TESTIMONY OF

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DOUBLELINE CAPITAL LP

ON BEHALF OF

THE ASSOCIATION OF MORTGAGE INVESTORS

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE
HOUSE COMMITTEE ON FINANCIAL SERVICES

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Introduction
Chairwoman Waters, Ranking Member Capito, thank you for inviting me to testify today. My name is Vincent Fiorillo and I am a part of the Mortgage-Backed Security Portfolio Management and Trading Department at Doubleline Capital in Los Angeles, California. I am testifying today in my capacity as a member of the Association of Mortgage Investors, a trade group organized to develop investor consensus on current public policy initiatives and to provide policy makers with the mortgage investor's point of view.

Allow me to start, Chairwoman Waters, by commending you, Ranking Member Capito, Chairman Frank, Ranking Member Bachus and the other members of the Financial Services Committee for your leadership in pursuing responsible and effective programs to help keep Americans in their homes, even before the financial crisis.

The Association of Mortgage Investors shares your frustration with the slow pace of efforts to provide homeowners and the entire housing market with meaningful and permanent relief. We are hopeful that substantial relief can be implemented more effectively and quickly. The Association believes that an effective solution is one that addresses the needs of homeowners with unsustainable mortgages that exceed their home's value. In short, we support a mortgage refinance program designed to help homeowners stay in their homes and rebuild equity.

My testimony today represents the views of the Association of Mortgage Investors. Our members are entrusted to make investment decisions on behalf of charitable institutions, endowments, foundations, universities, mutual funds, as well as hedge funds and sovereign wealth funds.

The Association of Mortgage Investors aims 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.

My Background
I have spent nearly 35 years working in the mortgage-finance industry and have a broad experience working across product types and for various clients. Over my career, I have seen the mortgage market and, in particular, the mortgage securities market, from the perspective of investors (the "buy side") and from the perspective of brokers and issuers (the "sell side").

It is important to recognize that mortgage finance has been instrumental in reducing housing costs and helping citizens achieve the American dream of homeownership. When I first began working in this industry in the 1970s, the mortgage finance industry was in its infancy. In fact, 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. This resulted in 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 became national and 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 securities structuring techniques.

The Role of Mortgage Investors in the Marketplace
The maintenance of a healthy securitization market is a vital source of 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 borrowers. The use of mortgage-backed securities equitably distributes risk in the mortgage finance industry, and prevents a build-up of a specific geographic region risk or type of underlying asset. These features, and many others, are those of a market which makes access to capital cheaper and thus spurs more mortgage lending. Without a responsible and viable securities market, home ownership will be an unfulfilled dream of many more people.

Today's mortgage market consists of approximately $11 trillion in outstanding mortgages. Of that $11 trillion, $5.4 trillion are held on the books of the GSE's as agency mortgage-backed securities (issued by one of the agencies) or in whole loan form. Another $3.6 trillion are on the bank balance sheets as whole loans or securities in their portfolios, of which $1.1 trillion are second liens (home equity loans/lines of credit or closed end second mortgages). 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 $1.8 trillion in first lien mortgages reside in private label mortgage-backed securities.

Those "private label" (non-Federal agency) securities are put together by investment banks that pool the mortgages into a trust. That trust is built around a document called a Pooling and Servicing Agreement 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, there are numerous representations and warranties 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 has been appropriate, in part, because they are governed by binding contracts that lead to the stability and predictability investors desire. Like any purchaser, investors expected the sellers of mortgage securities (which were often large banks) to stand behind their promises. Unfortunately, in the current environment, this critical component of mortgage securities market seems to have broken down.

Problems Causing Increased Foreclosures
While the Administration's HAMP was delayed in implementation and the number of permanent modifications does not appear to be on track to meet its stated goals, there were several specific issues that impacted investors' interests.

Income Documentation Problems
The current mortgage modification program has trial loan modifications for homeowners under the HAMP program that were permitted without any verification of the income stated on the modification application. This policy will change in June, and while investors applaud the new policy requiring income verification prior to the start of a trial modification, extending a trial modification without any proof of ability to pay resulted in many trial modifications that were doomed to fail from the outset. This lack of documentation has made it extremely difficult to convert trial modifications to permanent modifications. We believe the recent change in policy

requiring all documentation prior to a trial modification will lead to a higher yield of trial to permanent modifications. However, the HAMP gave some borrowers a false sense of optimism and may result in them being forced to sell homes at lower prices than they may have received one year ago.

