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SUBPRIME MORTGAGE MARKET TURMOIL: EXAMINING THE ROLE OF SECURITIZATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES AND INSURANCE AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON HOW SUBPRIME MORTGAGES ARE SECURITIZED; THE EFFECT OF RECENT INCREASES IN DEFAULTS AND DELINQUENCIES ON THE SUBPRIME SECURITIZATION MARKET FOR BOTH BORROWERS AND INVESTORS; AND HOW CREDIT RISK FOR MORTGAGE-BACKED SECURITIES IS DETERMINED AND HOW THE ASSIGNED RATINGS ARE MONITORED

TUESDAY, APRIL 17, 2007

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C O N T E N T S

TUESDAY, APRIL 17, 2007

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U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 3 p.m., in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. I call the hearing of the Subcommittee to order, and I want to thank Senator Allard, the Ranking Member, for joining me. I want to thank our witnesses for being here today. Senator Menendez has joined us, too.

Our hearing this afternoon builds on the record begun last fall by Senators Allard and Bunning when the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy first began to look to these issues.

In recent months, there has been a dramatic increase in home loan delinquencies and foreclosures, the closure or sale of over 40 subprime lenders, and an increase in buybacks of delinquent loans. While the subprime market has experienced most of the turbulence, there are now signs of weakness in the Alt-A market.

This is a complicated issue. Chairman Dodd and Senator Shelby have held a number of hearings where we have heard from brokers, originators, regulators, and borrowers regarding the causes and consequences of the current mortgage market turmoil. However, we are here today to look at the financial engine which helps drive this market: the securitization process.

Clearly, there are many benefits from securitization. Securitization creates liquidity, enables lenders to originate a greater volume of loans by drawing on a wide source of available capital, spreads risk, and allows investors to select their risk level of pattern of returns. When securitization works well, it bridges the gap between borrowers and investors and makes homeownership more affordable.

However, what happens when it does not work as well as it should? Does the complex structure of mortgage-backed securities and the servicer's duty to act on behalf of different investors limit the servicer's ability to provide loan workout options for the borrower? Also, is it possible that securitization can create perverse incentives, such as an erosion of underwriting standards or the development of exotic loan products that do more harm than good?

Lewis Ranieri, the pioneer of mortgage-backed securities, recently stated that he believes standards are largely set by the risk appetites of thousands of hedge fund, pension fund, and other money managers around the world. Emboldened by good return on mortgage investments, they have encouraged lenders to experiment with a profusion of loans. As many credit-stressed borrowers still face resets on some of these experimental loan products, the Center for Responsible Lending has estimated that one in five subprime loans originated during the prior 2 years will end in foreclosure, costing homeowners $164 billion, mostly in lost equity.

Last, there is some cause for concern on the investor front. Again, Lewis Ranieri stated last year, "When you start divorcing the creator of the risk from the ultimate holder of the risk, it becomes an issue of, Does the ultimate holder truly understand the nature of the risk that you have redistributed? By cutting it up in so many ways and complicating it by so many levels, do you still have clarity on the nature of the underlying risk? It is not clear that we have not gone in some ways too far, that we have not gone beyond the ability to have true transparency. That is a fair question that many of us in the business and people in the regulatory regime are wrestling with."

A related issue on this front is the steadily increased loss expectations for pools of subprime loans. According to a recent Moody's report, loss expectations have risen by about 30 percent over the last 3 years. Loss expectations ranged from an average of 4 to 4.5 percent in 2003 to an average of 5.5 to 6 percent today.

I am also concerned about possible downgrades of these securities that could affect pension plans and other large institutional investors and whether there could be a systemic effect down the road. As such, the purpose of our hearing this afternoon is twofold:

First, we want to examine how subprime mortgages are securitized, how credit risk for mortgage-backed securities is determined and monitored, and what effect the recent increase in defaults and foreclosures has had on the subprime securitization market.

Second, we want to learn what role, if any, the securitization process has played in the current subprime market turmoil and what issues Wall Street and Congress should consider as we move forward.

We will hear from one panel of witnesses, but before I introduce them, I want to recognize Senator Allard and other Members of the Committee who are with us today for their statements. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. First, I would like to congratulate my friend from Rhode Island on his first hearing as Chairman of the Subcommittee on Securities, Insurance, and Investment.

Over the years, I have had the privilege of working with Senator Reed in a number of different capacities, always valued our partnership and our ability to work together. We worked together on the Strategic Subcommittee on Armed Services at the time I was

Chairman, and then over here on Housing and Transportation we worked together, and now I have an opportunity to continue to work with him on Securities. And I am looking forward to continuing our working relationship. He has always had a thoughtful approach, and I have enjoyed working with him in that regard.

Today we are here, well aware of the difficulties in the mortgage markets. The effects have been dramatic and widespread. Individual families, neighborhoods, and entire communities suffer when foreclosure rates rise. That is the unfortunate reality for far too many.

Last year, Senator Reed and I had an opportunity to examine the matter from several different angles, including examining the role of nontraditional mortgage products. Under the leadership of Senator Dodd and Senator Shelby, the full Committee has also provided opportunities to delve into the mortgage markets.

Lately, we have even seen the uncertainties in the mortgage markets spill over into the broader financial markets, and this is concerning and certainly worthy, I think, of careful review. Yet in taking account of the mortgage and financial markets, there is still one significant component that we have not yet examined, and that is the secondary market.

As we transition from the Housing Subcommittee to the Securities Subcommittee, Chairman Reed has chosen an especially appropriate topic: the role of securitization in the subprime mortgage market. Today's hearing will allow us to build on our previous record in a new area of jurisdiction. I will be interested in hearing about how securitization has expanded homeownership opportunities, but also the accompanying policy concerns. As noted by FDIC Chairman Sheila Blair, there is no doubt that securitization has had an impact on looser underwriting standards as we have seen by lenders. I will be interested in hearing about the other ways in which the dispersion of risk has affected the subprime mortgage markets.

Once again I would like to thank Chairman Reed for convening this important hearing. We have an excellent line-up of witnesses, and I am confident that they will help us understand the role of securitization in the subprime mortgage markets, which will give us a much fuller and richer understanding of the markets. I look forward to your testimony.

Chairman REED. Thank you very much, Senator Allard.

Senator Menendez, do you have an opening remark?

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman. I, too, want to commend you on having this as your first hearing on an incredibly important issue, and also I appreciate Senator Allard and his work.

As we proceed with the hearing, I think it is important to remember what this is ultimately all about, and that is, the American dream of owning a home. In the last full Banking Committee hearing, we heard from individuals who became victims to deceptive predatory lenders, and I told of a story, one of many in my own State in New Jersey, of a woman who could not make the payments on her home after the teaser rate expired, and she is still facing foreclosure action today.

It seems to me that in the face of the tsunami of foreclosures we are facing, we must not lose sight of our objective and work toward a solution that protects the homeowners. I do not think anyone can argue against the notion that we are in an increasing subprime crisis. Over 40 subprime lenders have halted operations or filed for bankruptcy. We now have the highest delinquency rate in 4 years. As many as one in five recent subprime mortgages will end in foreclosure, and 2.2 million subprime borrowers have had their homes foreclosed or are facing foreclosure. That to me is simply unacceptable.

So as we move forward today on one of the different dimensions of this issue, Mr. Chairman, I hope we remember this is not just numbers. They are a single mother struggling to make ends meet, an elderly couple facing the depletion of their life savings, or a minority family crushed with the reality that they may lose their first home. It is a financial nightmare for families across America, and I fear it is only going to get worse.

Last, I think it is time for all parties to take responsibility, to change behavior in order to prevent particularly in the context of predatory loans. In the Banking hearing last month, after some of my questions, regulators were forced to stand up and say that they did too little too late. And today I hope we will hear from those who are involved in the overall chain of this process to take some responsibility for their part in how we move forward and how we can improve the securitization process. As long as it appears that there is an overzealous secondary market for these loans, they will continue to flourish without checks and balances. And so we certainly want to see the secondary market continue to exist, but we also, I believe, need to make sure that there are some appropriate checks and balances at the end of the day in order to ensure that we do not have the animal instincts of the marketplace take over, as it seems to have today.

So I look forward to the testimony and to working with you, Mr. Chairman.

Chairman REED. Thank you, Senator Menendez.

Senator Crapo, do you have a statement?

OPENING STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Yes, just very briefly, Mr. Chairman. I also applaud you for holding this hearing. I think it incumbent on all of us to understand much better the role of securitization in the mortgage market, not just the subprime market. But as this moves forward, we are going to be facing the question of whether there should be a regulatory governmental response and, if so, whether that response should come from the agencies who now have authority, or whether it requires further legislative authorization in terms of statutory changes, or whether the market discipline that is already being seen is adequate.

I agree with Senator Menendez. The ultimate question here is about protecting homeowners and making sure that that part of the American dream which is homeownership is something that we assure is available to the maximum number of people in America who want to have that part of their dream. There are two sides to that.

We are now seeing the very harmful side of the collapse or the crisis that we are seeing in the subprime market, and the stories that we are seeing about the impact that has on people.

The other side of it is that there are lot of people who will not be able to get a home if there is not adequate credit available to them. And it is that balance that we have to strike.

I am going to be very interested, as we go through this hearing and other hearings, to get answers to the basic question of what type of market discipline needs to be in place, what type is in place, what is happening today, why didn't it happen in a better way, why did we face this crisis, what was not in place that should have been, and is that going to lead us to require more regulatory oversight or more statutory authorities for such oversight.

I would note that if you look at the market itself right now and the adjustments that are occurring, we have noticed that stock prices of major subprime specialists have already plummeted. Firms which could not support their representations and warrants for loans that were sold into the secondary market when asked to buy back poorly unwritten loans are closing their doors as equity is exhausted. Credit spreads on lower-rated tranches of subprime securities have widened appreciably as investors already demand greater returns on these investments. Various segments of the subprime market have already raised credit standards on their own. Federal regulators in March have issued for comment a proposed statement on subprime mortgage lending.

So things are happening in the market itself and among the regulators and here in Congress as we are evaluating in hearings such as this.

But, again, Mr. Chairman, and to the witnesses and others, I really think our focus needs to be on finding that balance. You know, the proverbial pendulum needs to be adjusted, probably. The question is: Will we adjust it too far and stop people who should have some sort of credit from being able to get that credit and being able to get a hand on that rung and start down the process of homeownership? Or will we not move it far enough and leave people exposed to credit practices that will deny them that dream and cause them economic and financial hardship that will deprive them of the dream longer than it should have happened?

So it is that balance that I hope that we are able to strike here as we proceed, Mr. Chairman. Thank you.

Chairman REED. Thank you very much, Senator Crapo.

Senator Casey, do you have opening remarks?

OPENING STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Just very briefly. Thank you, Mr. Chairman, for calling this hearing and for the witnesses who will testify and everyone else who is here. I will, with your permission, submit a written statement for the record, but just by way of reiteration of what we have heard, this is a complex and technical area. But like a lot of things that happen in this town, it gets back to real people and real families and their lives. And one thing that we are going to be listening carefully to are the areas of testimony and the areas of questioning which involve incentives. What kinds of incentives do brokers have and firms have that create problems for real people and real families who have real-live budgets? And sometimes they are left out in the cold on their own because of the way some of these deals go down.

So I am going to be listening carefully to that, but I do want to commend the Chairman for calling this hearing, and we want to get to the statements.

Thank you very much.

Chairman REED. Thank you.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and I appreciate the opportunity to be here. I have a whole bunch of questions, but I have to be gone by 4, so I do not think we will get up to them. So I want to maybe ask a few of them in my opening statement and ask the witnesses to submit them in writing eventually, if that is OK.

But, first, let me just say I agree with my colleague from Idaho that we have to set a balance here, but I think we have to be cognizant of a few things as we do.

First, an amazing statistic which has not gotten enough attention. You know, you read some of particularly the more conservative publications, and they say, well, listen, this is great because all this subprime lending is allowing people to buy homes for the first time.

Well, that has some degree of truth, but only some. Eleven percent of the subprime mortgages issued were to first-time homebuyers. That is all—11 percent. The remainder were to two groups: one, people who had bought one home and were moving to another; but a large number are people refinancing. And at least in my experience—and this is mainly based on just people I have talked to in the field. There is no statistical basis that I have. A lot of the people who refinanced their homes were called up on the phone, they said, "Hey, do you want $50,000? I will do it for you." And their home is refinanced.

I bring up the case of a fellow I met from Ozone Park named Frank Ruggiero. He had a $350,000 mortgage. He has diabetes. He needed extra money. Some guy called him on the phone regularly and said, "I can get you $50,000, and the mortgage will be $1,500," which Ruggiero knew he could pay. He lived in Ozone Park. Of the $50,000 increase in the mortgage, he got $5,700. The mortgage broker got about $20,000 because they liked the spread on the loan between his old loan and his new loan. And the others picked up the rest. Worse, his interest rate went from $1,500 to $3,800 in a short time, and he is about to lose his home, and he did not get the help he needed to pay for his diabetes condition.

Well, something is wrong when that happens, and to just say, well, we are creating new markets for people, yes, we said that in the 1890's and maybe the 1920's, but not in the 21st century. So we have got to figure out what to do.

Just a couple of other quick points. The market itself has pretty severe discipline. Any company that has gotten involved in buying a lot of these loans, they are paying a price now—lots of them. And that discipline, sometimes even the pendulum swings a little too far. But that is how markets work.

The people who are left holding the bag are the Mr. Ruggieros, and then people who initially sold them the mortgages are gone. You know, the guy who sold Frank Ruggiero his mortgage got $20,000, and he is off into the sunset, and there is virtually no regulation over people like that. And we ought to have it, and I intend to fight for it. That is very, very important, particularly if the mortgage broker did not come from a bank. That is not to condemn all mortgage brokers. Some do a very fine and necessary job in society.

And the questions that I have relate to how we help the future Mr. Ruggieros. We all know in 2007, 2008, and maybe 2009, there are going to be more of these loans because the most extreme of the liar loans, of the ARMs that just jumped, were issued in 2005, 2006. So the chickens will come home to roost a year, 2 years, 3 years later, when the rate goes way up.

What can we do to assist them? I have called for aiding some nonprofits, for the Federal Government to actually shell out some money to the nonprofits who help people refinance the loans. We have found that a foreclosure can on average cost stakeholders up to $80,000. Foreclosure prevention may only cost $3,300.

And my questions are: If we give money to these nonprofits and others, they could be—but they are people whose job is to help the next Mr. Ruggiero refinance. My questions that I would ask the holders, particularly Mr. Sinha and Mr. Sherr, is: How much leverage do these nonprofits have in getting some of the existing stakeholders to get back in the game when it is in their interest to do so? What percentage of the securitized subprimes have clauses that prohibit or significantly limit loan modifications? I would ask the panel again, in writing, to discuss those. Is there anything the holder of the loan can do to ease the servicer's ability to prevent foreclosures by modifying the loans? And since it would be in both the servicer's and loan holder's best economic interest to prevent foreclosure, shouldn't loan servicers put a time-out on foreclosures until they can work out loan modifications consistent with what the loan holders need?

So those are some of the questions that I would like to ask, practical questions. I would ask that you folks all submit something to the Committee in writing so we can take a look, but these are aimed at preventing large numbers of foreclosures.

One final fact, Mr. Chairman. Sorry to go on a little bit here. This is not just going to affect the people who have the loans, the mortgagor side or mortgagee side, no matter how far up the chain. It is estimated that for every foreclosure within one-eighth of a mile of your home the property falls by 0.9 percent. That is an average, obviously. But in some neighborhoods, some communities, our Joint Economic Committee issued statistics that one out of every 21 homes in Detroit had foreclosure; one in 23 in Atlanta. It is going to hurt property values significantly.

So having a diminution of future foreclosures, which will get worse if we do nothing, makes sense for everybody. And I would ask all of your help in figuring out how we do that.

Thank you, Mr. Chairman.

Chairman REED. Thank you very much, Senator Schumer. And if your staff prepares those questions, we will forward them to the witnesses.

Senator SCHUMER. Thank you.

Chairman REED. Thank you very much.

We are very fortunate to have a knowledgeable and very accomplished panel. Let me introduce them, and then I will recognize Mr. Sinha to make his presentation.

We are joined by Gyan Sinha. He is the Senior Managing Director and Head of the Asset-Backed Research Group at Bear Stearns. He has been consistently one of the top-ranked analysts in Institutional Investors All-American Fixed Income Research Survey for his work in asset-backed securities, notably in prepayments, ARMs, and CDOs. Prior to joining Bear Stearns, he was a Vice President at CS First Boston in the mortgage research area, an assistant professor in the Faculty of Commerce at the University of British Columbia from 1991 to 1993.

Next to Mr. Sinha is Mr. David Sherr. Mr. Sherr is currently serving as a Managing Director and Head of the Global Securitization Products business at Lehman Brothers. Mr. Sherr first joined Lehman Brothers in 1986 and has previously served as head of mortgage trading. Additionally, he is a member of the Fixed Income Division Operating Committee.

Next to Mr. Sherr is Ms. Susan Barnes. Ms. Barnes is the Managing Director and Practice Leader of the U.S. Residential Mortgage Group, with responsibility for managing all Standard & Poor's U.S. RMBS activities, products, and analysis. Previously, as the senior analytical manager of the Residential Mortgage Group, Ms. Barnes was responsible for the development and implementation of criteria for all residential mortgage products. Prior to joining Standard & Poor's in 1993 from Citicorp Securities Markets, she worked with primary mortgage companies as well as secondary market participants.

Next to Ms. Barnes is Mr. Warren Kornfeld. Mr. Kornfeld coheads Moody's Residential Mortgage-Backed Securities Group, which is responsible for rating residential mortgage securitizations, including subprime, jumbo, Alt-A, HELOC, FHA, VA, and closed and seconds. In addition, Mr. Kornfeld is in charge of Moody's RMBS and ABS Service Ratings Group. Mr. Kornfeld has more than 20 years of experience in the securitization market. Prior to joining Moody's in 2001, Mr. Kornfeld headed up the Securitization Group at William Blair and Company. Before joining William Blair, Mr. Kornfeld was previously with the Industrial Bank of Japan, Bickford & Partners, Inc., and Trepp & Company.

Next to Mr. Kornfeld is Mr. Kurt Eggert. Mr. Eggert is a professor of law and Director of Clinical Legal Education at Chapman University Law School. He has written extensively on securitization and predatory lending issues, and previously testified before Congress on predatory lending issues. Professor Eggert is a member of the Federal Reserve Board's Consumer Advisory Council, where he chairs the Subcommittee on Consumer Credit. From 1990 until 1999, he was a senior attorney at Bet Tzedek Legal Services in Los Angeles, where he specialized in complex litigation including consumer fraud and home equity fraud.

Finally, Mr. Chris Peterson is an assistant professor of law at the University of Florida, Levin College of Law, where he teaches commercial and consumer law courses. Professor Peterson served as the judicial clerk for the United States Court of Appeals for the Tenth Circuit. He has also served as a consumer attorney responsible for consumer finance issues on behalf of the United States Public Interest Research Group. His book on the economics, history, and law governing high-cost consumer debt received the American College of Consumer Financial Services Attorneys' Outstanding Book of the Year prize for 2004.

We look forward to all of your testimony, ladies and gentlemen. Let me just say that all your statements will be in the record. Try to hold to 5 minutes. You can assume everything that you have written will be read by all of us—at least by all the staff—and that we will eagerly await your improvised comments and your insights into this very difficult problem. I must commend my colleagues for very thoughtful opening statements.

Mr. Sinha.

