage credit risk; they are buying US government credit risk.

Redwood has managed to now issue three fully private MBS transactions through sound underwriting controls and structural enhancements that have gained the confidence of investors. However, the private market we have revived will remain very small without the kind of broader structural reforms contained in the legislation.

THE PRIVATE MORTGAGE MARKET INVESTMENT ACT OF 2011

I would now like to comment on a few of the specific provisions of the legislation and also to propose consideration of some additional provisions.

Standard Mortgage Classifications

The legislation directs the FHFA to establish classifications for mortgages securities having different degrees of credit risk, ranging from little to substantial. The FHFA will also establish criteria for each classification, and develop standard form securitization agreements. The legislation would not prohibit nonstandard mortgage products – they would just be subject to a different regulatory regime. This construct is generally workable and the effort to build more standardization into the mortgage process is the right objective.

Second Liens

The legislation addresses issues regarding second liens in three ways, by permitting a servicer of a first lien loan to charge additional fees if a second results in a CLTV of 80% or more, by requiring notice to the servicer of the first if a second is put in place, and also in the context of servicer conflicts. While these proposed provisions go a long way toward addressing the second lien issue, we propose that consideration be given to addressing this issue more broadly as well.

A lender who makes a first lien residential mortgage loan considers the credit quality of the borrower, the value of the property that serves as collateral, and the relationship between the size of the loan and the property value, the LTV ratio.

The credit quality analysis includes a determination of whether the borrower will be willing to make the required mortgage payments, a determination that takes into account the borrower's equity in the property. The more equity that the borrower has in the property, the less likely that the borrower will default on the mortgage payment obligation.

In the event that a lender makes an 80% LTV loan, and the borrower subsequently takes out a second, the credit quality of the first will have deteriorated. The LTV will have increased and the borrower's equity in the property will have decreased. In addition, the borrower's debt burden will have increased. All in all, the borrower will have less incentive to avoid default and will be more likely to default.

Investors in RMBS backed by newly originated firsts will have the same experience as the lender. When investors invest in RMBS backed by a pool of 80% firsts, they do not want to find that defaults exceed expectations because subsequently originated seconds have resulted in CLTVs of 90% or more.

In many forms of secured lending, it is common for a borrower to be required to get the consent of first lien holders in order to be permitted to incur additional debt. This feature could be imported into residential mortgage finance by contractually requiring that a borrower obtain the consent of the first lien holder (which is the RMBS trustee where the loan has been securitized) before taking on a second if the CLTV would exceed a specified threshold.

If the borrower nevertheless took on the second without the consent of the first lien holder, the first lien holder should be permitted to declare the loan immediately due and payable (often referred to as a "due-on-sale clause"). This solution would require Congressional consent to amend the Garn-St. Germain Depository Institutions Act of 1982 which currently prohibits the exercise of due-on-sale clauses triggered by the creation of a subordinate lien.

Identification of Representation and Warranty Breaches

The proposed legislation addresses the issue of rep and warranty breaches by contemplating a process for mandatory arbitration in the event of a disagreement between investors and issuers on whether there was a breach obligating an originator or securitization sponsor to repurchase a loan or to indemnify a loss

The proposed legislation also contemplates appointment of an independent third party by a majority of the investors to, among other things, inform the trustee of any securitization agreement breaches. We agree that the designation of someone to identify breaches is essential in order for the mandatory arbitration provision to have its intended impact.

Redwood has in our three recent securitizations pioneered the use of mandatory arbitration to resolve disputes on securitization rep and warranty put back claims and we have also designated a party in our securitizations to identify breaches and to make claims. Namely, the party who owns the first loss pieces (that is the party who will bear the loss first if the claim is denied) has the right to determine what actions to pursue. And, if the AAA investors disagree <u>with a decision not to pursue a claim, those investors</u> can, through a vote, compel the master servicer or trustee to pursue the claim. We believe that the interests of all parties to a securitization are best served if the party with the greatest incentive to investigate claims is the party designated to do so rather than an independent third party. On the one hand, an independent third party would have no skin in the game and therefore no incentive to aggressively identify and pursue claims. On the other hand, in order to avoid second guessing, an independent third party might make claims excessively, in respect of every delinquency, resulting in excessive costs to the trust.

We recognize the importance of this issue and we would be happy to discuss the details of our structure and our concerns with you in more detail.

Investor Enforcement Mechanism

Many of the most important actions that can be taken in a securitization require the consent or direction of all or a specified portion of the transaction's investors. For example, many proposed amendments to the transaction documents require the approval of a majority of investors while other amendments require the approval of all investors. In addition, investors often have the power to remove transaction parties upon the occurrence of specified events, such as the failure to remit a payment within the specified period, the bankruptcy or insolvency of the party or the material failure to observe a covenant.

It is often the case that no single investor holds a large enough portion of the certificates to independently meet the threshold that is required to take particular actions. In these situations, multiple investors would be required to coordinate their efforts in order to direct or consent to a proposed action. However, many investors hold their interests indirectly in the form of beneficial interests in securities in which the holder of record is a clearing agency (such as The Depository Trust Company or its nominee). Neither the transaction parties nor the investors are able to efficiently discover the identity of any investor holding such a beneficial interest through a clearing agency. As a result, situations may arise where multiple investors want to take an action and would, taken together, meet the threshold but are unable to move forward due to an inability to communicate with each other.

