

Testimony of Martin S. Hughes

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Before the

United States House of Representatives

Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on

Facilitating Continued Demand in the U.S. Mortgage Market Without a Government Guarantee

September 7, 2011 – New York, NY



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Introduction

Good Morning, Chairman Garrett, Vice Chairman Schweikert, Ranking Member Waters, and Members of the Committee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange that invests in mortgage credit risk. I appreciate the opportunity to testify on facilitating continued demand in the U.S. mortgage market without a government guarantee and look forward to responding to your questions.

Overview

My testimony is focused on restoring a fully functioning private-sector residential mortgage finance market. Currently, about 90% of all new mortgage originations rely on government support.¹ Given the fact that there is \$9.6 trillion of outstanding first lien mortgage debt,² this level of public subsidization is simply not sustainable. Obviously the Committee understands this and I commend you for devoting the time and energy toward enacting appropriate reforms to draw private capital back into the mortgage market.

The main sources of private-sector capital that previously financed residential mortgages include banks, mutual funds, pension funds, and insurance companies. For the non-banks, the transmission mechanism for providing this financing was through their investments in triple-A rated residential mortgage-backed securities (RMBS). My testimony will recommend how to bring these “triple-A investors” back to this securitization market, thereby enabling the government to reduce its role in the mortgage market, and with the confidence that every creditworthy borrower will still be able to get a mortgage loan on reasonable terms.

¹ 2011 Mortgage Market Statistical Annual, Volume I, page 19

² Federal Reserve Flow of Funds of the United States, Fourth Quarter, Tables L.217 and L.218

Background on Redwood Trust

Redwood Trust commenced operations in 1994 as an investor in residential mortgage credit risk. We are not a direct lender or mortgage servicer. Our primary focus has been on the prime jumbo mortgage market, or that portion of the mortgage market where the loan balances exceed the limits imposed by Fannie Mae and Freddie Mac (the "GSEs") for participation in their programs. Similar to the GSEs, Redwood also provides credit enhancement, but our focus is on the prime jumbo mortgage market. We provide credit enhancement by investing in the subordinate securities of private residential mortgage securitizations, which enables the senior securities to obtain triple-A ratings. We have invested in subordinate securities created by others' securitizations as well as subordinate securities created by our own securitizations. (From 1997 through 2007, Redwood securitized over \$35 billion of mortgage loans through 52 securitizations and invested nearly \$300 million in those securitizations.)

Recent Securitization Activity

In April 2010, Redwood Trust was the first company, and is so far the only company, to sponsor a securitization of newly originated residential mortgage loans without any government support since the market froze in 2008. The size of that first transaction was \$238 million. In March 2011, we completed a second securitization of \$295 million, and we anticipate that we will complete two more securitizations this year.

Completing these transactions required that we address the concerns and interests of triple-A investors who, in the wake of the financial crisis, had lost confidence that their rights and interests would be respected and, consequently, that their investments would be safe and secure. We worked hard to regain their trust by putting together transactions that included even more comprehensive disclosure, better structure, and a new enforcement mechanism for representation and warranty breaches. In

addition, Redwood Trust retained meaningful exposure to the transaction's future performance — i.e., through risk retention or “skin-in-the-game” — and, in doing so, aligned our interests with those of investors. Investors responded with significant demand to acquire the triple-A rated securities, as evidenced by the fact that the first offering of those securities was oversubscribed by a factor of six to one. The second securitization was also quickly and fully subscribed.

To be clear, Redwood Trust has a financial interest in the return of private sector securitization for residential mortgages. We hoped that our decision to securitize loans in 2010 would demonstrate to policymakers that private capital would support well-structured securitizations that also have a proper alignment of interests between the sponsor and the triple-A investors. Based in part on the success of our two recent mortgage securitizations and on-going discussions with triple-A investors, we have confidence that the private market will continue to invest in safe, well-structured, prime securitizations that are backed by “good” mortgage loans. We consider “good” loans to be loans on properties where the borrowers have made real down payments, demonstrated an ability to repay, and have a good credit rating. We are proud of our history of sponsoring residential mortgage securitizations and of our more recent role in helping to restart the private securitization market, and we are pleased to have the opportunity to share our insights and observations with the Committee.