STATEMENT OF GYAN SINHA, SENIOR MANAGING DIRECTOR AND HEAD OF ABS AND CDO RESEARCH, BEAR STEARNS & COMPANY, INC.

Mr. SINHA. Good afternoon, Chairman Reed, Ranking Member Allard, and members of the Senate Subcommittee on Securities, Insurance, and Investment. My name is Gyan Sinha. I am a Senior Managing Director at Bear Stearns and head the division responsible for market research regarding asset-backed securities and collateralized debt obligations. In that capacity, I analyze mortgage loans and securities in the private-label market. The nonprime sector constitutes a portion of the private-label market.

I have been invited today to present testimony regarding four matters related to the mortgage securitization process and recent developments in the marketplace. I will address each of these issues in turn, beginning with an overview of the mechanics of nonprime mortgage securitization.

Nonprime borrowers maintain loans through mortgage brokers or retail lending establishments. Once a suitably large number of loans have been originated, the loans are often packaged as a portfolio and moved into securitization vehicles owned by a third party. The securitization vehicle then issues mortgage-backed securities, often referred to as "MBS." The MBS generate revenues which finance the purchase of loans by the securitization vehicle.

The decision to buy loans from originating lenders for purposes of securitization is based on a determination of whether the loss-adjusted yield that can be generated from the purchase of the asset, after paying for financing expenses in the MBS market, is commensurate with the risk of the loans. If the securitization sponsor elects to move forward with a purchase after making this determination, it will also conduct due diligence before acquiring the assets. The cashflows from the loans are then divided among debt classes. These debt classes are divided into senior, mezzanine, and subordinate, with ratings ranging from AAA to BB. Typically, any losses in the maligned loans are allocated to the lowest-rated bonds initially and then moved up the rating scale as the face amount of each class is eroded due to higher and higher losses.

The amount of MBS that can be issued is determined based on criteria established by the rating agencies. Typically, the amount of MBS that are issued is less than the par amount of the mortgage loans. This difference is referred to as overcollateralization. The claim of equity holders in the securitization is comprised of two components: the overcollateralization amount and the difference between the coupon net of servicing expenses and the weighted average cost of debt. The equity holder's cash-flow entitlement is net of any current period losses.

MBS are purchased by a wide variety of investors. For senior debt borrowers, MBS have provided a preferred alternative to other credit-risky instruments, such as corporate bonds. As a result, institutions with low funding costs, such as banks, view them with favor and have purchased many of them. In recent years, the lower-rated tranches have been bought primarily by collateralized debt obligations. CDOs in turn issue debt to finance the purchase of these bonds. There has been significant foreign investment in CDOs that further spreads market risk.

Finally, at the lower end of the capital structure, hedge funds to purchase the speculative grade and unrated equity portion of the MBS. In making purchase determinations, hedge funds tend to employ the same risk-adjusted calculus as used by the original buyer of the loans.

You have also asked about the effect of increases in defaults and delinquencies. Without doubt, the rise in defaults and delinquencies has had a significant impact recently in the nonprime securitization market. At this juncture we are witnessing a significant correction in the MBS market of nonprime loans. A number of originators have exited the industry. The risk profile of the loans being considered in the nonprime market today has generally improved as loan originators have moved to change loan-to-value limits, requiring multiple appraisals on collateral and enhanced verification of borrower income. Valuations appear to have stabilized at this juncture, albeit at lower levels, since the beginning of the year.

For those that remain in the market, significant challenges will persist. Managing the credit risk of a nonprime portfolio in an environment of stagnant or even declining real estate prices will require a different strategy than that used in the last 5 years. From an economic value perspective, it is in the interest of all parties in a securitization vehicle that the value of the maligned loans in the securitization is maximized. Accordingly, services will have strong incentives to offer loss mitigation options to borrowers that have a reasonable chance of succeeding. This is particularly true given that the alternative will be to foreclose upon and ultimately attempt to sell the property in an unfavorable housing market.

The Subcommittee has asked me to discuss impediments in the securitization process that would make it more difficult to mitigate potential foreclosures. Loan modifications present one of the most viable vehicles for mitigating foreclosures under appropriate circumstances. However, it is important to note that there is considerable variation based on tax law and contractual requirements across transactions with respect to the scope of permissible modifications.

Despite these various limitations, services are indicating various loss mitigation steps within the flexibility that they have under existing securitization agreements.

I think my time is up.

Chairman REED. If you have a minute more, you may finish.

Mr. SINHA. OK. Thank you.

The Subcommittee has also asked, finally, about credit risk assessment. I think there are two members on the panel that are better equipped from the rating agencies to deal with that. I will skip that in the interest of time.

In closing, I would like to emphasize that while the issues surrounding the recent events in the nonprime market warrant serious attention, the securitization process that has occurred for over 25 years has resulted in considerable benefits to borrowers in the broader economy. This market has allowed American homebuyers to tap into a rising global pool of savings through increased credit availability, raising overall homeownership rates in the United States. At the same time, securitization has also allowed this increase in mortgage lending to be achieved without an excessive concentration of risk. This has permitted any shocks to the system, such as the current one, to be absorbed without major disruption to the broader economy. Thus, it is important in evaluating any potential responses to the current concerns to ensure that the availability of mortgage credit is not unduly restricted and the historic benefits provided by the securitization process are not eroded.

I would be happy to answer any questions that you may have. Thank you.

Chairman REED. Thank you very much, Mr. Sinha.

Mr. Sherr, and if you could bring that microphone up close so everyone can hear.

STATEMENT OF DAVID SHERR, MANAGING DIRECTOR AND GLOBAL HEAD OF SECURITIZED PRODUCTS, LEHMAN BROTHERS, INC.

Mr. SHERR. Chairman Reed, Ranking Member Allard, and Members of the Subcommittee. I am David Sherr, Managing Director and Global Head of Securitized Products at Lehman Brothers. I appreciate the opportunity to appear before the Subcommittee today on behalf of Lehman Brothers. Lehman, an innovator in global finance, serves the financial needs of corporations, governments, and municipalities, institutional clients, and high-net-worth individuals worldwide. Lehman is pleased to share with the Subcommittee its experience in the subprime mortgage securitization process.

The subprime mortgage securitization market is a subset of the broader mortgage securitization market. Mortgage securitization was developed approximately 30 years ago. Since then, the mortgage-backed securities market has grown to become the largest fixed-income segment of the Nation's capital markets, with approximately $6.5 trillion of securitized mortgage debt outstanding as of the end of 2006.

While the Subcommittee is focused on very recent instances of foreclosure, please remember that for three decades mortgage-backed securities have provided and continue to provide great benefits to the average American. Because of mortgage securitization, loans for home purchases have become more widely available for all borrowers, including those considered subprime. If not for the innovation of the mortgage securitization, the United States would not have become the Nation of homeowners that it is today, with homeownership close to its highest level in our history, almost 70 percent.

Before securitization became widespread, banks had relatively limited capital available to make loans to prospective homeowners. Their lending activities were constrained because they had no effective means to convert their existing loan portfolios to cash that could be used to make additional loans. There was no liquid market for mortgage loans.

With the advent of securitization, banks and other financial institutions have been able to monetize their existing loan portfolios and to transfer the risks associated with those loans to sophisticated investors. As a result, more money is available to borrowers who wish to buy their own homes or to refinance their existing mortgage loans on more attractive terms.

Securitization represents a new way to fund America's demand for home mortgages by accessing the significant liquidity of the capital markets. Borrowers continue to take out loans with local banks and State-regulated mortgage companies, just as they always have. Those lenders determine if they want to retain mortgage loans or transfer them into the secondary market, either in whole loan form or through securitization. If a lender elects securitization, the loans are assembled into pools by sponsors, such as Lehman.

The lenders continue to stand behind their decision to make a loan by making representations about the loan quality. After the rating agencies have completed their review of the pool, the loans are conveyed into a securitization trust and interests in the loans are sold to investors in the form of securities. From then on, payments made by borrowers on their mortgage loans flow through to make payments on these securities.

It should be noted that sponsors of mortgage-backed securitizations such as Lehman are careful about choosing the lenders with whom they do business. All the lenders selling loans to Lehman are either federally chartered banks or State-regulated originators. Prior to establishing a business relationship with a particular lender, Lehman spends time learning about that lender, its past conduct and its lending practices and standards. Further, Lehman, like other securitization sponsors, performs a quality check on the mortgage loans before purchase them. These reviews include sample testing to confirm that loans were underwritten in accordance with designated guidelines and complied with applicable law.

The Subcommittee has asked about the incentives of the participants in the subprime mortgage securitization process. Consumers benefit because they are able to obtain loans with a greater variety of payment structures. This is especially true for borrowers considered to be subprime, many of whom who did not have access to mortgage loans and so could not purchase their own homes prior to the creation of the securitization market. Lenders benefit because they are able to free up capital to make additional loans, and investors benefit because mortgage-backed securities present a diverse range of investment options, with investors able to choose the type of product and the risk-reward profile appropriate for their needs.

It cannot be emphasized enough that no participant in the securitization process has any incentive to encourage the origination of loans that are expected to become delinquent. No financial institutions would knowingly want to make or securitize a loan that it expected would go into default; rather, the success of mortgage-backed securities as an investment vehicle depends upon the expectation that homeowners generally will make their monthly payments since those payments form the basis for the cashflow to bondholders.

As it relates to the impact of recent increasing defaults on the market, the market currently is adapting to changes in the performance of subprime loans, just as it adapts to other changes that significantly affect participants in the mortgage securitization process. Importantly, the interest of all market participants, from the borrower to the investor, are generally aligned with regard to reducing the number of defaults and delinquency. Everybody loses when the only viable option for managing loans is foreclosure. Given the general alignment of interest, it is not surprising that the market is adjusting rapidly to minimize foreclosures and improve the performance of securitized loans.

For example, mortgage loans to subprime borrowers are now being underwritten according to stricter guidelines to reflect current market conditions. At the same time, the volume of securitizations has been reduced, as has the range of mortgage products being offered to consumers. Further, financial intermediaries are pushing forward new practices, including contacting borrowers early when their loans appear to be at risk for default. All these adjustments in the market are being driven by the fact that nobody benefits from the underwriting of loans that do not ultimately perform. We must be careful, however, not to overreact to the increased number of delinquencies and defaults which could lead to an undue tightening of credit availability to prospective homeowners.

At the same time that we consider how the market has changed, we should also keep in mind how it has stayed the same. The vast majority of subprime borrowers remain current in their loan obligations, and the mortgage securitization process continues to provide unprecedented access to the capital markets so that others can purchase their own homes.

So how do we mitigate potential foreclosures? Mortgage securitization structures do provide flexibility to avoid foreclosure. Much of that flexibility rests in the hands of the financial institutions that service mortgage pools. Servicers collect principal and interest payments from borrowers and also make decisions on the administration of the pooled home loans. They have flexibility to work with borrowers so that loan payments will be made while exercising the right to foreclosure only as a last resort.

Notably, many of the largest servicers are commercial banks, which also hold substantial mortgage loans in their own portfolios. Regardless of whether these banks are managing their own portfolios or servicing loans in a securitized pool, we expect they generally will follow the same prudent home retention practices in an effort to avoid foreclosure.

The title of this hearing speaks to the role of securitization in the subprime mortgage market turmoil. Because none of the participants in the securitization process benefits from foreclosure, the market has evolved and will continue to evolve so as to minimize the number of foreclosures. Servicers are ramping up their home retention teams, both with respect to early intervention for at-risk borrowers and loan modification programs for borrowers that are in financial distress. To the extent that the servicer currently lacks any necessary powers to reduce the number of foreclosures in a prudent manner—and Lehman does not believe that such powers are materially lacking—the market will adjust by enhancing the servicer's flexibility in future contracts. In short, we expect that the subprime mortgage securitization process will continue to create opportunities for a long-ignored segment of the population to join and remain in the ranks of American homeowners.

Thank you again for the opportunity to be here today, and I also welcome any questions you might have.

Chairman REED. Thank you.

Ms. Barnes, and if you could bring the microphone close to you.

STATEMENT OF SUSAN BARNES, MANAGING DIRECTOR, STANDARD & POOR'S RATINGS SERVICES

Ms. BARNES. Thank you, Mr. Chairman, Members of the Subcommittee. Good afternoon. I am Susan Barnes, Managing Director of the U.S. Residential Mortgage-Backed Securities Group for Standard & Poor's. S&P recognizes the hardship the current subprime situation is placing on certain homeowners. However, as requested by this Subcommittee, my testimony is focused on the effects the subprime market has had on the financial sector.

Today I will discuss our ratings analysis for these transactions, including the factors we consider when evaluating mortgage securities backed by subprime mortgage loans and the impact the current mortgage loan delinquencies and defaults on the performance of RMBS transactions based by subprime mortgage loans. As described more fully in my written testimony, S&P's rating process for these transactions includes a loan-level collateral analysis, a review of the cash-flow within the transaction, a review of the originator and servicer operational procedures, and a review of the transactional documents for legal and structural provisions.

First, S&P performs a loan-level collateral analysis on these transactions. Specifically, we evaluate the loan characteristics, quantify multiple risk factors, and assess the default probability associated with each factor. This helps us determine how much credit enhancement is, the amount of additional assets or funds needed to support the rated bonds and cover losses.

In 2006, using this analysis we identified the deteriorating credit quality of the mortgage loans and consequently increased the credit enhancement requirements necessary to maintain a given rating on a mortgage-backed security. Next, we assessed the cash flow availability generated by mortgage loans through a proprietary model which assumed certain stresses related to the timing of payments and prepayments on the mortgage loans and uses the S&P mortgage default and loss assumptions to simulate the cash-flow of an RMBS transaction's underlying loans under these stresses.

We then evaluate the availability and impact of various credit enhancement mechanisms on the transaction. We also perform a review of the practices and policies of the originators and servicers to gain comfort with the ongoing performance of the transaction. Included within this review is an evaluation of the monthly servicer report.

Additionally, we review legal documents and opinions of third-party counsel to assess whether the transaction will pay interest as promised and whether the bondholders will receive the promised principal payments before the stated maturity of the bonds.

Now to the current market. The poor performance of subprime mortgages originated in 2006 dampened investor appetite for such mortgages, causing the interest rate sought by investors to increase as compared to mortgage-backed bonds issued in prior years. Therefore, the securitization of subprime loans has become less economical, resulting in fewer subprime mortgage loan originations in 2007.

While delinquencies for the 2006 vintage are much higher than what the market has experienced in recent years, they are not atypical with past long-term performance of the RMBS market, such as the delinquencies reported for the 2000 vintage after similar seasoning.

Regardless, subprime loans and transactions rated in 2006 have been performing worse than previous recent vintages. This performance may be attributed to a variety of factors, such as lenders' underwriting guidelines that stretch too far, this falling of home price appreciation rates, and ARM loans that in rising interest rate environments create a heightened risk of delinquencies.

Due to minor home price declines in 2007, we expect losses and negative rating actions to keep increasing in the near term relative to previous years. However, as long as interest rates and unemployment remain at historical lows and income growth continues to be positive, we believe there is sufficient protection for the majority of investment grade bonds. As of April 12, 2007, only 0.3 percent of the outstanding subprime ratings issued in 2006 have been downgraded or placed on Creditwatch.

S&P views loss mitigation efforts, such as forbearance and loan restructuring, as an important part of servicing securitized mortgage loans. Generally, servicers have the ability to mitigate losses by a variety of techniques so long as they act in the best interest of investors and in accordance with the standard servicing industry practices. So long as these standards are met, S&P believes that the current ratings on the RMBS securities will not be negatively affected.

We do need to be sensitive, however, to the balance between the negative effect of the potential reductions in prepayments received from borrowers and available to pay investors, with the positive impact of fewer borrower defaults.

Let me conclude by stating S&P does not anticipate pervasive negative rating actions on financial institutions due to rising credit stresses in the subprime mortgage sector since the majority of rated financial institutions have diversified assets and mortgage lending and servicing operations aligned with strong interest rate and credit risk management oversight. Specialty finance companies that focus solely on the subprime market, however, do not enjoy the same protection and have felt the effects of the current subprime credit stresses.

We thank you again for the opportunity to participate in these hearings and are happy to answer any questions you may have.

Chairman REED. Thank you, Ms. Barnes.

Mr. Kornfeld.

STATEMENT OF WARREN KORNFELD, MANAGING DIRECTOR, RESIDENTIAL MORTGAGE-BACKED SECURITIES RATING GROUP, MOODY'S INVESTORS SERVICE

Mr. KORNFELD. Thank you. Good afternoon, Chairman Reed and Members of the Subcommittee. I appreciate the opportunity to be here on behalf of my colleagues at Moody's Investors Service.

By way of background, Moody's publishes rating opinions that speak only to one aspect of the subprime securitization market, which is the credit risk associated with the bonds that are issued by the securitization structures.

The use of securitization has grown rapidly both in the U.S. and abroad since its inception approximately 30 years ago. Today it is an important source of funding for financial institutions and corporations. Securitization is essentially the packaging of a collection of assets, which can include loans, into a security that can be sold to bond investors. Securitization transactions vary in complexity depending on specific structural and legal considerations, as well as in the type of asset that is being securitized.

Through securitization, mortgages of many different kinds can be packaged into bonds, commonly referred to as "mortgage-backed securities," which are then sold into the market like any other bond.

The total mortgage loan origination volume in 2006 was approximately $2.5 trillion, and of this, approximately $1.9 trillion was securitized. Furthermore, we estimate that roughly 25 percent of the total mortgage securitizations were backed by subprime mortgages. Securitizations use various features to protect bondholders from losses. These include overcollateralization, subordination, and excess spread. The more loss protection or credit enhancement a bond has, the higher the likelihood that the investors holding that bond will receive the interest and principal promised to them.

When Moody's is asked to rate a subprime mortgage-backed securitization, we first estimate the amount of cumulative losses that the underlying pool of subprime mortgage loans will experience over the lifetime of the loans. Moody's considers both quantitative as well as qualitative factors to arrive at the cumulative loss estimate. We then analyze the structure of the transaction and the level of loss protection allocated to each tranche of bonds.

Finally, based on all of this information, a Moody's rating Committee determines the rating of each tranche. Moody's regularly monitors its rating on securitization tranches through a number of steps. We receive updated loan performance statistics, generally monthly. A Moody's surveillance analyst will further investigate the status of any outlier transactions and consider whether a rating committee should be convened to consider a rating change.

The majority of the subprime mortgages contained in the bonds that Moody's has rated and that originated between 2002 and 2005 have been performing better than historical experience might have suggested. In contrast, the mortgages that originated in 2006 are not performing as well. It should be noted, however, that the 2006 loans are, on average, performing similarly to loans originated and securitized in 2002 and 2001.

Pools of securitized mortgages from 2006 have experienced rising delinquencies and loans in foreclosure, but due to the typically long time to foreclose and liquidate the underlying property, actual losses are only beginning to be realized. Among several factors, we believe that the magnitude and extent of negative home price trends will have the biggest impact on future losses in subprime pools. Economic factors, such as interest rates and unemployment, will also play a significant role.

From 2003 to 2006, as has already been noted, Moody's cumulative loss expectations of subprime securitization steadily increased by approximately 30 percent in response to the increasing risk characteristics of the mortgage loans being securitized, as well as changes in our market outlook. As Moody's loss expectations have steadily increased over the past few years, the amount of loss protection in bonds we have rated has also increased. We believe that performance of these mortgages will need to deteriorate significantly for the vast majority of the bonds we have rated single-A or higher to be at risk of loss.