In order to address this issue, a centralized clearing-house for bond registry or other mechanism should be created which would facilitate the ability of investors to communicate with each other.

Some private companies have attempted to create a limited bond registry by inviting investors to volunteer information about their holdings.[1] However, this approach is limited as holders may not be aware of these companies and the registry would only become useful if a large number of holders supply their information.

The SEC recently re-proposed certain rules, often referred to as "Regulation AB II", which contained, among other things, a proposal to facilitate investor communication. Under this proposal, periodic Form 10-D filings would be required to include any request from an investor to communicate with other investors for the purpose of exercising investor rights. As currently proposed, this rule would only apply to shelf-eligible transactions and not other registered transactions or private placements.

We propose that mechanics to facilitate investor communications would make securitizations more attractive to investors and we propose that the legislation be broadened to address this issue.

Servicer Conflicts and Servicer Performance

A servicer plays a significant role in the overall performance of a securitization. Investors generally expect a servicer to act in the best interests of the trust as a whole. However, circumstances may exist which may give rise to potential conflicts of interest which raise a question as to whether the servicer is acting in a manner contrary to the interests of the trust and investors.

In addition, although a servicer is engaged to service mortgage loans in a securitization pool for the benefit of the investors, the investors typically have a limited ability to directly influence the activities of the servicer. One reason for this is that there are few objective standards by which a servicer's performance may be measured.

Conflicts

The proposed legislation addresses servicer conflicts by prohibiting a servicer from servicing a first mortgage if it has an interest in a second lien secured by the same property. Other conflicts, or appearances of conflicts, that may merit focus is when a servicer or a servicer's affiliate owns classes of bonds in a securitization, which gives rise to the concern that servicer actions will favor one class over another .

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[1] For example, Talcott Franklin, a Dallas-based attorney, created a clearing house by inviting investors to submit information under the attorney-client privilege about their holdings for inclusion in a database which would then be used to facilitate collective action with other investors in the same securitization. The clearing house website can be found at http://web.me.com/jennifertfranklin/Talcott_Franklin_P.C./Clearing_House.html.

Surveillance

Even when there are no conflicts, in order to assure investors that the servicer is fulfilling its responsibilities, standards should be developed to govern when a trustee must investigate the servicer's performance. For example, a trustee could be required to examine situations where there have been excessive loss severities, high levels of modification activity, early payment defaults, and excessive foreclosure delays.

In addition, standards could be developed for appointment of a third-party credit risk manager to conduct ongoing surveillance of servicing activities and to report its findings to the trustee and the investors on a regular basis.

Servicer Performance Triggers

To give investors a measure of control over the servicer, servicer performance triggers could be established based on industry best practices benchmarks. The triggers could relate to, among other things, average loss severity, adherence to foreclosure timelines, and average REO liquidation timelines. Hearings should be held with industry participants in order to help create these benchmarks and the benchmarks should be reviewed on a periodic basis.

Presumably, a securitization in which a servicer is under-performing would have many borrowers in various stages of delinquency and default. In these cases, it can be extremely detrimental to a borrower to transfer servicing in the middle of a loss mitigation process. Many of the problems we see today - misplaced documents, starting and stopping of foreclosure, and inconsistency of help would be exacerbated by transferring the borrower to a new servicer.

Instead of requiring the termination of the servicer, all servicers should have a plan in place with a specialty servicer for taking over the servicing of the loans. This plan should include compatible servicing systems, systematic note taking and consistent mailing addresses, emails and fax numbers for borrowers to use. If a servicer's performance is measurably below the benchmarks, this specialty servicer would step-in and take over the servicing at no additional cost to the trust.

Many traditional RMBS securitizations provided for the possibility of removal of the servicer upon the occurrence of an "event of default" such as a material failure by the servicer to observe a covenant. However, because many events of default were formulated with general language rather than by reference to specific and clear triggers, the question of whether an event of default occurred could be subject to dispute. Also, removal of the servicer following an event of default often required the direction by a threshold level of investors, thereby introducing issues regarding impediments to investor coordination. By using clear triggers and an efficient mechanism to avoid disruption to a borrower and to put a specialty servicer in place once a trigger is hit (at no additional cost to the trust), investors would have greater comfort in the servicer's ability to minimize losses.

CONCLUSION

I encourage you to move aggressively with enactment of this very important legislation during this Congress and not let it get sidetracked with more complicated issues, such as GSE reform. This legislation, along with regulatory plans to "level the playing field", could spur a broad resurgence of the private MBS market in the short-term, for the benefit of homeowners, lenders, and investors. In fact, I expect you will find that the velocity gained in the private MBS market as a result of this legislation will likely broaden your policy options for a final long-term resolution of the GSEs, and what, if anything, replaces them.

Thank you for inviting me to testify and I look forward to answering any questions.

United States House of Representatives
Committee on Financial Services

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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:
Martin S. Hughes	Redwood Trust, Inc.
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.