The Outlook for Private Mortgage Securitization in 2011

The outlook for nongovernment or private residential mortgage securitizations backed by newly originated mortgage loans (“new securitizations”) in 2011 remains very weak by historical standards. Year-to-date through August 31, 2011, only one securitization of newly originated mortgage loans totaling \$295 million has been completed, and that was our deal. There are no good industry estimates of new private securitization volume in 2011, as the market is still thawing from its deep freeze. While

we would welcome other securitizations in 2011 to provide additional third-party validation of the viability of securitization, the yearly volume will be a small fraction of the \$180 billion average annual volume from 2002 through 2007.³

IMPORTANT MARKET OBSERVATIONS

The Primary or Origination Half of the Private Market is Functioning

Contrary to the claims of some policymakers and market observers, half of the private residential market is functioning and originating nongovernment-guaranteed mortgages. According to Inside Mortgage Finance, the top ten jumbo mortgage lenders originated \$25 billion in the first quarter of 2011 and originated \$30 billion in the fourth quarter of 2010. Clearly, the nongovernment guaranteed origination segment of the private market is functioning well.

Some commentators contend that nongovernment guaranteed mortgage rates are so high that a substantial number of potential homeowners are priced out of buying a house. We believe this argument is without merit. There is a small rate difference (currently approximately 0.625%) between a conforming and a private jumbo mortgage loan, which can be verified by reviewing the rate sheet from any private market mortgage conduit buyer.⁴ This premium is slightly higher than the loans in our last securitization in March 2011 (SEMT 2011-1) in which the mortgage rates on the underlying collateral averaged just under 0.50% higher than the conforming rate over the time period those loans were originated.

³ 2011 Mortgage Market Statistical Annual, Volume II, page 31.

⁴ On 9/1/11, the private jumbo mortgage rate quoted by GMAC was 4.75%, compared to an agency conforming loan at 4.125%. The current 0.625% premium is slightly higher than the recent past due to spread widening across most risk assets due to the increased level of stress in the financial markets.

Beyond the issue of rate, let's look at who the higher loan limits are benefiting and consider whether those borrowers truly need a government subsidy. Consider the example of a \$729,750 mortgage, amortized over 30 years at a fixed rate of 4.25%. (Assuming a 20% down payment, this mortgage will support the purchase of a house at a cost of \$912,187.) The monthly mortgage payment on this loan is \$3,590 compared to \$3,807 if the rate is increased to 4.75%, a monthly payment increase of \$217. While \$217 may be too much to overcome for a borrower at the median income level, the borrower who can qualify for the \$3,590 payment would need to have a gross monthly income of at least \$12,821⁵ (or \$153,857 annually). An income of this amount is three times the real median household income.⁶ Not all borrowers who qualify for the mortgage at 4.25% will be able to qualify at 4.75%. For example, the borrower who just qualifies for an 80% loan-to-value loan on a \$912,187 house at 4.25% will still be able to qualify for an 80% loan on a slightly less expensive home priced at \$860,255 at a mortgage rate of 4.75%. Importantly, we should ask whether taxpayers should be subsidizing the ability of higher income borrowers to buy a more expensive house, given the nation's debt crisis.

The Secondary Market Half of the Private Market is not Working

The segment of the private market that is not functioning well is the private securitization market. There are three reasons. First, there is currently no financial incentive for bank originators, who have historically been the dominate mortgage securitization sponsors, to securitize mortgage loans. According to the Federal Reserve's latest H.3 report, excess reserves (deposits that could otherwise be loaned to borrowers) in the banking system total \$1.6 trillion, a truly staggering number, and those reserves are earning a rate of 0.25% per annum. The excessive reserves and the low interest rate

⁵ A mortgage borrower's monthly mortgage payment cannot exceed 28% of gross monthly income per the underwriting standards of Fannie Mae and Freddie Mac.