Finally, I want to give Moody's view on loan modifications by servicers in the event of a borrower's delinquency. Loan modifications are typically aimed at providing borrowers an opportunity to make good on the loan obligations. Some RMBS transactions, however, do have limits on the percentage of loans in any one securitization pool that the servicer may modify. Moody's believes that restrictions in securitizations which limit a servicer's flexibility to modify distressed loans are generally not beneficial to the holder of the bonds. We believe loan modifications can typically have positive credit implications for securities backed by subprime mortgage loans.

With that, I thank you, and I would be pleased to answer any questions.

Chairman REED. Thank you very much, Mr. Kornfeld.

Professor Eggert.

STATEMENT OF KURT EGGERT, PROFESSOR OF LAW, CHAPMAN UNIVERSITY SCHOOL OF LAW

Mr. EGGERT. Thank you, Chairman Reed and Ranking Member Allard and other Members of the Committee. I would like to talk about how securitization has changed the mortgage industry as we know it, and some of those changes have not been beneficial to borrowers.

Securitization has put subprime lending largely in the hands of thinly capitalized and lightly regulated lenders and mortgage brokers. Many of the companies doing subprime loans are non-banks regulated by State agencies, and without the underwriting standards imposed by regulators of, say, depository institutions.

Securitization is designed to divert value away from the originator. That is the whole point of securitization: it allows banks to originate loan, quickly sell it to the secondary market and to investors, and that way the lender does not have to hold the mortgage. And to a large extent, it reduces its own risk if the loan goes bad.

It also allows lenders to easily go belly up. We have seen even large subprime lenders go belly up recently, and because they are not holding all the loans that they have made for the last 5, 10, 15 years, it is much easier for them to go out of business.

If you look at the history of the subprime market, you see sort of waves of lenders going out of business and then coming back into business and going out of business. So many borrowers who took out loans find that their lender, when they go to discuss fraud, is no longer there for them to argue with.

The secondary market is protected in large part from risk of default and from risk of fraud. It is protected in part because of the risk abatement aspects that the secondary market imposes in securitization so they ask for credit enhancements of various types to protect them against default. And it is also protected by something called the holder in due course doctrine, which provides that if a loan is purchased by a bona fide purchaser, many of the defenses that the originator has to the—that the borrower has to the originator are cut off, and so the borrower may be able to sue the lender but cannot sue the secondary market or the current holder for some aspects of fraud. And if the lender has gone belly up, that leaves the borrower kind of with its defenses cut off completely.

Another thing that securitization has done is made the regulation of the subprime market a de facto regulation, really is by the securitizers. The rating agencies and the investment houses that assemble the pools by and large determine the underwriting criteria, by and large determine what kinds of products are being offered, and so they are the true regulators of the subprime industry, much more so than the State regulators that may supervise the non-bank entities. However, rating agencies and the securitizers are not monitored in the same way that a formal agency might be monitored. There is no congressional oversight of them, and so there are concerns about—I have greater concerns about turning over regulation to essentially private parties.

Securitization also puts impediments in loan modifications. We have heard of some of those impediments already. Servicers may have limited flexibility—they may have flexibility, but it may be limited by the terms of the servicing agreements. These terms may be vaguely written so that the service area is not even sure how far it can go in making modifications. The pooling agreements may limit the number of loans that may be modified, and so loan pools that turn out to have a much higher risk of default may leave some borrowers unable to get their loans modified because so many other borrowers had the same problems.

Servicers might be overwhelmed by an increasing number of defaults, and I would be interested to see how many servicers are going to add new staff that they will need to do loan modification.

Loan modification is much more time-intensive than merely collecting payments. Are servicers going to hire the new people that they need to do this kind of in-depth counseling?

Another problem is that if you take a unitary interest in a loan and split it up among all the different tranches in a securitization, it makes it harder for the servicer to modify the loan. Servicers act in the best interests of investors, but investors may benefit differently by different loan modifications. Different tranches of the securitization may be helped or may be hurt by loan modifications. And so you might have a servicer engaging in what I call tranche warfare as they decide which tranche will benefit and which will be harmed. That kind of discretion may be difficult for servicers to use, concerned as they are about protecting all investors.

Securitization also loosens underwriting. It has transformed underwriting from a very specific thing designed to protect a depository institution to a very automated process that can be objectively monitored, but also that can be altered depending on the market needs. If the market needs looser underwriting, we have looser underwriting. If a market needs tighter underwriting, we have tighter underwriting. But that kind of inconsistent underwriting can be very harmful to borrowers.

And so I think we need to see the secondary market become more accountable and more responsible for what it has done to loans, and there are two ways to do that, and then I will be done. I am almost done.

First is assignee liability. Have the current holders of market be liable where there has been fraud against the borrowers. And the other thing is I think we need to have regulatory oversight over the securitizers and the rating agencies who are actually regulating the subprime industry.

Thank you.

Chairman REED. Thank you very much, Mr. Eggert.

Mr. Peterson.

STATEMENT OF CHRISTOPHER L. PETERSON, ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF FLORIDA

Mr. PETERSON. Mr. Chairman and Ranking Member Allard, thanks to the Committee for holding these hearings. It is a tremendous honor and a privilege to be here to speak with you today and share a few thoughts. And I would also like to, before I begin, express some empathy for the folks at Virginia Tech. It is a terrible tragedy.

I would like to make three points in my 5 minutes: first, I would like to talk about maybe a very short historical overview of how I see the forces in the marketplace, in the mortgage marketplace working; second, the current state of what I think the law is; and, third, what I think the law has to become at some point if we want to prevent the kinds of problems that we have seen in the past year.

An overview of the market. I think that in my view you can picture the American mortgage market in three periods. First was an era of two-party mortgage finance, and this was from the founding of the Republic probably up until the Great Depression was the predominant mode, where there was a lender and a borrower, two people, they worked things out. The mortgagee gives a mortgage in exchange for borrowing money. And in that market the incentive is—the dominant incentive is the lender polices the underwriting because they want to get paid back. They receive their money out of the monthly payments on the loan.

After the Great Depression, when that system broke down, we had to find some way to restart the economy, and so Congress, under the leadership of the administration, passed a variety of statutes that created programs that created what I think of as a three-party model of mortgage finance, which had a lender, an originator, a borrower, and also the Government acted in virtually all of the middle-class mortgage loans in some direct underwriting capability, in some way guaranteeing it or insuring it, some direct, active involvement of the Federal Government or an agency affiliated with the Federal Government.

Although the lender did not get paid out of the proceeds of monthly payments, instead they got—there was still some force there that was policing the marketplace, and that was the sort of public institutional, public policy forces of the Government. So that substituted for the profit motive to some degree of the lenders.

Since 1977, when the first private-label mortgage securitization took place, I think there has been a third era of mortgage finance, and I think of that as the private-label securitization markets. And in that era, which—the first was in 1997—or, excuse me, 1977, but it really did not take off, you know, get large until the 1990's after, you know, the tax hurdles and some accounting hurdles were sort of cleared out of the way. And the problem, as I see it, is that the two core mechanisms of policing loan origination have broken down to some degree. The people that make the loans do not get paid out of the proceeds of the monthly payments on those loans. Instead, they get paid out of the fees and from selling the loan to somebody else. So there is less short-term, immediate incentive to make sure that the loan gets paid back on time.

And the second thing that has broken down is that those folks—there is no Government involvement, there is no stable bureaucratic hand which is not—you know, a non-risk-seeking hand that is trying to act in the benefit of the public that is overseeing this process anymore. Those are the two forces, and to a large extent, they have been—they are gone.

So what is left to try and make sure that things do not fall apart and get out of hand? Well, there is only one thing that is really left, and that is the rule of law. That is what I want to talk about next.

So what is the current state of the law? And I do not want to be disrespectful or anything, but my sense is that, after having studied it for most of my adult life, it is really in shambles, particularly the Federal law is. It does not do much. You read through it all, and at the end of the day you find out, well, the Federal law does not really apply. And what has happened, I think, is that the market has evolved past the law. All of the statutes that we have passed, which were good statutes, good compromises from both sides of the aisle—the Truth in Lending Act, the Fair Debt Collection Practices Act, less by the Homeownership and Equity Protection Act. The vast majority of them were all basically conceived in an era that predated securitization by 10, 20 years. So their basic scope and definitions and structure has not—does not even conceive of the type of lending that we are seeing now.

Just to give an example, what is the most important definition in the entire Consumer Credit Protection Act? Well, that would be the definition of a creditor. What is a creditor? It is the person to whom a loan is initially payable. But the person to whom a loan is initially payable neither holds the loan nor does that person in today's market actually ever talk to the person that is actually going to take out the money.

The Truth in Lending Act, the statute was supposed to promote fair and efficient comparison and shopping, does not even apply to the mortgage brokers that actually talk to the borrower. That is a pretty serious breakdown in the law. And there are half a dozen other examples. You know, the Fair Debt Collection Practices Act does not even apply to debt collectors—or it only applies to debt collectors, which in most cases will not apply in the servicing market—the servicing for mortgage loans.

I see I am already out of time.

So the last bit is what should we do to try and fix that. In my view, I think that, you know, we could talk about all these trends that we can sort of do to try and fix things a little bit here and there, but I think honestly we need to have comprehensive reform of the Nation's consumer credit law. We need to go back to the drawing board and re-update—update everything, and that is going to include comprehensive reform of the Truth in Lending Act and RESPA, trying to integrate those into a more coherent disclosure process. The Fair Debt Collection Practices Act needs to be revisited. I think that we need to figure out what we want to do finally about usury law and the Marquette Doctrine, which I think is a big problem, in my opinion.

Finally, we need to reconsider how it is that various participants and middlemen in this market are going to be held liable for, I think, in some instances aiding and abetting the process of making predatory loans.

If you want my opinion—you called me up here—we need to fix the whole legal system, or this is just going to happen again. So that is what I think.

Chairman REED. Thank you very much, Mr. Peterson.

What I propose to do is have 6-minute rounds, at least two rounds, I think, so if you do not get a chance to ask a question in the first round, my colleagues, stick around because we will go again.

Let me open up a line of questioning for Mr. Sinha and Mr. Sherr. William Dallas, who is the CEO of Ownit, which was one of the mortgage companies that went out of business through bankruptcy, said, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full-documentation loan." He said, "What would you do?" rhetorically. And, in fact, we have looked at some of the publicly filed documents and some of these subprime originators, and there is language very similar to the following in all of them: "We seek to increase our premiums on whole loan sales by closely monitoring requirements of institutional purchases and focusing on originating and purchasing the types of loans for which institutional purchases tend to pay higher premiums."

It raises the question, you know: Who is designing these products? Where are the incentives coming for some of these exotics? Is it coming from the Ownits, the creative originators? Or is it coming from Wall Street and the securitization process by saying this is what we want to buy and we are paying more for it?

Your thoughts, Mr. Sinha.

Mr. SINHA. Generally speaking, I think in the securitization markets, the securitization markets will effectively make a decision about whether to buy something or not to buy something and at what spread or price to buy it. So secondary market investors generally will not dictate what types of loans are effectively being made. The process effectively starts with the loans being presented to the rating agencies. The rating agencies will then take their own opinion about the risk of the pool which these loans effectively constitute and then will assign the enhancement levels appropriately at levels that they think are commensurate with the models that they run. And then that transaction is brought to the market, and the market then decides I will buy this at this spread.

So, generally speaking, I think, you know, the pools are presented to the market.

Chairman REED. So you see the role as very passive, the securitization—these originators come with apples and oranges and pears, and you look around and, you know, you pick——

Mr. SINHA. I think in general, as I look at these markets—and people do refer to these markets as effectively markets where you have risk-based pricing. Risk-based pricing is being done at the loan level itself. The loan is viewed as a mix of risks that have to be priced, and that is how the markets are pricing it, and that is how they are bringing it to the rating agencies. And then the markets are—ultimately, the capital markets are providing the final pricing level of which that risk would clear.

Chairman REED. Mr. Sherr, your thoughts.

Mr. SHERR. I think to a large degree these mortgage originators are relatively sophisticated, and they are clearly monitoring the capital markets to get a sense of what the value of the product they are originating is. And so there are loans—they are a running business. There are clearly loans that are probably more profitable for them to make, and there are clearly loans that cost them money to make. And I think part of their diligence is making sure they are originating loans that, one, they think they can transfer, and making sure they are not originating loans that ultimately, if their system breaks down, if they are losing money on every loan they originate.

Chairman REED. The question here all throughout, because it is a very complicated process, is who is ultimately watching over to make sure that that loan that is made to the borrower is within the competence of that borrower to pay for. And the impression I got from, you know, the quote from this individual was that he was not looking much at the borrower's capacity, he was looking at the highest premium he could get, the types of loans. Also, I think what—I do not want to put words in your mouth, but you are also saying, you know, we are not looking either, I mean, because he is bring us this paper. Is that——

Mr. SHERR. No, that is not what I am saying. Ultimately, at the end of the day, if he is going to run a business and continue to think he has access to the capital markets, his loans have to perform as expected. And the market turns, as you are seeing—you talk about loan repurchase. The market turn very quickly when loans start to underperform and cuts off his capital and his ability to run his business.

So I think there are lot of market-policing mechanisms across the board that prevent those abuses and make sure loans are originated to guidelines.

Chairman REED. Thank you.

I want to turn now to Ms. Barnes and Mr. Kornfeld about the rating agencies, and you gave very detailed testimony about the process. You indicated clearly you have been downgrading some of the paper that you previously had rated.

There was a comment made by Jeanette Tavakoli of Tavakoli Structured Finance pointing out that AA-rated tranches of CDOs backed by subprime mortgage paper now yield far more than AA-rated debt backed by other assets, which is suggesting that maybe these ratings are not as—they are not being believed by the marketplace.

Is there a problem with the model right now? You do not have enough historic data or these new products came on so quickly? Or are you looking carefully and reviewing your models to make sure they are accurate? Ms. Barnes.

Ms. BARNES. As with any mortgage product or any product within structured finance, as new products come to the market—you know, mortgages are not new. The characteristics are new. And what is new in the paradigm here is this combination of characteristics. It is this low-doc, high LTV, the piggy-back loans to a subprime borrower. That is really what is the new paradigm that we are seeing here. So while all those characteristics are not new to us, it was that combination.

So what we typically do, in developing our default probabilities and ultimate losses, is look back on historical performance and then gauge what would happen in the future. As we cited, what we saw was the performance was actually deteriorating earlier than we had expected. And that is why back in 2006, when we saw this high-risk characteristics coming in with higher early payment defaults—that is really what is different here. It is not the delinquencies themselves. It is the amount of loans that are defaulting within the first few months of the loans.

We actually increased our enhancement levels and default probabilities to protect the bond holders because of that likelihood.

But to answer your question specifically about the CDO buyers, the CDO buyers are going to base their determination on the spreads and what is available in the marketplace. So I would not say it is a fundamental disbelief but it is that concern in the marketplace with the higher yields that people are asking for. It is no longer economical for people to keep putting their money into mortgages and they are just shifting it to the next product.

Chairman REED. Mr. Kornfeld quickly, because my time has expired.

Mr. KORNFELD. Our focus once again is credit, which is only one part of what goes into spreads. There are a lot of different things as far as in spreads.

We do take, however, we have a lot of discussions, a lot of participants out in the marketplace. And we look at spreads as far as what investors are saying in regards to whether it is a tactical, whether it is a fundamental credit evaluation that those spreads are indicating.

Chairman REED. Thank you.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I think we understand that when you have a primary lender dealing with somebody who wants to borrow money, and then he goes ahead and securitizes it out, there is a spreading of the risk. So ultimately, where does the accountability rise? I think that is—does somebody maybe want to respond to that? Mr. Kornfeld, maybe?

Mr. KORNFELD. From our standpoint, once again, I am not sure if that is really a question for a rating agency for a policy, almost in a way somebody would have a policy standpoint.

Our role is a specific role. We have been rating credit, assessing credit worthiness in regards to a likelihood of a bond, as to whether a bond is going to pay or not. We do not look at ourselves in regard to that from that sort of type of role.

What we have to do, though, is our reputation is obviously very, very important. We continually publish how we are going and performing in regards to the ratings. We want a single-A rating to perform like a single-A rating. We do not want it to perform like a AAA. We do not want it to perform like something lower.

Senator ALLARD. Now, will certain investors say that we want a certain particular type of loan coming to us? And does this drive subprime mortgage instruments that perhaps are of questionable value as far as the borrower is concerned?

Mr. KORNFELD. There is a discipline. The investors generally would not specify specifically of a typical loan type. But there is a balance in the marketplace that sometimes as far as the marketplace will view as we are too conservative. Frequently, actually, we are viewed in the mortgage market as the most conservative rating agency. Many market participants view us, in general, as being conservative. But that is not our goal. Our goal is, once again, from a credit standpoint, to be relatively accurate.

So sometimes, yes, investors are going to believe that we are right on a risk and other times they are going to believe that we are either over and under. And they will price it accordingly in regards to spreads as part of their overall investment decision.

Senator ALLARD. I wonder who would buy a BB rating security rating today. Does anybody want to answer that question? Mr. Peterson?

Mr. PETERSON. If I were a servicer and if I bought that, it would help me get the servicing rights. And then I have a lot of opportunities to tap fees out of the borrowers and make my money out of those fees instead of the BBB bond. And I would want to do it.

Senator ALLARD. But the people that are buying the security, who would buy that kind of security?

Mr. PETERSON. The servicer.

Senator ALLARD. The servicer would?

Mr. PETERSON. Right.

Senator ALLARD. Well then, is that—do you think, is that a limited market today? How would that compare to a AA rating, as a BB rating?

Mr. PETERSON. I am sure that the folks on that side of the table would be better able to answer that than me.

Senator ALLARD. I can understand the fees driving that. Who would buy a BB, I guess, when you look at it as an investment vehicle? I mean, they are on the market. Somebody is buying them?

Mr. SHERR. There are a fair amount of sophisticated investors who participate in this space, and it all gets down to price. Am I being compensated for the risk that I am taking in buying that security?

Certain securities rating BB trade at different prices. The market for a certain vintage of mortgage loans is repriced to reflect the additional risk that the investor is taking. And investors to the market—the market and investors find that appropriate——

Senator ALLARD. So they are rather sophisticated investors——

Mr. SHERR. By and large——

Senator ALLARD [continuing]. That understand the risk. And so if things go bad, they understand the risks?

Mr. SHERR. By and large, the lower rate mortgage investors, I would say, are a relatively sophisticated group of investors.

Senator ALLARD. Now those that buy the AAA or the AA, those are probably the—would you describe them as less sophisticated type of investor?

Mr. SHERR. I do not know if it is less sophisticated, because certainly very sophisticated investors participate in investment grade and high rated bonds. I would say the risk those investors are taking is significantly less, and therefore they are getting paid significantly less on that security to take that risk.

Senator ALLARD. I am going to yield back the balance of my time. I will let the rest of the committee ask questions.

Chairman REED. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

A quick question, a yes or no would do, to Mr. Sinha and Mr. Sherr. Any responsibility from the securitizers for what has happened in the secondary market in the defaults and foreclosures?

Mr. SHERR. I do not think there—I mean, I think we spent, at Lehman, a tremendous amount of time trying to diligence the counterparties that we deal with. And we have done a tremendous amount of work, both on the investor side and the originator side, making sure we are dealing with reputable counterparties and doing everything within our means to make sure that the loans that we are buying and the transactions that we are doing in the marketplace conform to the guidelines as represented when we went into the transaction.

Senator MENENDEZ. Meaning?

Mr. SHERR. Meaning no.

Senator MENENDEZ. Thank you.

Mr. Sinha, can you be more succinct? Yes or no?