Furthermore, the calculations used to evaluate a borrower's application do not factor in the borrower's home equity loan, second lien or other non-mortgage debts to the payment calculation. Such an approach lacks the holistic view needed to ensure that a borrower has an actual ability to pay a modified mortgage, and again is likely to lead to a redefault in the near future.

In fact, the most recent report on the current HAMP program underscores this difficulty. Of the nearly 170,000 successful permanent modifications, half of them are saddled with extraordinary amounts of total debt service with the median level of total debt to income (pre-tax) being 58.9 percent. This leaves very little room to pay for other necessities including food, clothing, and transportation and will likely lead to a future default. As such, we're delaying the problem instead of creating a permanent fix.

Second Liens Issue

The major impediment to the viability of the program is the servicing conflicts that exist when servicers hold second lien mortgages. There is significant uncertainty as to how those second liens will be handled under the program. Traditionally, there is no such uncertainty because first lien mortgage holders had a clear understanding of their priority status over second liens. The second lien problem exists because many banks and their affiliated servicers offered additional forms of financing to consumers, such as home equity loans and other second mortgages. The vast majority remain on the balance sheets of our nation's largest financial institutions and these second mortgages are a major financial burden for homeowners.

In fact, the four banks that service approximately 40 percent of mortgages held roughly $419 billion of second liens on their balance sheets as of December 31, 2009. Under temporary loan modification programs such as Making Home Affordable, banks are able to defer the recognition of losses on the second lien portfolios. In fact, the current HAMP program actually improves the cash flow available to the second mortgage at the expense of the first mortgage and defers the immediate loss that would be recognized in a foreclosure, short sale or short refinance. Although the largest institutions have now signed up for the 2MP second lien modification program under HAMP, that one year old program has yet to be implemented.

In these negative equity scenarios, the second lien would receive no proceeds in a foreclosure action. On the other hand, the modification program allows this uncollateralized obligation to remain outstanding and on the books of the financial institution as a performing asset, even though the homeowner has no equity in their home. Our analysis of 44.1 million first lien loans from a primary credit bureau database indicated that, of all second lien mortgages, only 3 percent are current with a corresponding first lien mortgage that is delinquent.

Investors' Solutions to Foreclosure Crisis

Mortgage investors believe that any successful solution to the housing crisis must address two key components: affordability and negative equity.

Negative equity and near negative equity mortgages account for nearly 28 percent of all residential properties nationwide. There are approximately 15 million borrowers who owe more than their homes are worth. About a third of those mortgages are already in default and potentially in need of assistance.

The nation's foreclosure crisis must be solved by addressing both the problems of "<u>ability to pay</u>" and "<u>willingness to pay</u>". The interests of homeowners and mortgage investors are completely aligned. A homeowner who cannot afford his mortgage AND who owes more than his home is worth runs a very serious risk of losing the home through foreclosure. Furthermore, there is serious risk that even a homeowner who is current on their mortgage payments, but owes more than the home is worth, could leave the home instead of continuing to pay what amounts to "high interest rent" on the home. In order to provide relief to both homeowners facing possible foreclosure and the entire housing market, a program must be introduced that reduces principal to provide affordability and equity to homeowners that are underwater in their mortgage and in financial distress.

To be successful, a loan modification or principal reduction program must be designed to ensure that the risk of default is minimized. The only way to effectively accomplish this is to reduce the homeowner's overall debt to ensure that their "debt to income" ratio is sustainable. This involves reducing mortgage balances on all liens on the property, first mortgage, and other subordinate liens.

Furthermore, as provided in the Administration's recently announced FHA short refinancing program, this involves a rigorous qualification process and underwriting that ensures that the homeowner has the best chance to make their payments and stay in the home.

Mortgage investors maintain that any true relief must come from significant principal forgiveness on first and second lien mortgage debt in connection with the refinancing of the overextended homeowner into a new, low interest rate mortgage. This is a position that we have communicated to key policymakers from Capitol Hill, to the Departments of Treasury and Housing and Urban Development, and with Community Housing Advocates.

The solutions offered prior to Treasury's announcement last month failed to address the entire consumer debt burden, and overlooked entirely the impact of negative equity. While a loan modification involving principal forbearance, term extension or temporary rate reduction, as provided in the original HAMP program, may provide temporary relief, by not addressing negative equity, homeowners would be trapped in a mortgage that cannot be refinanced and a house that cannot be sold. Further, for those who seek mobility to pursue new employment opportunities, they would no longer feel "trapped" by their mortgage and would be able to sell without enduring a life-altering loss on the sale.