⁶ U.S. Census Bureau, Income, Poverty, and Health Insurance Coverage in the United States: 2009, page 7.

environment have reduced the cost of funds for the largest 50 banks to an average of 0.81% in the second quarter of 2011.⁷ Banks have a strong financial incentive to hold loans that cannot be sold to Fannie Mae or Freddie Mac in their portfolios to earn the spread between the mortgage yields (currently about 4.75% for jumbo loans) and their low cost of funds.

The second reason is that the government is crowding out the private market through loan programs that make 90% of borrowers eligible for a below-market-rate government guaranteed mortgage loan. Private capital simply cannot compete with government subsidized mortgage programs.

Third, there is a need to resolve several key regulatory and market issues, including reform of underwriting and servicing standards, greater investor protections, and addressing the second mortgage problem. The current lack of a financial incentive for banks to securitize RMBS will self correct over time with an improving economy, but it is critical that regulators and industry practitioners address structural issues so that there will be a functioning private RMBS market. Without a functioning private market, there can be no material GSE reform that restarts the mortgage market without a government guarantee.

It's Not That Hard to Fix the Mortgage Market

The mortgage market worked very well for many years, and the private market share averaged over 50% from 1985 through 2007.⁸ Over much of that period, annual losses were very low and averaged about 10 to 15 basis points per annum. Loan modifications (or the need for them) were virtually unheard of. In summary, the mortgage market worked well.

⁷ SNL DataSource

⁸ The government share was calculated by dividing the annual securitization volume of Fannie Mae, Freddie Mac, and Ginnie Mae by the industry origination volume, based on data obtained from 2011 Mortgage Market Statistical Annual, Volume I, page 19.

So what changed to cause the mass destruction of so much of the financial wealth of borrowers and the financial markets? The real answer could take well over 600 pages as noted by the report of the Financial Crisis Inquiry Commission and the dissents, but our view is that the main culprit was a serious decline in mortgage underwriting standards. When combined with declining standards and requirements in virtually every other aspect of the origination-to-securitization chain, destruction resulted.

Fixing the mortgage market is not complicated if the problem is broken down to its components, mainly making a distinction between the prime market, which represents about 90% of the mortgage market, and the non-prime segment, which represents the rest of the market. Reforms needed to restore basic functioning of the prime mortgage market are different in nature from the reforms needed to prevent future abuses in the subprime market. A new regulation designed to accomplish one objective can easily do great harm to fulfillment of the other objective, if applied to both. We see that happening with much of the Dodd-Frank rulemaking.

We strongly believe that if the policymakers would focus first on restoring the prime mortgage market, resolution would be much faster and benefit the largest section of the market. The complexities related to risk retention, premium capture, qualified mortgages, and conflicts of interest are largely related to the subprime market, not the prime market.

MAJOR STRUCTURAL HURDLES TO RE-STARTING THE PRIVATE RMBS MARKET

1) The Government is Crowding Out the Private Sector

The government must begin to reduce its participation in the mortgage market, and allowing the temporary increase in the conforming loan limits to expire at the end of September 2011 would be a good first step. Through the GSEs and the Federal Housing Administration (FHA), the government has stepped in and taken the credit risk on about 90% of the mortgages originated in the U.S., without passing on the full cost of the risk assumed. Government subsidies must be scaled back to permit a private market to flourish. We note that post-crisis, the private asset-backed securities markets for auto loans, credit cards loans, and now commercial real estate loans are up and functioning, while the private RMBS market barely has a pulse. The difference is the pervasive below-market government financing in the residential mortgage sector that is crowding out traditional private market players.