Mr. SINHA. No.

Senator MENENDEZ. No, thank you.

Ms. Barnes, Mr. Kornfeld, any responsibility from the credit rating agencies? Yes or no?

Ms. BARNES. No.

Senator MENENDEZ. No? Mr. Kornfeld?

Mr. KORNFELD. For a simple yes or no, no. It is a difficult question, though, in terms of simple yes or no.

What the rating agency does is to express our opinion. What we are trying to do is do our best opinion——

Senator MENENDEZ. Your opinion matters in the terms of investors and what it means in terms of them willing to make commitments and then fuel the secondary market, does it not?

Mr. KORNFELD. But rating is not a pass/fail. A rating is trying to do what the probability of the potential losses to a bond holder.

Senator MENENDEZ. So the answer is no for you, as well?

Mr. KORNFELD. Yes.

Senator MENENDEZ. Now no one has any responsibility at the table.

Let me ask this: Mr. Sherr, what is an acceptable percentage of default rates and foreclosures in the market, as far as from a market perspective?

Mr. SHERR. Different loans carry different loan level characteristics and different loans have different frequencies of default. So it is hard to say that there is an acceptable standard for delinquencies.

Senator MENENDEZ. Is 20 percent acceptable?

Mr. SHERR. No, it is not acceptable.

Senator MENENDEZ. That is what we have right now going.

I asked you that question because, as I listened to your testimony, it sounds that you are as chagrined about defaults and you suggest that for securitizers that is clearly not a good thing. But it certainly seems to me that the securitizers have looked the other way, fueling a market that has very little discipline over itself, and therefore not so concerned about the rate of default looking at it in a mass way, well, X percent is fine and we will take that as part of the risk in an equation of investing.

Is that a fair statement?

Mr. SHERR. I do not think so. I think the market—think about the recourse. You mentioned pretty much every independent subprime originator who has been forced out of business. So clearly there are ramifications for running a business the wrong way.

Senator MENENDEZ. Well, those are the originators. I am talking about the securitizers. Isn't there a good part of what happens to the securitizer is that if the loan defaults the originator has to buy it back? Isn't that a good part of what happens?

Mr. SHERR. I do not know if it is a good part. No one wants to see loans go down.

Senator MENENDEZ. No, I say a good part meaning isn't it a significant part of what happens in the marketplace, that the originator, as part of the agreement with the securitizer, has to buy it back?

Mr. SHERR. The originator makes representations around his loan and he typically reps that the loan will not default on their first payment.

Senator MENENDEZ. So what I am saying is the securitizer has a much more limited liability here at the end of the day. Between that and the credit rating agencies, it seems to me that while you say you are chagrined about defaults, you actually fuel the marketplace in a way that has no controls, largely speaking, over it as defined by the two professors here. And ultimately, when you talked in response to the Chairman's questions and you said market mechanisms are in place. But they are in place only when we are at the default stage. Isn't that a little late for market mechanisms to take place?

Mr. SINHA. Senator, if I can just add to this, I think at the end of the day ex poste, every loan that defaults is effectively something that is not the favorable outcome for the people that effectively advance the funds for that. The real question is in a market where there is greater risk if credit is going to be advanced to those borrowers, what is the right level of pricing or spread that has to be charged to make it worthwhile for capital to be advanced into that sector?

And I think the big attempt over the 10 years has been to get capital into markets that were otherwise perceived as risky, that conventional lending would not go to but where the introduction of a balance between risks and spread has allowed funding to go to.

So at the end of the day, I think the people that are funding these loans have a tremendous amount at stake because they are responsible. They have their own fiduciary duties to their investors. And if they make a loan and that loan does not perform, they are just as much hurt by that loan going bad.

So the real challenge, I think, is for us to figure out—and there is no perfect situations in the world and there are no perfect solutions. But the question is, on balance, the fact that we are able to make loans to people that were perceived as risky, and risky enough 10 years ago that they were delegated to the outer reaches of the finance markets and have become much more mainstream, is that benefit sufficient to alter the fact that yes, there have been some issues in terms of the fact that an above larger number of borrowers are going into foreclosure than was otherwise expected?

I think that is part of the reason why you are seeing the kind of correction that you are seeing in the markets, in terms of people re-evaluating the types of risks they were taking on.

But I think that is the mechanism for ensuring that mid-course corrections are made, is when people do not get their money back or their bonds get downgraded. That has real consequences for those folks that are have. We are also accountable.

Senator MENENDEZ. When you have lost your home, a mid-course correction is a little late.

Mr. Chairman, I have plenty of other questions. I will wait for the second round.

Chairman REED. Thank you.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

I think this question is probably for Mr. Sinha and Mr. Sherr and Mr. Eggert and Mr. Peterson, on different sides of the question.

That is what are the benefits and drawbacks of requiring borrowers to be qualified at the fully indexed rate, which is suggested in the proposed interagency subprime mortgage lending statement?

Mr. SINHA. Senator Crapo, I think the benefit would be that to the extent that there are dangers put on or risks put on borrowers from a payment shock perspective by allowing them to qualify, or effectively qualifying them at the fully indexed fully amortizing rate, you've clearly removed that risk from the table.

The drawback would be that there may be some borrowers that are truly able to handle the payment shock that would not then be able to afford that mortgage anymore because the bar has been raised.

So I think, as I said earlier, there are never any perfect solutions. I think what the right balance is in terms of the right amount of time that you need to provide to that borrower such that there would be a reasonable expectation that he or she would be able to handle the payment shock if that comes. That probably is the right solution. I do not know what the answer to that question is.

And I think it is specific to every borrower in terms of their own financial and individual circumstances.

Senator CRAPO. Mr. Sherr, did you want to add to that?

Mr. SHERR. No, I would agree. I think that clearly, by qualifying potential borrowers to the fully index rate, you create a pool of loans that arguably perform better. On the other hand, you are going to restrict credit potentially. And typically there are mitigants that would allow an underwriter to make a loan that otherwise may not qualify at a fully indexed rate. But we run the risk of not providing credit to that group of potential borrowers.

Senator CRAPO. So it would shrink credit and, if I understand you right, in your opinion it would probably shrink it more than we would need to to solve the problem we are dealing with here?

Mr. SHERR. I would agree with that.

Senator CRAPO. Thank you.

Mr. Eggert or Mr. Peterson, do either of you want to respond?

Mr. EGGERT. I think one of the advantages of forcing you to underwrite to the full rate is some of what we are seeing are borrowers who do not realize how high the rates on their loans are going to go or could go. And when they are being sold these loans, they are being sold them based on the teaser rate.

If you look at the ads for a lot of the subprime loans, it is “reduce your loan payments by $500” and all they are advertising is the teaser rate. When they sit down with the mortgage broker, the mortgage broker talks about the teaser rate.

Many of the borrowers do not see the full rates at all until closing, and may not understand it at that point.

Senator CRAPO. And this proposal would solve that?

Mr. EGGERT. It would mitigate it because while it would not solve the problem completely, at least you would get borrowers into loans that they could afford when they are fully indexed.

Senator CRAPO. Thank you.

Mr. Peterson.

Mr. PETERSON. I think it is a reasonable, decent idea. But I think it is a Band-aid. I mean, if you do that, then it will help tighten up credit a little bit. There will be a few less really dangerous poorly underwritten loans. But my sense is that you could probably start to think of ways to make the same sort of things happen with different contract mechanisms and contract around that rule.

So ultimately, I do not know that it would necessary prevent the types of things we have seen.

Senator CRAPO. Thank you.

And with the couple of minutes I have left, I will come back to Mr. Sinha and Mr. Sherr. What would be the impact on the secondary market if Congress or the—well, if Congress, imposed assignee liability standards similar to the Georgia or New Jersey State laws? What has been your experience with these laws? And what do you think would happen?

Mr. SINHA. Senator, we actually have had an experience with assignee liability in two states, Georgia and New Jersey, and in the State of New Jersey, in the high cost market. From the investor's perspective, and that is predominantly the client base that I serve, if you think about the securitization process, anything that makes the process inherently unpredictable in terms of how you adhere to a particular standard or what the particular sort of consequential losses might be as a result of any piece of legislation makes the rating process fundamentally not possible.

So as a result of that, when we have seen this type of risk come into the market, what we have seen are investors effectively saying that we do not have the ability anymore to understand the type of risk that we are buying.

I do not want to necessarily speak for the rating agencies, but I think that has been that same argument that has been applied, as well.

So it comes back down to if it is a risk that is quantifiable and that one can sort of rate around or structure around. Markets can price it. But if it is completely up in the air and it is completely indeterminate, and there is no real way of objective standard of determining whether you are in compliance with it or not, then it becomes very hard for the capital markets to deal with.

Senator CRAPO. Quickly, Mr. Sherr.

Mr. SHERR. I would say why not get at the problem more directly? If the goal is to cut out predatory lending, which I think every responsible lender would support, why not define clearly what is a predatory loan and create a national standard that would regulate those loans being made? As opposed to trying to transfer that risk to second and third order investors who may not be close enough to the transaction to fully understand what risk he is taking. And therefore, I do think you will find that it may have significant impacts on the capital available for borrowers.

Senator CRAPO. Thank you.

Chairman REED. Thank you very much, Senator Crapo.

Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much, and I want to thank the witnesses for your testimony.

I want to focus on where do we go from here? What are solutions or proposed solutions?

I am going to start with both Professors Eggert and Peterson. Professor Eggert, I was looking at your testimony and, in particular, I know sometimes when you have limited time you do not have the ability to go through all of it. These are pretty significant pieces of work here.

But I wanted to reiterate and have you reiterate, if you have covered a lot of this already, but especially if you have not, some of the conclusory statements that you make. I am looking at page 29.

I was struck by one of the last sentences in your testimony. It said, and I quote from page 29, "To be effective, any regulation that protects consumers from inappropriate loans, must affect the actions of the Wall Street players that direct the securitization of subprime loans. A regulatory regime that purports to limit the harmful effects of predatory loans or loans unsuited to borrowers must include not only the lenders that originate the loans, but also the rating agencies and investment houses that create the loan products, determine the underwriting standards" and it goes on from there.

I just wanted to have you comment on that, in terms of specific focus of reform, based upon not just your testimony but your experience.

Mr. PETERSON. I think the reason I say that is if you look at how this process works, I think we have had a presentation as the secondary market are mere passive purchasers of loans and oh, they may select a loan but it is really the lenders who decide loans.

But if you talk to people on the origination side, they will tell you the complete opposite. They will say our underwriting criteria are set by the secondary market. They tell us what kinds of loans they want to buy. They tell us what underwriting criteria they want us to use. And that is what we do because we are selling to them.

So the securitizers and the rating agencies really are the de facto regulators. If you are going to fix the problem so that we do not have the high levels of default we have seen, I think you have to involve the de facto regulators. There are, I think, two ways to do that.

One, I think, is assignee liability. Rating agencies and the investment houses are really looking out for the investors. They are not looking out for the borrowers. If you want to make them decrease the amount of inappropriate lending, the way to do that is to make inappropriate lending hurt the investors. If investors are on the hook when somebody is defrauded, then the securitizers are going to make sure fewer people are defrauded and that fewer defrauded people's loans get securitized. Assignee liability is the way to make the secondary market do real monitoring of the originators.

And also, I think the other thing is that there should be more regulatory purview over the rating agencies and the investment houses. I have not quite—I have come to this conclusion recently and I cannot sit here and tell you exactly how that should work. But we are used to having our national mortgage market regulated. I think we all want it to be regulated.

But at the current moment, it is not really regulated other than by these private de facto regulators, as far as the subprime industry.

And so we need to figure out a way to pull back the subprime market under real regulation. Exactly how that will work, I think will take some thinking. But I think that should be something that should be on the agenda.

Senator CASEY. Thank you. If we have more time later, I will ask your colleagues at the witness table to respond.

But I do want to ask Professor Peterson, in terms of, as you say in your testimony, not believing in a wait and see attitude but having specific steps. Can you outline, you have got about four or five specific recommendations. Can you summarize those for us?

Mr. PETERSON. Sure.

Senator CASEY. Or highlight one.

Mr. PETERSON. Yes. I can fill up a little booklet of things that I think that need to probably be fixed with the Federal consumer lending regulations.

But specifically related to this problem, if I could just pick two things that I would focus on, the first is that at a minimum, the bare minimum that we need to do is apply the Federal Trade Commission's Holder in Due Course Notice Rule that is applied to say car lending ever since the 1970's. That should apply to all home mortgages. The markets have been able to do that. That provides some assignee liability, but it is a cap level of assignee liability that I think that the rating agencies and the investment banks can live with. That is the first thing.

The second thing is that I think it would be great if the Federal Government would step up and articulate some sort of standard of imputed liability for investment banks that package mortgage loans. Because remember, if you have assignee liability, that is just going to get the investors on the hook. But a lot of those investors are innocent parties and nobody wants to have uncapped liability for these innocent parties.

But if you really want to have some deterrent mechanism, then you need to have some uncapped liability for the truly bad actors, the real predators that are out there. You have to have punitive damages or you will not ever be able to deter them.

And the way that you need to do that is I think there has to be imputed liability for the investment banks that are facilitating it. If the investment banks know or should have known that there is predatory loans or unsuitable loans being packaged in those securities, those investment banks should be liable.

Senator CASEY. I know I am out of time. Thank you.

Chairman REED. Thank you very much, Senator Casey.

Let me begin the second round and address follow-on questions to Mr. Sinha and Mr. Sherr.

Both Bear Stearns and Lehman Brothers not only are securitized, they also originate. You have got vertical integration. I am wondering, in your origination, were you involved in low-doc and no-doc loans and some of the more exotic products?

Mr. SINHA. Senator, yes. I should point out, though, that I am head of research. And what I know about Bears' operations are what are publicly available to everybody.

I think lim-doc loans were a commonplace aspect of the markets over the last couple of years. So to that extent, yes.

Chairman REED. It goes back to my original question. What made it attractive to Bear Stearns? Was it the origination fees or the securitization fees? It goes back, I think, to who was driving the train here, my initial question? Do you have any notion about that?

Mr. SINHA. Again, I cannot speak specifically about the decisions at Bear. But I think generally speaking the market throws out a menu of alternatives into the marketplace. At any given point in time you will see a variety of mortgages being offered out. And it is really sort of—you know, the demand in terms of the borrower base that will determine any one particular type of instrument that does decide to come in.

What we have seen is overall broader market participants is that the increasing levels of home price appreciation over the last couple of years did, in and of themselves, create sort of a feedback mechanism in terms of what people refer to as affordability products. And so I think the last couple of years of very high home price appreciation rates are also responsible, to some extent, in terms of broadening the menu of offerings that get thrown out there.

Chairman REED. Mr. Sherr, the same question. Since your company dos originations as well as securitizations, what was driving these low-doc loans?

Mr. SHERR. You know, I think we tried to identify an underserved market. And if you think about the entire Alt-A market, for example, that is a documentation market, for the most part. We found there were a number of borrowers who were denied—who could not access credit for whatever reason, they were self-employed. There were a number of reasons why they could not provide the full documentation or chose not to provide the full documentation that a traditional bank may have wanted. And we found a market segment that we thought made sense from a risk-adjusted basis and provided capital to borrowers who otherwise could not get it.

Chairman REED. You know, one of the points that were made when we looked at this, so many of these no-doc or low-doc loans did not routinely escrow taxes or insurance, which suggests to me, you know, this is a segment of the economy who probably would be well advised to save some money for taxes. And yet, with that characteristic, would that not suggest to you that this loan could be bad? Or that there would be other demands on the salaries of these individuals?

Mr. Sherr.

Mr. SHERR. I think all of those characteristics were taken into account when you underwrite the loan. I think it is important to understand that when you make the loan it is in everyone's interest that the borrower can afford to pay that loan back.

Chairman REED. Let me just go back to the rating agencies. You have already begun to downgrade some of this paper. You suggest, though, I think you are confident. Do not—let me have you reaffirm that that issue go forward, unless there is a tremendous deceleration in wages or economic activity, that it is not going to have serious systemic repercussions. Is that fair?

Ms. BARNES. We believe that there is sufficient credit enhancement, given the current economic stresses, for the vast majority of the investment grade tranches. The speculative grade tranches obviously would experience a higher downgrade ratio. That is what they are designed for.

Chairman REED. So to the extent of the non-investment grade tranches, who is holding those? That would be hedge funds, principally?

Ms. BARNES. Typically, yes. Those were those people you were addressing earlier.

Chairman REED. Have you, either through some analysis or through a gut check about what is the impact if these investment grade or non-investment grade securities go down, is there going to be an impact? For example, pension funds are invested in hedge funds. Is there a domino effect?

Ms. BARNES. Pension funds are typically investors in the higher rated tranches, the teachers retirement fund and others. Those are your AAA investors, so fairly insulated from this.

A domino effect, the speculative grade investors do expect and are paid for the higher yields, so do have a higher downgrade ratio or default probability. And it is baked into their overall return expectations.

Chairman REED. Quick comment, Mr. Kornfeld?

Mr. KORNFELD. No.

Chairman REED. Let me ask another question which goes to something Senator Schumer raised initially. And that is at this point there is a recognition by everyone on this panel, everyone in the room, everyone across the country, that foreclosure is bad. It is bad for people who lose their homes. It is probably bad for the financial institutions that do not come out whole after the transaction.

And yet, there seems to be some inhibitions because of the securitization process and how flexible the servicer or whoever is holding the paper can be in terms of working out—Professor Eggert pointed out, where are these people that go into the field and start talking one-on-one with the homeowners to work this out?

So I just want to get a sense. Mr. Sinha, you suggest in some of your comments that there are different REMIC rules, which are tax rules. There are accounting rules such as FAS 140. There are covenants within all these documentations with respect to how much leeway they have.

Given all of this cross-cutting restrictions realistically, if someone did have a pool of $1 billion, like some financial institutions are proposing, how effectively could they deploy that money to help individuals? What are the transaction costs? Do you have a—I am going to ask everyone. Do you have a notion of that?

Mr. SINHA. Sure. I mean, not to downplay the significance of some of those restrictions, but I do not think they are insurmountable. And certainly, in some instances, they are a lot easier. In others they may be more difficult.

But I think the issue that would be faced by everybody in the market is that there is a cohort of borrowers that are going to be facing stagnant housing markets and potentially a reset coming up. And not dealing with them in a sensible way, considering the fact that the market's risk profile has changed, would be shooting oneself in the foot fundamentally.

So I think my perception, this is my opinion, is that I think when people are faced with the gravity of the situation, to some extent, I think it should be easier to arrive at a consensus in terms of the right thing to do. I mean, the right thing for investors and borrowers is that borrowers stay in their homes and keep making their payments. And the more of that we can generate, the better off everybody is.

So I think from that perspective, in my opinion, I am more optimistic about that aspect.

Chairman REED. Mr. Sherr.

Mr. SHERR. Although, I would agree there are rules and guidelines for how securitization should be serviced, I would agree with Mr. Sinha that at the end of the day the servicer has a tremendous amount of flexibility to do what is in the best interest of that securitization.

I think, again, it is very important to understand that in this environment the interests of the borrower and the interests of the lender are very much aligned. The interests of the securitization and the interests of the lender are very much aligned. No one wins in a foreclosure.

Mr. Schumer represented the disparity between loss, between putting someone on forbearance or loan modification plan and actually trying to sell that home in a down market. It is in everyone's best interest to accommodate that borrower and keep him in his loan for as long as possible.

Chairman REED. Ms. Barnes, Mr. Kornfeld, comments from your perspective?