Administration's Newest Proposal: Principal Reduction, FHA Short Refinance

The Association of Mortgage Investors supports the framework of FHA's recent announcement to reduce principal through a refinancing program for homeowners who are "underwater" on their mortgage. This program, if properly implemented, can provide relief for qualifying homeowners and contribute to the housing market's stabilization and the economy as a whole. Successful implementation cannot be presumed, because numerous details need to be determined by the Treasury and HUD/FHA that could either minimize or increase the execution risks of the entire program. We fear that these implementation logistics could easily be overlooked.

As we have noted in our proposals for principal reduction over the last year, any market solution must involve all market participants. Everyone must share the burden. Solutions cannot be a windfall for certain stakeholders and terrible for others. In this regard, the Association agrees that taxpayer funds should not be used for principal writedowns.

In essence, the most recent Administration FHA refinancing proposal has focused on three primary principles:

- First, the qualifying homeowner must be eligible for a HAMP modification and have a mortgage that is "underwater" (where the combined loan-to-value ratio is greater than 100 percent).
- Second, the mortgage investor would agree to permanently reduce (forgive) principal necessary to get the homeowner's mortgage to a 97.75 percent loan to value (LTV) ratio, therefore "restoring equity" at the same time the borrower is refinanced into a new agency-compliant fixed rate mortgage with an agency-compliant monthly payment. Furthermore, if the property has a second lien, the combined debt of the first and second liens cannot exceed 115 percent of loan to value ratio and also cannot exceed 31 percent of the homeowner's debt to income ratio.
- Third, this is a voluntary program.

Mortgage investors have been willing to realize significant losses in existing RMBS investments to facilitate the refinancing of borrowers from distressed mortgages into newly originated fixed rate mortgages based on the current value of the property. In this proposal, the cost of reducing principal on primary mortgages held by investors would be borne by the investor.

Obstacles to Success of New Administration Proposals

The Administration's proposal is overly vague on how second and other subordinate liens will be treated under the program. For example, it is not clear whether the mortgage servicer can approve a reduction in the homeowner's first lien only to have the holder of the second lien, which is typically the parent company of the mortgage servicer, opt out of the program and thereby avoid any principal reduction.

The problem with that scenario is threefold:

- First, it will ultimately hurt the homeowner, because their total debt to income will still be excessive and the risk of default will remain clear.
- Second, it completely ignores the priority of liens and enriches the bank's second lien position at the expense of the senior first lien positions which are held by investors who represent pension funds and foundations. This situation is negative for the mortgage marketplace now and in the future because investors will be reluctant to invest in mortgages with uncertain rules that create additional risk. This risk will ultimately result in increased borrowing costs for future homebuyers.

- Third, despite the concept of FHA's refinance program having maximum benefit to homeowners and investors, we fear servicers will not implement this new program and will instead choose a modification that benefits their own interests and leaves the homeowner in a distressed financial position, likely to default in the future.

It is very difficult to see how the inherent conflicts that exist within largest financial institutions are adequately managed given their role as both servicer of the majority of investor owned mortgages and holder of the majority of second liens.

The experiences in the HAMP program suggest that management of these conflicts is inadequate. We are concerned that second lien holders will balk at participating in the new principal reduction programs, as evidenced from their reluctance to sign up and then implement the 2MP program or other obstructive aspects of the current HAMP program. These same tactics would lead to program failure.

One of the best ways to deal with moral hazard is to ensure that the homeowner actually qualifies for the new mortgage and has a greater opportunity of staying current on the new mortgage. By engaging in an FHA refinancing, the homeowner will have to qualify for the new mortgage. This involves income verification and dealing with excessive debt issues.

If policy makers believe that more needs to be done to deal with a "moral hazard" issue, mortgage investors would be happy to be a part of such dialogue.

Conclusion

Mortgage investors believe that the Administration's newly announced program for principal reduction leading to an FHA refinancing program is an important step forward. However, with the current lack of detail, investors are extremely worried that there are significant execution risks to the program that are similar to some of the experiences that we have seen in the current HAMP program. This program will need clear instruction to servicers that participation of both first and second liens in the principal reduction/refinancing program is necessary and must take priority over other options that are in the servicer's self interest, but harmful to homeowners and investors. Anything short of participation by both first and second lien holders will surely prevent the program from meeting its goals. If second or other subordinate liens are not active participants in a principal reduction program, the homeowner will remain saddled with excessive debt. Furthermore, by not respecting the priority of liens, rebuilding the mortgage market in the future will only be more difficult.

Thank you for the opportunity to share my views and those of the Association of Mortgage Investors with the subcommittee.

I welcome any questions that you might have.