Critics will argue that Redwood Trust's transactions were backed by unusually high quality jumbo mortgage loans and are therefore not representative of the market. In fact, that argument proves the point that the government is crowding out private securitizations, by maintaining an abnormally high conforming loan limit and by subsidizing the guarantee fees that the GSEs charge issuers. No private sector securitizer can compete with that – we can only securitize the small volume of prime quality loans beyond the government's reach. We are ready to purchase and securitize prime mortgage loans of any loan amount, and can do so at an affordable rate once the government creates a level playing field.

We strongly advocate testing, on a safe and measured basis, the private market's ability to replace government-dependent mortgage financing. The reduction in the conforming loan limit in high cost

areas from \$729,750 to \$625,500 represents about 2% of total annual industry originations⁹, which we view as a small measured step. As noted above, there is ample liquidity and origination capacity in the banking system to allow banks to step into this small breach, while financing through private residential mortgage securitization regains its footing.¹⁰

The private mortgage market has already begun to demonstrate a capacity to meet the challenge. With the conforming loan rate scheduled to adjust in less than 30 days, a smooth transition is currently underway. Originators have implemented strict policies for closing loans at the higher limit by a date certain, in some cases by September 15. This allows a proper cushion of time to ensure new conforming loans get funded and sold as planned. In addition, secondary market buyers of jumbo loans, including Redwood Trust, are issuing rate sheets to originators for the purchase of jumbo loans above the new loan limit.

The market is successfully preparing to step in and fill the void, or opportunity, created by the lower loan limit. This is the kind of incremental step the government should take, in conjunction with the right supportive reforms, to permit the private market to develop.

Additionally, the Administration should follow through on its plan to increase guarantee fees to market levels over time to eventually level the field between the private market and the GSEs. A gradual

⁹Federal Housing Finance Administration's Mortgage Market Note 11-01, page 4, Fannie Mae and Freddie Mac originated "just over \$30 billion" of conforming jumbo loans in 2010, compared to \$1.57 trillion of total industry originations.

¹⁰ Excluding Bank of America's \$4.1 billion of jumbo mortgage production in the first quarter of 2011, the remaining three major banks (Wells Fargo, Chase, Citi) funded \$10.3 billion of jumbo loans, which annualized to \$41 billion exceeds the \$30 billion of conforming jumbo loans purchased by Fannie Mae and Freddie Mac in 2010. On 8/31/11, Bank of American announced it was going to exit the correspondent lending channel, which may reduce its jumbo origination volume. However, not all of the bank's jumbo loan volume was originated through its correspondent channel.

government withdrawal from the mortgage market over a five-year period will enable time for a safe, attractive, robust private market to develop.

As the housing market begins to recover, we support further measured reductions on a periodic basis in the conforming loan limit as a means of continuing to diminish the role of the government in this market and reduce the related risk to taxpayers, and as a result increase the share of the mortgage market available to the private sector. We note that with housing prices now down in excess of 30% from their peak in mid-2006¹¹, it would seem logical to consider reducing the conforming loan limit by a similar amount over time.

2) No financial urgency to challenge the status quo

We note that keeping the status quo (high conforming loan limits and government involvement in the mortgage market) effectively prevents the creation of any sense of urgency to restore private securitization, especially by traditional bank securitization sponsors. These major banks benefit by selling 90% of their mortgage originations into a very attractive government bid, and they have ample balance sheet capacity to easily portfolio the remaining jumbo loans and earn an attractive spread income. There is simply no financial incentive at this juncture for banks to sell loans through a non-agency securitization.

During the onset of the financial crisis, it was essential for the government to increase its support of the mortgage market. Today, that crisis level of support and the on-going burden on taxpayers to support 90% of a \$10 trillion market is simply untenable. We strongly advocate that the time has come to more

¹¹ S&P/Case-Shiller Home Price Index press release dated April 26, 2011.

broadly demonstrate the private market's ability to replace government-dependent mortgage financing, and do so on a safe and measured basis to prevent negative consequences to the housing market.