Ms. BARNES. I agree with the comments. It is in everyone's best interest to have the loans repay. But in applying the forbearance process, the servicers will first need to determine is it even feasible for the people to even repay these terms. Because there is no point in setting a new interest rate if they are going to default again. So that is one aspect.

And then two, as far as applying widespread loss mitigation efforts, it does put a sense of uncertainty in the repayment of bonds. Because as servicers had the ability then to change interest rates, change terms, it is then something that needs to be factored into the ultimate return profile for the investors on the individual bonds.

Chairman REED. You earlier, limits in terms of the modification is based upon your credit evaluation?

Ms. BARNES. No. Some documents do require or limit the percentage. But that is not a Standard & Poor's requirement or limitation.

Chairman REED. But some credit rating agencies would have that?

Ms. BARNES. I do not know who is driving it. It is in some of the documents.

Mr. KORNFELD. It is not, as far as in terms of a requirement that we have put. We do not advocate having the caps, as I mentioned in my initial remarks, in terms of anything that would reduce the servicer's flexibility we do not think is a benefit to bond holders.

Nor do we think it is obviously a benefit to borrowers.

Do concur that we do not think that this is insurmountable. We do think that if all the various groups get together, we think there is some communication, we think there is some education.

Chairman REED. Mr. Eggert and Mr. Peterson. Everyone gets a chance.

Mr. EGGERT. First, I would like to react to a statement we have heard a couple of times, that the interests of the investors and the interests of the borrowers are congruent and so the people taking care of the investors will take care of borrowers.

I do not think that is true. They diverge in one significant way. Both sides do not want higher defaults but investors are willing to accept higher defaults as long as they also obtain higher interest rates in return. The more the risk, the more return they want. In other words, they are willing to accept one bad thing for borrowers, which is higher defaults, as long as the borrowers get the double whammy of also getting higher interest rates.

So the interests are not congruent. And what we have seen recently is that the investors, faced with these higher default rates, have said we need higher returns and so we need subprime loans to cost borrowers more, which I think also makes them more likely to be defaulted.

As far as the difficulty in giving servicers flexibility, I think one study found that the terms, that about 30 percent of bond deals had the kinds of terms saying you cannot have more than X number of loan modifications.

But the real question, I think, is who is going to be giving servicers their marching orders? Who is going to be telling them how to deal with these loan modifications? If these were loans held by national banks, we would be looking to Federal regulators to give the banks an idea of how to respond to increased default rates. Here we do not have that. We do not have the kind of regulation that I think could help us respond to this kind of problem.

Chairman REED. Professor Peterson, finally.

Mr. PETERSON. The thing I want to respond to is I am not so sure that I agree with the statement that it is in everybody's best interests to avoid foreclosure. I am not sure that that is true. It is certainly in the investor's interest, by and large, and in the investment bank's interest, by and large. But if you are the servicer, it may be in your best interest to foreclose, in some cases. For example, if there is a divergence in the incentives of the investors and you, if you look at the contract and there is the potential for you to get a lot of fees—if you have a fee generating opportunity at a foreclosure, it may be more profitable for you to foreclose than not foreclose.

So the question that I would want to know is whether or not the insistence on foreclosure is because of a lack of flexibility because of conflicts with tranches in the pooling servicing agreement or if it is because the servicer is reluctant to give up the windfall of fees from foreclosing in exchange for the hard process of helping a borrower reformulate the loan or repattern the loan and work it out. Because that is going to be a difficult, time consuming thing. Do you take the fees or do you help them work it out? It may be possibly in the interests of the servicer not to work it out, and instead take the fees.

And I would have to look at some hard numbers to know which that is. And it may be different in different cases. But I have not seen—I have never seen anything that convinced me that the servicers do not have an incentive to foreclose.

Chairman REED. Well, thank you. This is very revealing to me. Again, I think there is the issue of the congruence of the incentives to foreclose, not foreclose, forbear, not forbear. But then there is also the issue of the capacity to communicate and get it done and who is going to take the lead to get it done, if in fact there is either a pool of private money or public money or any other mechanism to help these people.

So I think that we have explored and exposed a very significant issue.

Senator Crapo, do you have additional questions?

Senator CRAPO. No.

Chairman REED. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Let me ask you, Mr. Sinha and Mr. Sherr, do you know if your companies have purchased tranches of mortgages from New Jersey?

Mr. SHERR. From who?

Senator MENENDEZ. New Jersey. Mortgages that originated in New Jersey, properties in New Jersey?

Mr. SINHA. Frankly, I would refer the—I do not know. It is possible that we do have New Jersey loans.

Senator MENENDEZ. Would you know, Mr. Sherr?

Mr. SHERR. I believe we have.

Senator MENENDEZ. And the reason I ask that question, because in response to Senator Crapo's question about assignee liability, you gave a negative response of view of assignee liability. Yet, New Jersey has assignee liability under its law and it is the 13th State, in terms of Senator Schumer's joint economic study, in the number of defaults that have taken place across the country. So obviously, there is a lot of people buying those mortgages, notwithstanding assignee liability.

So I think it is fair to say that notwithstanding assignee liability, there is still clearly a marketplace to buy those mortgages. Yet, it creates some recourse to the borrower at the end of the day.

Let me ask you this: in the purchases of these tranches of mortgages, you never had any sense that there was any predatory lending loans within them?

Mr. SHERR. If we purchased a loan, it was our opinion there were no predatory loans in that tranche or in that pool. And we do that via diligence and compliance checks.

Senator MENENDEZ. Mr. Sinha.

Mr. SINHA. I mean, I would generally, again, agree with that statement. I think nobody knowingly would want to purchase a predatory loan.

Senator MENENDEZ. But with the number or percentages of loans that are falling within that category—and I agree with you, Mr. Sherr. You said let's have a national law that defines predatory lending and let's have a consequence. I agree with you.

And I do not believe every subprime loan is a bad thing, either. But I also do not buy the general statement that if we do anything we are going to find ourselves with limiting access to capital to all of these people who might not otherwise have the wherewithal.

Well, getting that access and then having your home foreclosed not only has a direct consequence on your life, but it also has a direct consequence on your credit for a long period of time. So striking a balance here is, I think, what is important.

What I do not hear the industry as coming forth—other than saying we have no responsibility, we have done what we need to do—I do not hear the industry coming forth and being proactive in this. And I think that is a mistake on behalf of the industry's part.

But is it not true that market investors are really in the best—at least under the existing system—they are in the best position not only to keep bad players and products out of the market in the first place by not funding them? And also in a better position to make originating offenders accountable.

It seems to me that you have a responsibility with your underwriting standards that would work a long way, both for your investors as well as for the marketplace and for the people who are losing their homes. Don't you think that you, in fact, have by virtue of the power—I mean, you know, if you cannot securitize it, it will not sell.

Mr. SINHA. That is correct, Senator. I think, if you couch the issue, I think, in terms of better disclosure to borrowers, better education for borrowers, better up front education about the types of products and the types of risks the borrowers are taking, better enforcement of existing practices, marketing practices, et cetera, I think they would go——

Senator MENENDEZ. I agree with you all of those things. Those are the downstream things.

I am asking you, from your perspective, isn't there a role for you to have a stronger, more—I do not want to use the word stringent because that can go overboard—but a stronger standard that understands that some of these products that are being purchased are products that ultimately are leading to the number of foreclosures that we have?

Because if you would not securitize them, they would not be able to be out there loaning it.

Mr. SINHA. That is correct, Senator, but I think traditionally there is a certain expectation that loans that have certain sets of characteristics behave in a certain way. That is where the disconnect comes about. It is not that everybody sort of knowingly knows that—understands that that is a bad loan. It is just at the end of the day, in hindsight, the loan does not turn out to be as it was supposed to be.

Senator MENENDEZ. Let me just turn to the rating agencies for a moment. As I understand it, 97.9 percent of all subprime deals over the last 3 years has been rated by S&P and jointly, often a second rating, as well. So really, your respective agencies have been out there doing all this rating.

I asked you a question earlier and, of course, you gave me the answer that you really do not see any responsibility. With all the information that has been coming to light in these hearings, can you explain to me how you could have possibly given and continue to give strong ratings to these inherently flowed investment vehicles? Didn't you have some earlier signs that this market segment was writing checks that you simply could not cash?

And don't you think that you have any responsibility in this regard?

Ms. BARNES. Well, to address your first couple of points, in looking at those loan characteristics, we did identify them as being riskier and, in doing so, increased our enhancement levels by 50 percent in 2006. So in essence, making those loans more costly to be originated because we do believe that the default rate was higher. And we went out publicly with that in the middle of last year.

Senator MENENDEZ. Mr. Kornfeld.

Mr. KORNFELD. Obviously, in terms of the magnitude of the situation is very, very serious. But to a certain extent we want to frame somewhat of the issue. It is not all subprime loans. It is mostly confined to 2006. And it is also not all of 2006's originations. There are a significant portion of 2006 originations that are performing.

But once again I do not want to, by any means, it is a very good question, it is a very proper question to be asking.

Part of the areas are certain specific areas. It is the areas as far as—it is not even completely the stated documentation loans. It is the loans to wage earners. And the significant growth over the last year or two have been to salaried borrowers. And that is where, in terms of from a risk standpoint, things have performed somewhat worse than expectation.

It is also, it is very much in where you combine those risk characteristics all together where you take a no equity loan, you take it as maybe stated documentation and maybe it is a stated wager earner. And then you combine it with a borrower with either a first-time borrower or a borrower with limited mortgage history. And you bring all of those together and, as far as the overall risk, it is not complete.

From our standpoint, once again, what the market judges us on that if we are incorrect in regards to consistently whether we under or basically over, in regards to the risk estimation, then as far as the market is going to no longer be utilizing and relying on our ratings.

Ms. BARNES. I am sorry, Senator. I just wanted to answer your question about how we could give high ratings to these poorer quality loans. I just wanted to make sure that it is understood that we do not make the loans, we do not give the approval of these loans. We simply assess the risk of these loans, and in doing so those individual tranches.

And when I mentioned that our enhancement levels were increased by 50 percent, the ratings are asked of us from the issuer. So if they say they want to issue a BBB bond, we reply based on our credit assessment what enhancement level of protection to cover losses would be to achieve that BBB. So in essence, we can give the same rating but it will become much more costly because that enhancement level or the amount of protection increased by 50 percent over that period.

Senator MENENDEZ. And you believe that the ratings that you gave, at the end of the day, covered more than sufficiently the risk in the marketplace?

Ms. BARNES. For the majority of the investment grade bonds, yes.

Senator MENENDEZ. Mr. Chairman, if I may, one last question?

Let me turn to the two professors. If it was moot court and you heard all of this testimony, can you give me a verdict on no responsibility by the securitizers or the credit rating agencies?

Mr. PETERSON. I think that there is some responsibility, obviously. And I do not mean to be rude or disrespectful, but I do.

And if I could encapsulate it, the sentence that was said earlier was that no one would want to purchase a predatory loan. I think that that is false. Sure you would. If you could purchase it and then, especially if you could purchase it through a shell company that did not have your fingerprints all over it, and then you sold it to some sucker at a profit, then you would want to do it; right? And you would pretend that you did not know that it was a predatory loan.

Or you would actually not know that it was a predatory loan because you did not check. That is the situation when you would want to buy a predatory loan. And I think that is what has been happening.

As far as the yes or no question that you asked earlier, responsibility? I would give, for the rating agencies, maybe they did not do as good a job as they could. But ultimately I do not, in the end, see them as the primary culprit. They are trying to sell a product, accurate ratings. And maybe I will regret this statement later, but I would probably give them more or less a pass.

But I do think that the investment banks are very much responsible for this. I think that a lot of them knew or should have known that this sort of thing could happen and they were profiting from the transaction fees in packaging and selling these loans.

If they find out that it is a predatory loan or that it does not suit the borrower's needs, that just means they cannot go through with the deal and they are going to lose all the revenue they would have made in going through with the deal.

If the loan does not pay out, well, it is bad for the investors. But ultimately that does not come out of the investment bank's pocket. So I think they are very much responsible.

Mr. EGGERT. I think there are sort of two levels of responsibility, since if I were in moot court there would have to be two of everything.

The first level of responsibility is what has been done with the loans the last year or two? And I think we do see responsibility. I think there could have been a lot more done to look at the individual loans. I think there has been—what securitization does is it values quantity over quality. And as long as there were a lot of loans going through and they could push the risk off in various ways, then it did not matter if many of these loans, objectively looking at them, were bad loans.

But I think the other aspect of responsibility is in designing the market. If you look at predatory lending laws, you see that the rating agencies have, to some extent, fought against good assignee liability, have essentially told the States if you have assignee liability that we do not like, we are not going to rate in your State, and have to some extent attempted to act as a super legislator deciding what our assignee liability laws should be.

As a result, I think in some places we have had less strong predatory lending laws than we might have had.

Securitizers and that industry can do better than borrowers and should bear the responsibility for predatory loans. They have better access to information about who the bad lenders are, about what the bad scams are. They are better able to determine if a loan is above market interest, which many loans—the essence of a predatory loan often is that it is way too expensive. And the secondary market can see which loans are way too expensive and want to buy loans that are too expensive because they are more profitable. Not that they want to seek out predatory loans, but if they have above-market loans, that is good.

And so I think we need to put the onus on them to stop the problem because they are better able to do it, certainly than the borrowers are.

Mr. KORNFELD. Mr. Chairman, could I just respond to the one statement in regards to the rating agencies?

Chairman REED. Absolutely, Mr. Kornfeld. Yes, you may.

Mr. KORNFELD. Thank you.

Chairman REED. This is not a debate, but please.

Mr. KORNFELD. I understand it is not a debate.

The rating agencies do not opine whether law is good, whether law is bad, whether this predatory lending law is a good thing or a bad thing.

What we are looking for, in terms of on the predatory, and we have both published in terms of on this, is can the risk be quantified? As long as the risk can be quantified, we are able to rate the other securities.

I am not, off the top of my head, I am not the expert in terms of within Moody's on New Jersey's law. But for instance, New Jersey does have a law which has been clearly defined and has, as Senator Menendez has pointed out, has still allowed for lending to be done within the State.

Chairman REED. Ms. Barnes, yes.

Ms. BARNES. I would echo a lot of the comments that Warren has just stated. Standard & Poor's would just like to go on record that we support all of the predatory lending laws that are—in fact, as long as the damages are quantifiable and that the terms are clear, meaning people can definitively determine whether they are adhering to the law or breaking the law. So terms like net tangible benefit are the ones that put into question that cause the secondary markets concern.

Chairman REED. Thank you very much. I want to thank my colleagues. This has been a very serious and a very thoughtful discussion about a problem that is affecting many, many Americans across the country. And I think it has given us all an opportunity to reflect, and also to think of ways in which we might be helpful.

And I think the first response, and the best response, will come from the industry. So I would hope in this case these discussions might prompt some serious thought about continued efforts by the industry, all segments in the industry, to respond. And perhaps we can be helpful in that regard, too.

But thank you all for your very fine testimony, and thank my colleagues.

I would just say that some of my colleagues will have written questions, additional written questions. I will ask them to get them into the committee by April 26th, and within 10 days after that if you could respond, I would appreciate it.

Thank you very much.

The hearing is adjourned.

[Whereupon, at 5:10 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions for the record follow:]

STATEMENT OF GYAN SINHA
SENIOR MANAGING DIRECTOR, HEAD OF ABS & CDO RESEARCH
BEAR, STEARNS & CO. INC.

BEFORE

SECURITIES, INSURANCE AND INVESTMENT SUBCOMMITTEE OF THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

APRIL 17, 2007

Good Afternoon Chairman Reed, Ranking Member Allard and members of the Senate Subcommittee on Securities, Insurance, and Investment. My name is Gyan Sinha. I am a Senior Managing Director at Bear Stearns and head the division responsible for market research regarding Asset-backed Securities and Collateralized Debt Obligations. In that capacity, I analyze mortgage loans and securities in the private-label market. The nonprime sector constitutes a portion of the private-label market.

I have been invited to present testimony regarding four matters related to the mortgage securitization process and recent developments in the market place:

1) The mechanics of the nonprime mortgage securitization process;

2) The impact of recent increases in defaults and delinquencies on the nonprime securitization market;

3) Characteristics of the securitization process that present challenges in mitigating potential foreclosures; and,

4) Factors taken into consideration in the securitization process when assessing credit risk for mortgage-backed securities and monitoring assigned ratings.

I will address each of these issues, in turn, beginning with an overview of the mechanics of nonprime mortgage securitization.

Mechanics of Nonprime Mortgage Securitizations

Nonprime borrowers may obtain loans through mortgage brokers or retail lending establishments. Once a suitably large number of loans have been originated, the loans are often packaged as a portfolio and moved into securitization vehicles owned by a third-party. The securitization vehicle issues mortgage-backed securities, often referred to as MBS. The MBS generate revenue which finances the purchase of loans by the securitization vehicle.

The decision to buy loans from an originating lender for purposes of securitization is based on a determination of whether the loss-adjusted yield that can be generated from the purchase of the asset, after paying for financing expenses in the MBS market, is commensurate with the risk of the loans. If the securitization sponsor elects to move forward with the purchase after making this determination, it also will conduct due diligence before acquiring the assets.

The cash flows from the loans then are divided among debt classes. These debt classes are subdivided into senior, mezzanine and subordinate, with ratings ranging from triple-A to double-B. Typically, any losses on the underlying loans are allocated to the lowest-rated bonds initially and then move up the ratings scale as the face amount of each class is eroded due to higher and higher losses.

The amount of MBS that can be issued is determined based on criteria established by the bond rating agencies. Typically, the amount of MBS that can be issued is less than the par amount of mortgage loans. This difference is referred to as "over-collateralization." The claim of equity holders in the securitization is comprised of two components: the over-collateralization amount and the difference between the net of servicing expenses and the weighted average cost of debt. The equity holder's cash flow entitlement is net of any current period losses.

MBS are purchased by a wide variety of investors. For the senior debt buyers, MBS have provided a preferred alternative to other credit-risky instruments such as corporate bonds. As a result, institutions with low funding costs, such as banks, view them with favor and have purchased many of them.

In recent years, the lower-rated tranches have been bought, primarily, by Collateralized Debt Obligations, also referred to as CDOs. CDOs, in turn, issue debt to finance the purchase of these bonds. There has been significant foreign investment in CDOs that further spreads market risk.

Finally, at the lower end of the capital structure, hedge funds tend to purchase the speculative grade and unrated equity portion of the MBS. In making purchase determinations, hedge funds tend to employ the same risk-adjusted calculus as used by the original buyer of the loans.

Effect of Recent Increases in Defaults and Delinquencies

The Subcommittee has asked about the effect of recent increases in defaults and delinquencies on the nonprime securitization market. Without doubt, the rise in defaults and delinquencies has had a significant impact on the nonprime securitization market. At this juncture, we are witnessing a significant correction in the MBS market for nonprime loans. A number of originators have exited the industry or been sold to larger, better-capitalized entities. The risk-profile of the loans being considered for funding in the nonprime market has generally improved as loan originators have moved to change loan-to-value limits, require multiple appraisals on collateral property, and enhanced verification of borrower income. Valuations appear to have stabilized, but are at lower levels than at the beginning of the year.

For those that remain in the market, significant challenges will persist. Managing the credit risk of a nonprime portfolio in an environment of stagnant or even declining real estate prices will require a different strategy than that used during the last five years. Servicers of securitized loans generally do not own them, which further complicates efforts to manage nonprime credit risk. Servicers will have to adjust debt collection strategies and explore innovative approaches that will enable borrowers to avoid foreclosure while working through temporary financial difficulties. From an economic value perspective, it is in the interest of all parties in a securitization that the value of the underlying loans in a securitization is maximized. Accordingly, servicers will have strong incentives to offer loss mitigation options to borrowers that have a reasonable chance of succeeding. This is particularly true given that the alternative will be to foreclose and ultimately attempt to sell the property in an unfavorable housing market.