3) Regulatory

In the wake of the Dodd Frank Act, there are many new regulatory requirements and market standards out for comment that are not yet finalized. The resulting uncertainty keeps many market participants out of the market. Once the rules of the road are known, market participants can begin to adjust their policies, practices, and operations.

A) Dodd-Frank Act Implementation Overview

We recognize joint regulators had a very difficult task in establishing, writing, and implementing the new rules as required by the Dodd-Frank Act. Before noting some specific concerns, we would like to offer some high level observations on the joint regulators' notice of proposed rulemaking on risk retention (NPR).

The NPR as written has some technical definitional and mechanical issues that need to be fixed, first and foremost among them, how the premium capture account works. This issue has been the source of much debate by market participants. We are hopeful that appropriate corrections will be made after all comment letters are reviewed.

We also note that regulators took a well intentioned approach to crafting a new set of risk retention rules to cover the entire mortgage securitization market – i.e., both the prime and subprime markets. In theory, this comprehensive approach should be a more expedient method for restarting securitization.

However, there are complex differences between the prime and subprime markets and their unique securitization structures that make it very difficult to apply a one-size-fits-all set of new rules.

The details are too complex for this testimony, but to over-simplify, the proposed rules are effectively subprime-centric. While the rules do a good job of addressing and deterring abuses relating to subprime securitization structures, they are overly and unnecessarily harsh when applied to prime securitization structures. This is meaningful since prime loans are approximately 90% of the overall market. If the proposed rules are adopted as written, prime borrowers (whose loans are financed through private securitization) will face unnecessarily higher mortgage rates.

In Redwood Trust's comment letter to the NPR, we proposed a more tailored approach that would keep intact the necessary safety protections, but eliminate the unnecessary structural inefficiencies that would lead to higher prime mortgage rates.

We believe that focusing first on restoring the prime segment of the market in a safe yet efficient manner would bring the greatest benefit to the largest number of stakeholders (borrowers, lenders, investors, and taxpayers) and would be more effective and productive than attempting to craft one all-encompassing regulatory solution that is likely to be challenging to implement given the complexities of the non-prime segment of the market.

B) Form of Risk Retention

We are strong advocates of requiring securitization sponsors to retain risk in order to properly align their interests with those of investors. We support the intent of the joint regulators' NPR on this issue.

In fact, it has always been Redwood Trust's operating model to retain the first-loss risk in our securitizations.

The NPR proposes four forms of risk retention: 1) a horizontal slice consisting of the most subordinate class or classes; 2) a vertical slice with pro-rata exposure to each class; 3) a combination of horizontal and vertical slices; and 4) a randomly selected sample of loans.

Redwood Trust believes the most effective form of risk retention is the horizontal slice and that other forms are much less effective. The horizontal slice requires the sponsor to retain all of the first-loss securities and places the sponsor's entire investment at risk. Only that approach will provide the required incentive for a sponsor to ensure that the senior securities are backed by safe and sound loans, which will benefit borrowers as well as investors.

The other forms of risk retention result in substantially less of the sponsor's investment in the first risk position, which reduces the incentive to sponsor quality securitizations. Over time, we believe investors will vote on the best form of risk retention and reward sponsors that retain horizontal "skin-in-the-game."

C) Qualified Residential Mortgages

We support the intention of the proposed definition of a qualified residential mortgage (QRM), but we believe it is a bit too restrictive. We support the concept of "common sense" underwriting, similar to the standards used by the GSEs for so many years prior to the period leading up to the credit bubble. These standards resulted in low credit losses for many years.