Impediments to Mitigation of Foreclosure

The Subcommittee has asked me to discuss impediments in the securitization process that would make it more difficult to mitigate potential foreclosures. Loan modifications present one of the most viable vehicles for mitigating foreclosures under appropriate circumstances. However, it is important to note that there is considerable variation based on tax law and contractual requirements across securitization transactions with respect to the scope of permissible loss mitigation options. For example, some grant loan servicers significant discretion in modifying loans, others permit some modifications, and some essentially prohibit such modifications.

Despite these various limitations, servicers are undertaking various loss mitigation steps within the flexibility that they have under existing securitization agreements, including loan modification. It should be noted that variations among transactions and borrowers preclude a uniform approach to loan modifications. Finally, loan modifications that involve debt forgiveness may create a tax liability for the borrower.

Credit-risk Assessment

The Subcommittee has inquired about factors taken into consideration in connection with credit-risk assessments and about ongoing monitoring of assigned ratings. Credit-risk is evaluated, in large part, based on information provided by national credit reporting agencies. Generally, nonprime borrowers have credit scores that are lower than the national average. These lower credit scores are typically the result of repeated episodes of delinquency or default with respect to automobile, credit card, or mortgage debt. There is a well-established relationship between prior delinquencies or defaults and the risk of future delinquencies or defaults. Specifically, borrowers who have had past delinquencies or defaults are more likely to default or become delinquent on future debts. Accordingly, such loans often are deemed to present a greater credit-risk than loans made to borrowers who have few delinquencies or defaults and carry higher interest rates.

To the extent the Subcommittee is interested in the ratings assigned to the debt tranches by credit rating and ongoing monitoring of those ratings, the credit rating agency witnesses appearing can address those issues.

Conclusion

In closing, I would like to emphasize that while the issues surrounding the recent events in the nonprime market warrant serious attention, the securitization process that has occurred for over 25 years has resulted in considerable benefits to borrowers and the broader economy. This market has allowed American homebuyers to tap into a rising global pool of savings through increased credit availability, raising overall homeownership rates in the United States. At the same time, securitization also has allowed this increase in mortgage lending to be achieved without an excessive concentration of risk. This has permitted any shocks to the system, such as the current one, to be absorbed without major disruption to the broader economy. Thus, it is important in evaluating any potential responses to the current concerns to ensure that the availability of mortgage credit is not unduly restricted and the historic benefits provided by the securitization process are not eroded.

I would be happy to answer any questions that you may have.

Witness Contact Information

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WRITTEN STATEMENT

**OF DAVID SHERR,
MANAGING DIRECTOR AND GLOBAL HEAD OF SECURITIZED PRODUCTS,
LEHMAN BROTHERS INC.**

**BEFORE THE
SENATE BANKING SUBCOMMITTEE
ON SECURITIES, INSURANCE, AND INVESTMENT**

APRIL 17, 2007

Chairman Reed, Ranking Member Allard, and members of the Subcommittee:

I am David Sherr, Managing Director and Global Head of Securitized Products at Lehman Brothers Inc. I appreciate the opportunity to appear before the Subcommittee today on behalf of Lehman Brothers Inc. ("Lehman"). Lehman, an innovator in global finance, serves the financial needs of corporations, governments and municipalities, institutional clients, and high net worth individuals worldwide. Founded in 1850, Lehman maintains leadership positions in equity and fixed income sales, trading and research, investment banking, private investment management, asset management and private equity. The Firm is headquartered in New York, with regional headquarters in London and Tokyo, and operates in a network of offices around the world. Lehman is pleased to share with the Subcommittee its experience in the subprime mortgage securitization process.

The Mechanics and Incentives of the Subprime Mortgage Securitization Process

The subprime mortgage securitization market is a part of the broader mortgage securitization market. Mortgage securitization was developed approximately 30 years ago. Since then, the mortgage-backed securities market has grown to become the largest fixed income segment of the nation's capital markets, with approximately $6.5 trillion of securitized mortgage debt outstanding as of the end of 2006.

While this Subcommittee is focused on very recent instances of foreclosure, please remember that for three decades mortgage-backed securities have provided, and continue to provide, great benefits to the average American. Because of mortgage securitization, loans for home purchases have become more widely available for all borrowers, including those considered subprime. If not for the innovation of mortgage securitization, the United States would not have become the nation of homeowners that it is today, with homeownership close to its highest level in our history – almost 70 percent overall.

Before securitization became widespread, banks had relatively limited capital available to make loans to prospective homeowners. Their lending activities were constrained because they had no effective means to convert their existing loan portfolios to cash that could be used to make additional loans. There was no liquid market for mortgage loans. With the advent of the securitization market, banks (and other financial institutions) have been able to monetize their existing loan portfolios and to transfer the risk associated with those loans to sophisticated investors. As a result, more money is available to borrowers who wish to buy their own homes, or to refinance their existing mortgage loans on more attractive terms.

Securitization represented a new way to fund America's demand for home mortgages by accessing the significant liquidity of the capital markets. Borrowers continue to take out loans with local banks and state-regulated mortgage companies, just as they always have. Those lenders determine if they want to retain mortgage loans or transfer them into the secondary market either in whole loan form or through securitization. If a lender elects securitization, the loans are assembled into pools by sponsors, such as Lehman. The lenders continue to stand behind their decision to make a loan by making representations about the loan quality. After the rating agencies have completed their review of the pool, the loans are conveyed to a "securitization trust" and interests in the loans are sold to investors in the form of securities. From then on, payments made by borrowers on their mortgage loans are applied to make payments on the securities.

It should be noted that sponsors of mortgage-backed securitizations, such as Lehman, are careful about choosing the lenders with whom they do business. All the lenders selling loans to Lehman are either federally chartered banks or state-regulated originators. Prior to establishing a business relationship with a particular lender, Lehman spends time learning about that lender, its past conduct and its lending standards. Further, Lehman, like other securitization sponsors, performs a quality check on the mortgage loans before purchasing them. These reviews include sample testing to confirm that loans were underwritten in accordance with designated guidelines and complied with applicable law.

The Subcommittee has asked about the "incentives" of the participants in the subprime mortgage securitization process. Consumers benefit because they are able to obtain loans with a greater variety of payment structures. This is especially true for borrowers considered to be subprime, many of whom did not have access to mortgage loans, and so could not purchase their own homes, prior to the creation of the securitization market. Lenders benefit because they are able to free up capital to make additional loans. And investors benefit because mortgage-backed securities present a diverse range of investment options, with investors being able to choose the type of product and risk/reward profile appropriate for their needs.

It cannot be emphasized enough that no participant in the securitization process has any incentive to encourage the origination of loans that are expected to become delinquent. No financial institution would knowingly want to make or securitize a loan that it expected would go into default. Rather, the success of mortgage-backed securities as an investment vehicle depends upon the expectation that homeowners generally will make their monthly payments, since those payments form the basis for the cash flows to bondholders.

The Effect Recent Increases in Defaults and Delinquencies Have Had on the Subprime Securitization Market

The market currently is adapting to changes in the performance of subprime loans, just as it adapts to any other change that significantly affects participants in the mortgage securitization process. Importantly, the interests of all market participants, from the borrower to the investor, are generally aligned with respect to reducing the number of defaults and delinquencies. Everybody loses when the only viable option for managing a loan is foreclosure. Given the general alignment of interests, it is not surprising that the market is adjusting rapidly to minimize foreclosures and improve the performance of securitized loans.

For example, mortgage loans to subprime borrowers are now being underwritten according to stricter guidelines to reflect current market conditions. At the same time, the volume of securitizations has been reduced, as has the range of mortgage products being offered to consumers. Further, financial intermediaries are pushing forward new practices, including contacting borrowers early when their loans appear to be at risk for default. All these adjustments in the market are being driven by the fact that nobody benefits from the underwriting of loans that do not ultimately perform.

We must be careful, however, not to overreact to the increased number of delinquencies and defaults, which could lead to an undue tightening of credit available to prospective homeowners. At the same time that we consider how the market has changed, we should also keep in mind how it has stayed the same. The vast majority of subprime borrowers remain current in their loan obligations. For those borrowers, the mortgage securitization process continues to provide unprecedented access to the capital markets, so that they can purchase their own homes.

Mitigation of Potential Foreclosures

Mortgage securitization structures provide flexibility to avoid foreclosures. Much of that flexibility rests in the hands of the financial institutions that service mortgage pools. Servicers collect principal and interest payments from borrowers, and also make decisions on the administration of the pooled home loans. They have flexibility to work with borrowers so that loan payments will be made, while exercising the right to foreclosure only as a last resort.

Notably, many of the largest servicers are commercial banks, which also hold substantial mortgage loans in their own portfolios. Regardless of whether these banks are managing their own portfolios or servicing loans in a securitized pool, we expect they generally will follow the same prudent "home retention" practices in an effort to avoid foreclosures.

The title of this hearing asks about the "role of securitization" in "subprime mortgage market turmoil." Because none of the participants in the securitization process benefit from foreclosures, the market has evolved, and will continue to evolve, so as to minimize the number of foreclosures. Servicers are ramping up their "home retention" teams both with respect to early intervention for "at risk" borrowers and loan modification programs for borrowers that are in financial distress. To the extent that the servicer currently lacks any necessary powers to reduce the number of foreclosures in a prudent manner (and Lehman does not believe that such powers are materially lacking), the market will adjust by enhancing the servicer's flexibility in future contracts. In short, we expect that the subprime mortgage securitization process will continue to create opportunities for a long-ignored segment of the population to join and remain in the ranks of American homeowners.

Thank you again for the opportunity to be here today. I welcome any questions you might have.

TESTIMONY OF SUSAN BARNES
MANAGING DIRECTOR
STANDARD & POOR'S RATINGS SERVICES

SUBMITTED TO THE SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT
U.S. SENATE BANKING, HOUSING, AND URBAN AFFAIRS COMMITTEE

"SUBPRIME MORTGAGE MARKET TURMOIL: EXAMINING THE ROLE OF SECURITIZATION"

April 17, 2007

Mr. Chairman, Members of the Subcommittee, good afternoon. I am Susan Barnes, Managing Director of Residential Mortgage-Backed Securities for Standard & Poor's Ratings Services ("S&P"). I appreciate the opportunity to appear before you today.

As requested, my testimony today will cover the following topics:

- The mechanics and structure of the mortgage loan securitization business;
- The residential mortgage-backed securities ("RMBS") ratings analysis with particular focus on the factors we consider when evaluating mortgage securities backed by subprime mortgage loans; and
- The impact of current mortgage loan delinquencies and defaults on the performance RMBS transactions backed by subprime mortgage loans.

Let me begin by first saying, S&P has been closely following the recent events in the subprime mortgage market and their impact on existing and future ratings of residential mortgage-backed securities.

S&P, which is a part of The McGraw-Hill Companies, Inc., began its credit rating activities ninety years ago, and today is a global leader in the field of credit ratings and credit risk analysis. Over that time, S&P has established an excellent track record of providing the market with independent, objective and rigorous analytical information and credit rating opinions. A rating from S&P represents our opinion on the future creditworthiness of a specific obligor or a particular financial obligation. In brief, a rating is our opinion on the future likelihood of payment of principal and interest on a security in accordance with its terms. Our ratings have been shown to be reliable indicators of the potential likelihood of default, in the aggregate, by rating category. Once published, we monitor ratings on an ongoing basis.

Although we comment on credit risk, our credit rating opinions are not intended to be and are not to be viewed as:

- Recommendations to buy, sell, or hold a particular security;
- Comments on the suitability of an investment for a particular investor or group of investors;
- Personal credit recommendations to any particular user of the ratings;
- Approval of possible extensions of credit or particular loans; or
- Investment or financial advice of any kind.

More detail on the nature of our rating opinions is available on our Website at ***www.standardandpoors.com.***

Credit ratings are an important component of the global capital markets and over the past century have served investors extremely well by providing an effective and objective tool to evaluate credit risk. Credit ratings provide reliable standards for issuers and investors around the world, facilitating efficient capital raising and the growth of new markets. S&P conducts its business grounded in the cornerstone principles of independence, transparency, credibility and quality. These principles have driven our long-standing track record of analytical excellence and objective commentary.

Studies on rating trends have repeatedly shown that there is a clear relationship between the initial rating assigned by S&P and the likelihood of default: the higher the initial rating, the lower the probability of default and vice versa.

For structured finance transactions, our Global Structured Finance Default Study published in January 2007 shows that the relationship between ratings and observed default rates was consistent with our expectations. The average one-year default rates since 1978 were near zero (0.04%) for investment grade securities and 2.33% for speculative grade securities. The same pattern prevailed across two- through five-year periods while the default rates were increasing. For example, the average five-year default rate for investment grade securities was 0.87% and 15.42% for speculative grade securities. Specifically, for the last five years (beginning in January 2002 and ending in December 2006), the five-year default rate among structured finance securities rated investment grade globally was 1.29%, compared with 16.92% for structured finance securities rated speculative grade.

The Mechanics of the Mortgage Loan Securitization Business

The dynamics of today's mortgage banking business rely heavily on the ability to securitize mortgage loans. Typically, a mortgage originator receives an application for a loan by a prospective borrower, usually through a mortgage broker or via the lender's retail branch office network. An originator will underwrite the loan (decide whether to lend the funds to a borrower) by looking at the following four factors: the borrower's current income in relation to the size of the mortgage loan, the borrower's credit history (including the FICO score), the appraised value of the house that secures the mortgage, and the size of down payment for the loan. The market generally refers to mortgage loans as "prime" or "subprime." Prime mortgage loans are generally granted to borrowers with average FICO scores of 730, with loan-to-value ratios of 50-80%, and borrower income to loan payment ratio no greater than 36%. Subprime mortgage loans are typically granted to borrowers with average FICO scores of 610, loan-to-value ratios of 80-100%, and borrower income to loan payment ratios of 45-50%. Once the loan is underwritten and approved in accordance with the parameters of the lender's underwriting standards, the borrower receives the proceeds of the mortgage loan.

Historically, a lending institution used its own capital funds or proceeds from unsecured borrowing to provide these mortgage loans, thus self-funding the lending process. The institution would hold the mortgage loans on its balance sheet, and would bear all of the credit and interest rate risk of the mortgage loan for the entire term of the loan. The institution would also bear the funding risk: the risk of mismatch between the maturity of the mortgage loan and the maturity of its unsecured borrowing. This funding risk was magnified in times of volatile interest rates, making risk management difficult. Credit, interest rate, and funding risk contributed significantly to the banking system stress in the early 1980's and led to the development of the mortgage finance market.

Today, once a mortgage loan is originated, the originator generally may:

1. Hold the mortgage loan on its balance sheet and take both the credit and interest rate risk;
2. Sell the mortgage loan to another financial institution as a whole loan sale;
3. Sell the mortgage loan directly into a securitization; or
4. Sell the mortgage loan to a mortgage conduit or loan aggregator, who in turn, may securitize the mortgage loan.

Today's mortgage market consists of thousands of mortgage lenders that either securitize their own mortgage loans or sell loans to conduit operations set up to issue mortgage-backed securities to capital market investors. In 2006, over 55% of all mortgage loans originated were packaged together and sold as mortgage-backed securities into the capital markets to investors.

A mortgage-backed security generally represents an undivided interest in the mortgage pool and the holders of the mortgage-backed securities become the ultimate owners of the loans. As the borrowers repay their principal and interest obligations each month, those funds are collected and passed through to the investors. The holders of the mortgage-backed securities have the rights to receive the future cashflows generated by the repayment of interest and principal on the underlying mortgage loans. These cashflows are distributed to investors in accordance with the predetermined structure and payment priorities agreed upon at the closing of the mortgage-backed securities transaction.

Essentially, the issuance of mortgage-backed securities channels funds from investors in the capital market directly to homeowners, through the intermediary of the mortgage originators. The securitization process allows subprime lenders access to liquidity to fund their mortgage originations. Furthermore, since most of the credit risk associated with mortgage lending gets transferred or sold through the securitization process, from the lender to the security-holder, securitization is not only a source of diversified collateralized funding, but also a critical risk management tool.

The Structured Finance Credit Rating Process

As a fundamental matter, and in their most simple form, structured financings legally isolate assets from any previous owner's insolvency, to enable a purchaser of securities backed by those assets to rely solely on the creditworthiness of those assets. Thus, the structure seeks to insulate payment on the structured finance securities from the risk of default of any such previous owner that is unrated or has a credit rating lower than the desired rating of the structured financing. In other words, S&P is able to base its ratings on the credit aspects of the isolated assets, or asset pools, without regard to the creditworthiness of any previous owner, seller, or contributor of the assets.

Our credit analysis generally addresses (1) the credit quality of the pool of securitized assets, (2) structural and legal risks of the transaction, (3) the payment structure and the cashflow mechanics of the securities, (4) relevant operational and administrative risks, and (5) any other sources of payment for the securities, e.g., guarantees, swaps, or other forms of credit support for the transaction. This analysis enables us to reach an opinion on the creditworthiness of the structured finance security, commonly stated as: an opinion on the future likelihood of the payment of principal and interest on the security in accordance with its terms.

Our rating analysts review information submitted by participants in the transaction, e.g., issuers, underwriters, and servicers. In addition, we use various quantitative techniques and models to enhance our understanding of the performance of the transaction. During the rating process the transaction participants usually refine transactional (credit and structure) elements to reach the final structure and credit profile of the transaction, and may submit additional or revised information for our review. The analyst evaluates the information and prepares a recommendation for the rating committee.

To determine a rating, we convene a rating committee comprised of S&P personnel who bring to bear particular credit experience and/or structured finance expertise relevant to the rating. The qualitative judgments of the committee are an integral part of the rating process as it is through this process that asset and transaction specific factors, as well as changes in the market and environment can be best assessed and addressed in the rating outcomes.

Once a rating is determined by the rating committee, S&P notifies the issuer and disseminates the rating to the public for free by, among other ways, posting it on our Website, www.standardandpoors.com. Along with the rating, we frequently publish a short narrative rationale authored by the lead analyst. The purpose of this rationale is to make public the basis for S&P's analysis and enhance transparency to the marketplace.

After a rating is assigned, S&P monitors or "surveils" the ratings to adjust for any developments that would impact the original rating. The purpose of this surveillance process is to ensure that the rating continues to reflect our credit opinion based on our assumption of the future performance of the transaction. The surveillance process varies based on our assessment of risks to the transaction. If information leads the surveillance analyst to believe a rating change is warranted, the analyst will present the information to a rating committee, which will then determine whether the rating should be changed. When a rating change is anticipated or occurs, our analysts similarly publish the new rating and a related ratings rationale.

S&P has a long-standing policy of providing our public credit ratings and the basis for those ratings broadly to the investing public as soon as possible and without cost. Public credit ratings (which constitute more than 90% of our credit ratings in the United States) are disseminated via real-time posts on our Website and through a wire feed to the news media as well as through our subscription services.

EVALUATING SUBPRIME MORTGAGE BACKED SECURITIES

We turn now to a more detailed description of the securitization of subprime mortgage loans.

Subprime Mortgage Loans

Subprime mortgage loans are made to borrowers who typically have weak credit histories. In the past two years, subprime mortgage loans accounted for about 20% of all mortgage loans. However, if we look at only adjustable rate and interest only mortgage loans, subprime loans accounted for 40% of these mortgages in 2006.

The increased availability of mortgage credit to subprime borrowers has contributed to the increase in home ownership rates across the United States. This increase has occurred simultaneously with a rise in originators loosening their underwriting guidelines. This loosening of underwriting standards included low equity and little to no income verification loans to first time homebuyers with weak credit histories.

Assessing Credit Risk of Mortgage-Backed Securities

S&P rates RMBS by analyzing the credit characteristics of the mortgage pool. The rating of each "tranche" or layer of an RMBS transaction (sometimes referred to as a Series) is determined by analyzing the amount of credit enhancement provided to support the tranche. Credit enhancement is the protection (i.e., additional assets or funds) needed to cover losses under stress scenarios to achieve a desired credit rating on a mortgage-backed security. A stress scenario simulates changes in the performance of the mortgage loan due to changes in economic and market conditions. Typical forms of credit enhancement include:

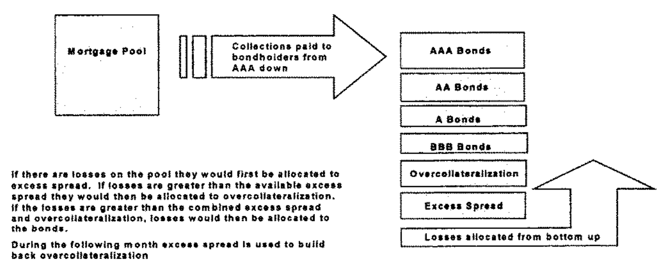
- Excess spread: the difference between the amount of interest paid on the mortgage loans and the amount of interest owed on the bonds;
- Overcollateralization: a greater principal amount of mortgage loans in a pool than mortgage bonds offered. (For example, if a transaction is based on a mortgage pool of $1,000,000 and

only $990,000 in mortgage bonds are issued, there is $10,000 –or 1.00%-- in "overcollateralization".)

- Subordination: prioritizing the manner in which mortgage loan losses are allocated to the various layers of bonds.

For a given rating category, to determine the appropriate level of credit enhancement, we assess the sufficiency of the assets available to pay the given tranche based on the priority of payments established by the transaction documents. In the example below, the AAA bonds are supported by the AA, A, BBB, overcollateralization and excess spread, while the BBB bonds only have the benefit of credit enhancement in the form of overcollateralization and excess spread. Therefore, the credit performance of each tranche is dependent upon the amount and availability of credit enhancement provided to a particular tranche.

Typical Subprime Transaction



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As a practical matter, S&P's analysis of an RMBS transaction breaks-down into the following four categories:

1. Conducting a loan-by-loan collateral analysis using S&P's Loan Evaluation and Estimate of Loss System ("LEVELS") Model;

2. Reviewing the cashflow aspect of the structure using our Standard & Poor's Interest Rate Evaluator ("SPIRE") Model by simulating the cashflow of an RMBS transaction's underlying residential mortgage loans;
3. Reviewing the originator and servicer operational procedures; and
4. Reviewing the transactional documents for legal and structural provisions.

Once a rating is issued, S&P conducts ongoing surveillance.

1) Loan Level Collateral Analysis (LEVELS Model)

S&P evaluates the overall creditworthiness of a pool of mortgage loans by conducting loan level analysis -- each mortgage loan is analyzed individually. This analysis is performed using our LEVELS model. Our criteria do not dictate the terms of the mortgage loans; rather the originator in the underwriting process determines these terms. S&P will evaluate the loan characteristics which include, but are not limited to: the amount of equity a borrower has in the home; the loan type; the amount of income verification; whether the borrower occupies the home; and the purpose of the loan. This analysis allows us to quantify multiple risk factors, or the layered risk, and allows for an assessment of the increased default probability that is associated with each factor. Based on the individual loan characteristics, the LEVELS model calculates probabilities of default and loss realized upon default, and on a pool basis, helps us determine how much credit enhancement is needed to support the rated bonds.

In particular, by using the LEVELS loan level analysis, S&P was able to identify the trend of deteriorating credit quality of the mortgage loans in 2006, and to increase the credit enhancement requirements necessary to maintain a given rating. In essence, we increased the probability of default assumptions for loans with little to no equity in May 2006 and correspondingly increased our credit enhancement requirements. Credit enhancement requirements for the average subprime transaction rated in 2006 increased by 50% as compared to deals from 2005.

2) Review of the Cashflow Modeling (the SPIRE Model)

An important aspect of our rating process is assessing the availability of cashflow (monthly payments) generated by the mortgage loans and available to pay principal and interest on the bonds presented to us for rating. The cashflow assessment, which is accomplished through the use of our SPIRE model, assumes certain stresses related to the timing of scheduled payments, as well as prepayments on the mortgage loans. The model uses the S&P mortgage default and loss assumptions (generated by the LEVELS model) and interest rate assumptions. The model simulates the cashflow of an RMBS transaction's underlying residential mortgage loans under various stress scenarios, and evaluates the availability and impact of various credit enhancement mechanisms on the transaction.

3) Review of the Originator and Servicer

S&P reviews the practices, polices and procedures of the originators and servicers primarily to gain comfort with the ongoing orderly performance of the transaction. For an originator, the topics reviewed include, but are not limited to: loan production practices such as broker and appraiser monitoring; loan underwriting; and quality control practices and findings. This review is conducted to provide S&P a sense of the reliability of the information provided to us when a rating is requested and on which we base our analysis. It is important to stress that S&P neither expects, nor requires, a given origination process, but we will adjust the credit support calculation based on the underwriting employed at origination.

For servicers, the review is different and more in depth than that for originators, as the servicer must continue to service the mortgage loan on behalf of the investors. Generally, for S&P to be willing to rate a transaction, the servicer must have a servicer evaluation of at least "Average", as provided in our servicer evaluation criteria. More detailed explanations of the servicer evaluation process can be found on our Website. In general, servicer reviews encompass: cash management; investor reporting; management of defaulted loans and management of properties acquired in foreclosures ("Real Estate Owned" or "REO"); as well as internal processes and controls. Servicer performance is reviewed on an ongoing basis in accordance with our review cycles and our assessment of performance risk.

4) Review of Transactional Documents

S&P will review the legal documents, and where appropriate, opinions of third party counsel that address transfer of the assets and insolvency of the transferor, as well as security interest and other legal or structural issues. S&P reviews the underlying documentation in order to understand the payment and servicing structure of the transaction. The underlying documentation forms the legal basis for the allocation of collections and losses to the various security holders.

Unless the credit risk of an entity is factored into the rating, S&P's analysis assumes the bankruptcy of the transaction participants in order to base its credit judgment solely on the performance of a given asset pool.

Ongoing Surveillance

Mortgage loan pool performance information is disclosed in a report prepared monthly by the servicer, in accordance with industry standards. Prior to issuing a rating on a transaction, S&P analysts review the form of the monthly servicer report to determine whether it contains sufficient information to enable us to do our scheduled surveillance.

The surveillance process seeks to identify those issues that should be reviewed for either an upgrade or a downgrade because of asset pool performance that may differ from the original assumptions. The surveillance function also monitors the credit quality of all entities that may be supporting parties to the transaction, such as liquidity providers. Analysts review performance data periodically during the course of the transaction, and present that analysis to a rating committee for review of whether to take a rating action. The rating committee then decides whether the rating change is appropriate. For changes to public ratings, a press release is normally disseminated.

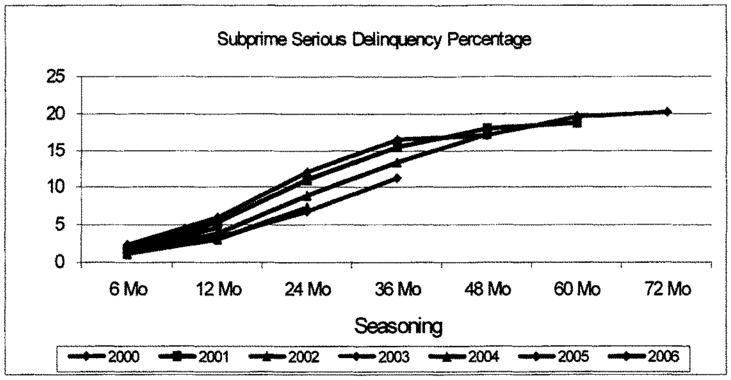
Additionally, the transaction documents generally require transaction participants to inform S&P of any changes to the original structure, including management, credit policy, system changes, or any change in the status of the parties involved in the transaction. The information is used as part of surveillance maintenance for the transaction, based primarily on our view of the likely risk of downgrade or upgrade of the transaction.

Between 1978 and 2006, S&P issued 46,912 RMBS ratings. 85% were initially rated investment grade: AAA to BBB. Of the $3.6 trillion in par value of RMBS outstanding as of January 1, 2007, 88.1% are rated AAA. In general, then, the vast majority of residential mortgage-backed securities ratings have been investment grade and very stable. S&P believes its models have captured the deterioration in the credit quality of the 2006 subprime mortgage loans.

Mortgage Loan Default and Delinquency Impact on the Subprime Securitization Market

The poor performance of subprime mortgage loans originated in 2006 has dampened investor appetite for subprime mortgage bonds. Accordingly, the interest rate sought by investors, given their risk appetite for mortgage bonds, has increased as compared to mortgage-backed bonds issued in prior years. Therefore, the securitization of subprime loans has become less economical, resulting in fewer subprime mortgage loan originations in 2007.

While delinquencies for the 2006 vintage are much higher than what the market has experienced in recent years, they are not atypical with past long-term performance of the RMBS market. For instance, serious delinquencies (90-plus days, foreclosure, and REO) for 2006 deals are nearly equal to delinquencies reported for the 2000 vintage after similar seasoning as evidenced by the chart below. However, we do expect the loans originated in 2006 will be the worst performing in recent history.



Overall, S&P forecasts losses ranging from 5.25% to 7.75% for the subprime mortgage loans contained in RMBS transactions rated in 2006. This is slightly above the losses incurred by subprime mortgage loans in RMBS transactions rated in 2000, the previous worst performing year, with average cumulative losses of about 5%.

We expect losses, and therefore negative rating actions, to keep increasing in the near-term relative to previous years because of likely minor home price declines through most of 2007. However, our simulations continue to reveal that as long as interest rates and unemployment remain at historical lows, and income growth continues to be positive, there is sufficient protection for the majority of investment grade bonds.

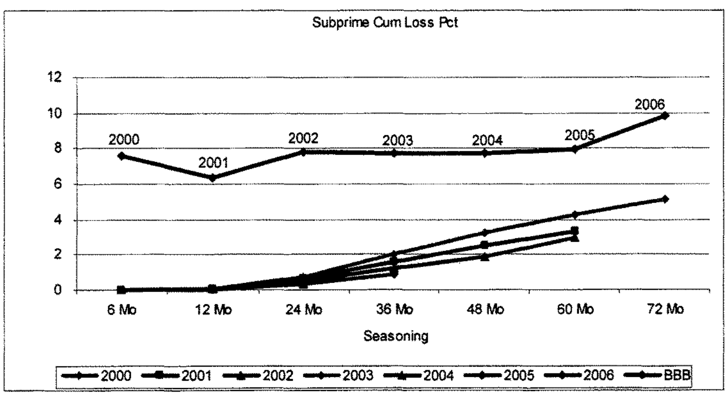
Subprime transactions rated in 2006 have been performing worse than in recent vintages. This performance may be attributed to a variety of factors:

- Lenders underwriting guidelines that stretched too far;
- Home price appreciation rates that are slowing; and
- Adjustable Rate Mortgage Loans that in rising interest rate environments create a heightened risk that borrowers may not be able to make larger payments.

S&P is actively monitoring subprime mortgage transactions on a monthly basis. While we do not expect there to be widespread downgrades, if the marketplace or economy as a whole experiences further financial distress, there could be a more prolonged period of negative performance, and S&P may need to take further rating actions.

As of April 12, 2007, S&P has downgraded 30 tranches of various 2006 subprime, Alt-A, and second-lien transactions, and placed 64 classes on *CreditWatch Negative*. To put this in perspective, there are currently 32 subprime transactions affected out of 1,025 rated subprime, transactions from 2006. That is only 0.3% of the outstanding ratings in the subprime area.

Subprime loan performance has declined, but as mentioned before, starting mid 2006, transactions began to include higher credit enhancement levels to account for increased probability of loss on subprime mortgage loan pools. The graph shows the average gap between losses experienced and losses that had served the basis for the analysis. The black line represents forecasted losses modeled into BBB rated tranches for the years 2000 through 2007.



Loss Mitigation Options in Securitization

Given the current credit stresses in the subprime market, many servicers and investors are exploring loss mitigation options available to them. S&P views loss mitigation efforts as an important part of servicing securitized mortgage loans. If a large percentage of mortgage loans go into default and foreclosure, the principal amount of losses may be greater than the losses that would result from forbearance or restructuring the mortgage loans.

In an RMBS transaction, mortgage loan servicers are obligated to act in the best interest of the investors and in accordance with standard servicing industry practices. Generally, servicers have the ability to mitigate losses by, among other things, entering forbearance agreements, extending the amortization terms, adding balloon payments, and/or restructuring or decreasing the mortgage rates. The primary purpose of loss mitigation efforts is to assist distressed borrowers who are temporarily unable to meet their mortgage obligations, minimize losses for the lender and the borrower, and to provide the opportunity for the borrower to cure any payment defaults. Forbearance agreements will generally defer payments of interest and capitalize the amounts of deferrals to be paid later during the term of the loan or as a balloon payment. Restructuring the loans may involve a combination of revisions to the interest rates and/or extensions to the maturity of the loans. A restructuring may also change the interest from floating rate to fixed rate, to avoid future stresses on a borrower's ability to pay.

We believe that a majority of the transactions allow the servicer to forbear or restructure mortgage loans within generally accepted servicer and industry standards. Some structured finance transactions may have provisions that limit a servicer's ability to restructure the mortgage loans to a certain percentage of the loans.

Given the many loss mitigation options, and the potential impact on investors, S&P is sensitive to the balance between the negative impact of the potential reduction in payments received from the borrower and available to pay investors, with the potential positive impact of a lower number of borrowers defaulting. So long as forbearance and restructuring of the subprime mortgage loans is consistent with industry standards, S&P believes that the ratings on the RMBS securities will not be negatively affected.

Financial Institutions and Lending Reform

S&P does not anticipate pervasive negative rating actions on financial institutions due to rising credit stresses in the subprime mortgage sector. Those financial institutions with diversified asset and mortgage lending and servicing operations, aligned with strong interest rate and credit risk management oversight, are well positioned to weather this downturn. Specialty finance companies that focus solely on the subprime market do not enjoy the protection provided by the diversification of loan portfolios and origination sources of the larger financial institutions, and have felt the effects of the current subprime credit stresses. Some of these entities have filed for bankruptcy protection and expect to restructure and emerge as viable entities. Others may look for opportunities for industry consolidation.

S&P strongly supports efforts to promote prudent lending practices. We have previously expressed this view in the context of predatory lending discussions, and perceive this matter as similar from a credit perspective.

For several reasons, we continue to urge that Congress exercise caution in crafting any legislative response to the current subprime lending situation. It is important to ensure that subprime borrowers continue to have access to fair and appropriate mortgage loans. If Congress should determine that legislation is the appropriate response, such legislation must provide clear guidelines to the market to ensure that there are no unintended consequences. Depending on the laws considered, a lender might reduce its activities within a given market sector if those loans are too costly to originate making it economically prohibitive. This would occur, for example, if a lending law imposes certain forbearance requirements intended to benefit borrowers or liability on purchasers or assignees of loans causing potential purchasers and assignees to reduce, or even cease, their purchasing of those loans to avoid liability under the law. Forbearance obligations (obligations to renegotiate the loans and/or reduce principal amount of the debt) may increase uncertainty in the performance of mortgage loan asset pools, and may affect repayment of the mortgage-backed securities. Investors may become unwilling to invest in subprime mortgage-backed securities, if the investment returns on the securities and/or the overcollateralization amounts are not raised commensurate with the increased risk. In other words, the return demanded by investors due to the uncertainty may make the origination and subsequent sale of such loans uneconomical, resulting in diminished availability of funds to borrowers.

From S&P's perspective, a second solution often proposed, a lending law that imposes liability on purchasers or assignees of mortgage loans ("assignee liability") to monitor and reduce unsafe practices in the lending market, also has significant downside risk. It might reduce the availability of funds to pay investors in securities backed by mortgage loans governed by the law, as the mortgage loan pool could be depleted by the amounts of any damages assessed to the trust. This would occur if the law placed responsibilities on the purchaser or assignee for violations attributable to the loan originator, even if the purchaser or assignee did not itself engage in prohibited lending practices.

If such laws were adopted, in performing a credit analysis of structured transactions backed by residential mortgage loans, S&P would evaluate the impact that such lending law might have on the availability of funds to pay the rated securities. To the extent that S&P determined that investors in securities backed by loans governed by a lending law might be negatively impacted, S&P could require additional credit support to protect investors or, in certain circumstances, preclude such loans from being included in S&P rated transactions. This again could reduce the availability of funds to prospective borrowers.

Conclusion

S&P recognizes the hardship the current subprime situation is placing on certain borrowers. However, as requested by this Subcommittee, we focused our comments on the effects the subprime market has on the financial sector.

As part of our rating and surveillance process for RMBS transactions, S&P actively monitors trends in the housing market, the mortgage finance market, consumer credit and the overall economy in order to ensure that our models, methodologies, criteria and analysis (which incorporate our views about possible future market scenarios) are fully informed. As a result, we were able to identify the trend of deteriorating credit quality of certain subprime mortgage loans in 2006 and increase the credit support necessary to support a given rating. Going forward we will continue to make changes to our criteria, models, methodologies and analysis to ensure that they appropriately reflect economic conditions.

Delinquencies and defaults in the subprime mortgage market have increased, and we expect that they will continue to increase. Therefore, we anticipate further downgrades in the ratings of the lower-rated tranches of subprime RMBS transactions. S&P continues to actively monitor the developments in the subprime market, and will continue to adjust its ratings accordingly.

Although S&P anticipates that subprime delinquencies and defaults will continue to increase, the pain in the financial sector from rising subprime mortgage loan defaults should be minimal for major banks because of their diversified income streams and because they have only a limited presence in this market. The financial players most affected will be stand-alone companies that specialize in subprime lending.

It is important to note that, absent the securitization market, the impact of credit stresses in the subprime mortgage sector would have been felt directly by the financial institutions. Thus, the securitization market has served to diffuse to a larger group of capital market investors, risks that 25 years ago would have gnawed at the foundations of the banking system. Securitization has proved to be both a source of increased liquidity in the mortgage market and a viable risk mitigation mechanism in periods of credit and market stress.

S&P also urges this Subcommittee to exercise care in crafting a response to the current credit stresses in the subprime market, as there is the potential for unintended consequences that could lead to further deterioration of the market and restrict liquidity in the subprime sector.

I thank you for the opportunity to participate in this hearing and am happy to answer any questions you may have.

Testimony of Warren Kornfeld
Managing Director
Moody's Investors Service

Before the
Subcommittee on Securities, Insurance and Investment
United States Senate

April 17, 2007

Good morning Chairman Reed, Ranking Member Allard, and members of the Subcommittee. My name is Warren Kornfeld, and I am a managing director for the residential mortgage backed securities rating team at Moody's Investors Service. On behalf of my colleagues, let me thank the Subcommittee on Securities, Insurance, and Investment for the opportunity to participate in today's panel on the role of securitization in the subprime mortgage market.