D) Servicer Functions and Responsibilities

We believe that the well-publicized mortgage servicing issues are an impediment to broadly restarting private residential mortgage securitization. Beyond the issue of lost documents and foreclosure practices, servicers have been on the front lines throughout the recent crisis. Focusing more narrowly on their role in the securitization structure, they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting direction. In their role, they are required to operate in the best interest of the securitization and not in the interest of any particular bond holder. In practice, without any clear guidance or requirements, they invariably anger one party or another when there are disagreements over what is and is not allowed – with the result of discouraging some triple-A investors from further investment in RMBS. We propose that uniform standards governing servicer responsibilities and conflicts of interest be established and that a credit risk manager be established to monitor servicer performance and actions. We have discussed this servicing issue in greater detail and have offered recommendations in our Guide to Restoring Private-Sector Residential Mortgage Securitization, which is available on our website.

4) Investor Protection

It is critical that policymakers understand the role of investors in the private mortgage market. Simply put, investors have the money, and there will be no material reduction in the government's role in the mortgage market without investors agreeing to increase their participation. Investors want a fair return on their investment; to have information about what they are investing in through access to increased data on the underlying collateral; simpler securitization structures; to know if there are any potential conflicts of interest with and among the originator, servicer, and sponsor; an alignment of interests with the sponsor; and confidence that their rights will be respected under contract law. Investors must have confidence that they will be protected from losses on the underlying collateral through improved

originator representations and warranties on the collateral sold to the securitization trust and that there is an effective enforcement mechanism (such as the mandatory binding arbitration that we used in our last two securitizations). We propose the establishment of national uniform standards for servicers' rules and responsibilities, along with benchmarks that allow for the removal of the servicer for poor performance.

5) Second Mortgages

If we really want to restore a safe securitization market, we also need to address second mortgages. One of the significant factors that contributed to the mortgage and housing crisis was the easy availability of home equity loans. Plain and simple, the more equity a borrower has in his or her home, the more likely that borrower will continue to make mortgage payments. Home equity loans often result in the borrower having little or no equity in their homes.

Although the proposed QRM standard will encourage lenders to originate loans to borrowers who have a minimum 20% down payment, there is no prohibition against the borrower immediately obtaining a second mortgage to borrow back the full amount of that down payment. The addition of a second mortgage that substantially erodes the borrower's equity and / or substantially increases a borrower's monthly debt payments increases the likelihood of default on the first mortgage. Many of the current regulatory reform efforts are centered on creating an alignment of interests between sponsors and investors through risk retention or "skin-in-the-game." However, the first and most important line of defense is at the borrower level. If the borrower can take his or her own "skin" out of the game through a second mortgage, what have we really accomplished? The answer is very little. We believe any failure to address borrower skin-in-the-game will be very discouraging not only to private RMBS investors, but all mortgage investors including FDIC-insured institutions.

To prevent the layering of additional leverage and risk, it is common in other forms of secured lending (including commercial and corporate lending) to require either the consent of the first mortgage holder to any additional leverage or to limit the new borrowing based on a prescribed formula approved by the first mortgage holder. We recommend extending this concept to residential mortgages.

Specifically, we recommend enactment of a Federal law that would prohibit any second mortgage on a residential property, unless the first mortgage holder gives its consent. Alternatively, a second mortgage could be subject to a formula whereby the new combined loan-to-value (based on a new appraisal) does not exceed 80%.

Conclusion


Looking ahead to the long-term future of housing finance, I see a number of positives emerging: safer mortgages that borrowers can afford, the return of loan loss rates to historically low norms for newly originated prime loans, and private capital willing to fund residential mortgages at affordable rates for borrowers through responsible, safe securitization. The first step is to give the private sector a chance by following through on the Administration's plan to reduce the conforming loan limits and increase the GSE's guarantee fees to market rates at a safe and measured pace.

Thank you for the opportunity to testify before the Committee today. I would be happy to answer your questions.

**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:
Martin S. Hughes	Redwood Trust, Inc.
3. Business Address and telephone number:	
4. Have <u>you</u> 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 <u>organizations you are representing</u> 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?
<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> 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.