As you know, the subprime residential mortgage market has been attracting considerable attention recently because subprime mortgage loans originated in 2006 are experiencing more delinquencies and defaults than did loans originated during the prior few years. The steady increase in the risk characteristics of loans made to subprime borrowers over the past several years and the recent slowing in home price appreciation have been major contributors to this weakening performance. I will focus my statement on the process of securitizing subprime mortgages, Moody's views on the credit performance of the subprime mortgage securitization market, the credit factors that Moody's considers when rating mortgage-backed securities, and the structural features of securitizations that affect loan modification.

I would note at the outset that Moody's opinions speak only to one aspect of the subprime securitization market, specifically the credit risk associated with the bonds that are issued by the securitization structures. Moreover, the observations and information contained herein are largely based on data and experience related to the subprime mortgage securitizations that Moody's rates, and not on the broader subprime mortgage market, some of which was securitized by the originators and rated by rating agencies other than Moody's, and some of which was not securitized.

I. Background on Moody's

Rating agencies occupy a niche in the investment information industry. Our role is to disseminate information about the relative creditworthiness of, among other things, corporations, governmental entities, and pools of assets collected in securitized or "structured finance" transactions. Moody's is the oldest bond rating agency in the world, having introduced ratings in 1909. From its beginning, Moody's focused on rating debt instruments. By 1924, Moody's was rating nearly every bond in the United States bond market.

Today, we are one of the world's most respected, widely utilized sources for credit ratings, research and risk analysis and our Structured Finance Group is the leading source of credit ratings and research for the structured finance market. The firm publishes market-leading credit opinions, deal research and commentary, serving more than 9,300 customer accounts at some 2,400 institutions around the globe. Our ratings and analysis track debt covering more than 100 sovereign nations, 12,000 corporate issuers, 29,000 public finance issuers, and 96,000 structured finance obligations.

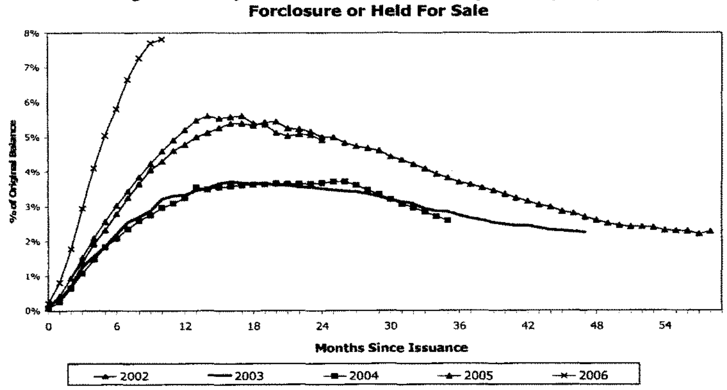
Moody's ratings are forward-looking opinions regarding relative expected loss, which reflects an assessment of both the probability that a debt instrument will default and the severity of loss in the event of default. Our ratings are expressed according to a simple system of letters and numbers, on a scale which has 21 categories ranging from Aaa to C. The lowest expected credit loss is at the Aaa level, with a higher expected loss rate at the Aa level, a yet higher expected loss rate at the A level, and so on down through the rating scale. In other words, the rating system is not a "pass-fail" system; rather, it is a probabilistic system in which the forecasted probability of future loss rises as the rating level declines.

Therefore, while Moody's ratings have done a good job predicting the relative credit risk of debt securities and debt issuers, as validated by various performance metrics including default studies, they are not statements of fact about past occurrences or guarantees of future performance. Furthermore, ratings are not investment recommendations. Moody's credit ratings provide an opinion on only one characteristic of fixed income securities or issuers of fixed income securities – the likelihood that debt will be repaid in a timely manner. That is just one element, and in many cases not the most material element, in an investor's decision-making process for credit-sensitive securities. Credit ratings do not address many other factors in the investment decision process, including the price, term, likelihood of prepayment or relative valuation of particular securities.

II. Moody's views on the credit performance of the subprime mortgage market

The majority of subprime mortgages originated between 2002 and 2005 have performed at or better than subprime loans have generally performed historically.[1] In contrast, the mortgages that were originated in 2006 are not, on the whole, performing as well. *Figure 1*[2] shows that more borrowers have become seriously delinquent on 2006 subprime loans than borrowers on loans originated between 2002 and 2005.

Figure 1: Subprime Loans 60 or More Days Delinquent, In Forclosure or Held For Sale



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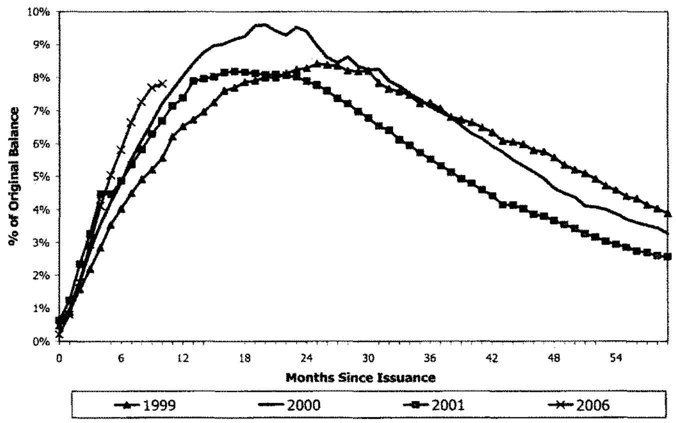
[1] This statement is based on the information that Moody's presently has on the performance of these loans and is subject to change as the loans mature.

[2] The data presented in this figure relates only to loans used in the securitizations that Moody's has rated, and therefore should not be construed as representing the entire subprime market.

It should be noted, however, that the 2006 loans are thus far, on average, performing similarly to loans originated and securitized in 2000 and 2001 (see figure 2).[3]

Figure 2: Subprime Loans 60 or More Days Delinquent, In Forclosure or Held For Sale



The performance of 2006 subprime loans follows a pattern that is a typical part of a residential housing credit cycle (although the amount of such loans outstanding is greater than the amount during the last cycle, both in absolute terms and as a percentage of total mortgage originations). During periods of growth in the housing market, borrowing demand increases, with existing mortgage lenders expanding their business and new lenders entering the market. Eventually, this leads to overcapacity in the mortgage lending market. If borrowing demand slows or falls (due to, for example,

3 The data presented in this figure relates only to loans used in the securitizations that Moody's has rated, and therefore should not be construed as representing the entire subprime market.

rising interest rates, slowing home price appreciation, or a slowing economy) competition among lenders for the reduced pool of borrowers intensifies. In order to maintain origination volume, lenders may lower their credit standards and make loans that are more likely to become delinquent and default.

Lending behavior in the subprime mortgage market over the past few decades has, in large part, followed this pattern, and through 2005 and 2006, in an effort to maintain or increase loan volume, lenders made it easier for borrowers to obtain loans. For example, borrowers could:

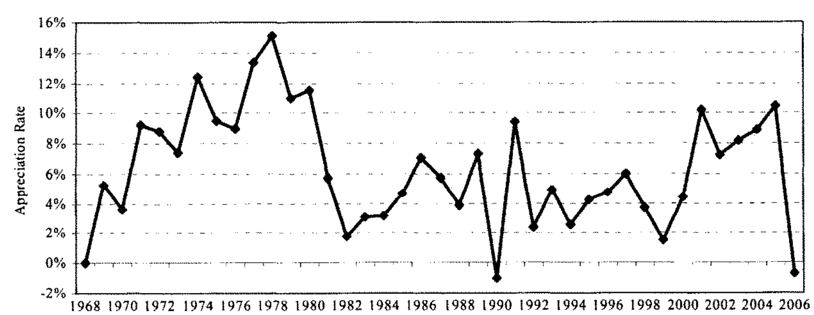
- obtain a mortgage with little or no money down;
- choose to provide little or no documented proof of income or assets on their loan application;
- obtain loans with low initial "teaser" interest rates that would reset to new, higher rates after two or three years;
- opt to pay only interest and no principal on their loans for several years, which lowered their monthly payments but prevented the build-up of equity in the property; or
- take out loans with longer terms, for example of 40 years or more, which have lower monthly payments that are spread out over a longer period of time and result in slower build-up of equity in the property.

The weaker performance of 2006 subprime mortgage loans was in large part due to the increasing risk characteristics of those mortgages. Often a loan was made with a combination of these characteristics, which is also known as "risk layering".

In addition, slowing and in some cases declining home price appreciation (see *Figure 3)* negatively impacted the ability of individuals to gain quick profits from houses they purchased with the expectation that they would be able to resell them in the immediate future for significantly greater sums. In prior years, these speculators – generally referred to as "flippers" – could rely on rising home prices to trade out of a home and repay a mortgage that they could not otherwise afford to pay.

As the housing market has weakened, the monthly payment obligations on these loans have caught up with many such borrowers, resulting in higher delinquencies and defaults. Furthermore, many subprime lenders tightened their lending criteria in late 2006 and early 2007, which may reduce future refinancing options for troubled borrowers.

Figure 3: Annual Rate of Median Home Price Appreciation



Source : National Association of Realtors

III. The process of securitizing subprime mortgages

The use of securitization has grown rapidly both in the US and abroad since its inception approximately 30 years ago. Today, it is an important source of funding for financial institutions and corporations. Securitization is essentially the packaging of a collection of assets, which could include mortgage loans, into a "security" that can then be sold to bond investors. The underlying group of assets is also called the underlying "pool" or "collateral". Securitization transactions vary in complexity depending on specific structural and legal considerations as well as on the type of asset that is being securitized.

Like other assets, subprime mortgages can be packaged into bonds using securitization. These bonds are commonly referred to as "mortgage-backed securities" ("MBS") or "asset-backed securities" ("ABS"), which are then sold into the market like any other bond. As noted earlier, not all subprime mortgages have been securitized and, of those that were securitized, Moody's has not rated all such securitizations. Moody's, therefore, cannot speak to the developments in the overall market. However, according to the Mortgage Bankers Association, total mortgage loan origination volume in 2006 was approximately $2.5 trillion and of this, we estimate that approximately $1.9 trillion (76%) was securitized. Moreover, according to Inside Mortgage Finance, approximately 20% of the total originations were subprime loans and we estimate that roughly 25% of the total mortgage securitizations were backed by subprime mortgages.

Before discussing in greater detail the process of securitizing subprime mortgages, it is important to understand the role played by the various market participants:

- Subprime borrowers – borrowers who have weaker credit histories.

- Mortgage originators, or lenders – entities that make the loans, such as banks or mortgage finance companies.
- Intermediaries – generally banks or investment banks that structure the securitizations and sell the bonds that are issued to the investors.
- Trustees – entities that are responsible for administering the securitizations.
- Servicers – entities that collect all payments on the subprime mortgage loans from the borrowers.
- Investors – entities that purchase the bonds which are backed by the assets and their related cash flows. In the securitization market, the investors are typically sophisticated institutional investors who generally make their investment decisions based on their own analysis, with ratings being one of many factors that they consider.

In securitizing subprime mortgages, the following steps are generally taken. First, a large number of subprime residential mortgage loans (typically thousands) are identified for securitization by the mortgage originator. Second, the originator creates a new corporation, limited liability company or trust,[4] which is the securitization issuer. The originator then sells all of its legal right to receive monthly payments on the subprime mortgages to the trust. The trust is now the "owner" or "holder" of the loans. Finally, the trust issues and sells bonds to investors. The bonds obligate the trust to make monthly payments to the investors. The trust uses the monthly loan payments it receives from borrowers on their mortgages to make the payments to the bond investors.

[4] For ease of reference, we will refer to these types of new entities as the "trust".

Securitizations, including those of subprime mortgage loans, use various features to protect each bondholder from losses. The more loss protection (also referred to as "credit enhancement") a bond has, the higher the likelihood that the investors holding that bond will receive the interest and principal promised to them. Some common types of loss protection are:

- a guarantee from a creditworthy entity, like an insurance company, that all or a certain portion of the losses above a certain level will be covered;
- "overcollateralization", which is the amount by which the aggregate mortgage balance exceeds the aggregate bond balance;
- "subordination", which means that instead of all bonds in the securitization sharing losses equally, losses are borne by bonds sequentially in reverse order of seniority; and
- "excess spread", which refers to the application of any excess amount of interest collected on the loans over the amount of interest payable on (and fees and expenses payable with respect to) the bonds to cover loan losses.

Figure 4 represents a simple subprime securitization transaction, where four classes, or "tranches", of bonds are issued. In this structure, losses would first be applied to reduce the "$10 net worth", or overcollateralization. Only when the losses exceed the overcollaterization amount would the bond balances be affected. Losses would be applied to the bond tranches in reverse order of seniority, such that losses are not allocated to a given tranche until the balances of all tranches that have a lower priority have been reduced, or written down, to zero.

Figure 4	
Simplified Balance Sheet for a Typical Subprime Securitization	
Assets (Loans)	Liabilities (Bonds) + Net Worth
$100 Mortgages	$65 Senior Bond
	$10 Mezzanine Bond #1
	$10 Mezzanine Bond #2
	$5 Subordinated Bond
	$10 Net Worth ("Overcollateralization")

For example, if the losses on the pool of mortgages were $20, as shown in *Figure 5*, then the outstanding mortgage balance of the pool would fall to $80. At this point, the overcollaterization amount would be written down from $10 to zero, and the remaining $10 of losses would result in losses for both the $5 subordinated bond and the $10 mezzanine bond #2. The principal amount of the $5 subordinated bond would be reduced, or "written down," to zero, and then the $10 balance of mezzanine bond #2 would be reduced by the remaining $5 of losses to a balance of $5. Losses are not allocated to a given tranche until the balances of all tranches that have a lower seniority have been written down to zero.

Figure 5	
Securitization After Incurring $20 of Losses	
Assets (Loans)	Liabilities (Bonds) + Net Worth
$80 Mortgages	$65 Senior Bond
	$10 Mezzanine Bond #1
	$5 Mezzanine Bond #2
	$0 Subordinated Bond
	$0 Net Worth ("Overcollateralization")

Consequently, the likelihood that an investor in a particular tranche will receive both the principal and interest due on the bond depends not only on the quality of the loans in the securitization, but also on the amount of loss protection provided. Because losses on subprime loans are generally expected to be much higher than losses on "prime" loans, a greater amount of loss protection is needed in a subprime securitization for the senior tranche to receive the same rating as the senior tranche of a prime securitization. The higher the seniority of a bond issued in a securitization, the more likely it will be repaid in full—meaning it is "less risky." Conversely, the lower the seniority of a bond, the less protection it will have against losses, making it less likely to be repaid in full. As a result, the tranches of a subprime securitization generally receive progressively lower ratings as the seniority of the tranches gets lower. Each progressively more subordinate bond has less loss protection because each has fewer bonds that can provide a cushion to absorb losses in case of defaults on some of the loans in the pool.

IV. How Moody's rates and monitors mortgage-backed securities

In rating a subprime mortgage backed securitization, Moody's first estimates the amount of cumulative losses that the underlying pool of subprime mortgage loans are expected to suffer over the lifetime of the loans (that is, until all the loans in the pool are either paid off or default). Because each pool of loans is different, Moody's cumulative loss estimate, or "expected loss," will be different from pool to pool.

In arriving at the cumulative loss estimate, Moody's considers both quantitative and qualitative factors. We analyze over 50 specific factors about the loans in a pool[5] which help us project the future performance of the loans under a large number of different projected future economic scenarios. The data we analyze include:

- credit bureau scores, which provide information about borrowers' loan repayment histories,
- the amount of equity borrowers have in their homes,
- how fully the borrowers documented their income and assets,
- whether the borrower intends to occupy or rent the property, and
- whether the loan is for purchase or for refinance.

Next, we consider the more qualitative factors of the asset pool such as the lending criteria which the lender uses when deciding whether to extend a mortgage loan, underwriting standards and past performance of similar loans made by that lender, the representations and warranties the lender is willing to provide regarding the loans, and how good the servicer has been at collection, billing, record-keeping and dealing with delinquent loans. We then analyze the structure of the transaction and the level of loss protection allocated to each tranche of bonds. Finally, based on all of this information, a Moody's rating committee determines the rating of each tranche.

Moody's regularly monitors its ratings on securitization tranches through a number of steps. We generally receive updated loan performance statistics on a monthly basis. Using this data, we assess the entire database of transactions we have rated on a monthly basis (sometimes more often), and flag potential rating "outliers" – securities

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5 We do not receive any personal information that identifies the borrower or the property.

whose deal performance indicates that the current rating may not be consistent with the current estimated risk of loss on the security. Once a specific rating is flagged, a Moody's surveillance analyst will further investigate the status of the transaction and consider whether a rating change should be considered. In so doing, our analysts avoid whole-sale rating actions as a result of market speculation. Rather, Moody's carefully and deliberately considers the data that we receive, on a transaction-by-transaction basis, relevant to the securities we have rated, and we conduct the ratings process judiciously to make sure that such relevant information is appropriately considered.

V. Moody's views on the subprime mortgage securitization market

Over the past several years, Moody's cumulative loss expectations for subprime mortgage securitizations have steadily increased, by approximately 30% in aggregate, in response to the increasing risk characteristics of subprime mortgage loans and changes in our market outlook. As Moody's loss expectations have increased over the past few years, the amount of loss protection on bonds we have rated has also increased. Consequently, bonds issued in 2006 which have been rated by Moody's have greater amounts of credit enhancement when compared to similarly rated bonds that were issued in prior years.

Pools of securitized 2006 mortgages have experienced rising delinquencies and loans in foreclosure, but due to the typically long time to foreclose and liquidate the underlying property, actual losses are only now beginning to be realized. However, it is likely that a number of factors will determine the ultimate level of loss. We believe that the magnitude and extent of negative home price trends will have the biggest impact on future losses on subprime pools. In addition, reduced availability of credit to subprime borrowers will limit refinancing opportunities and contribute to higher losses. Economic factors, such as interest rates and unemployment, will also play a significant role. Finally, mortgage servicers are expected to play a major role and will need to become more proactive as greater numbers of seriously delinquent borrowers become unable to refinance. Moody's expects creative payment plans, forbearance options and loan modifications to become more prevalent.

VI. Impediments to mitigating potential foreclosures

If a borrower misses a mortgage payment when due, and becomes "delinquent", the servicer will remind the borrower of the obligation to make the required loan payment. If the borrower continues to be delinquent on one or more payments, the servicer will often try to work with the borrower to resolve the problem. It is up to the servicer to try to prevent borrowers from defaulting and to minimize losses if a borrower does default. Furthermore, if the servicer forecloses on and sells a house, the sales proceeds – after paying legal costs, real estate broker fees and other expenses – will usually be less than the amount owed on the loan. As a result, the servicer is generally motivated to resolve problems and avoid foreclosures. One of the tools used by servicers to prevent foreclosures is to modify some of the terms of the loan.

Loan modifications are typically aimed at providing borrowers an opportunity to make good on their loan obligations. Loan modifications may include interest rate reductions, loan term extensions, payment deferrals, and forgiveness of payments, penalties or principal. Because these modifications are aimed at reducing or postponing borrowers' payments, they are particularly useful in mortgage environments such as the current subprime market, where delinquencies are increasing. Some residential MBS transactions have limits on the percentage of loans in any one securitization pool that the servicer may modify.

Moody's believes that restrictions in securitizations which limit a servicer's flexibility to modify distressed loans are generally not beneficial to the holders of the bonds. Loan modifications, when used judiciously, can mitigate losses on mortgage loans and increase the likelihood that bonds will be paid. Consequently, while loan modifications can not eliminate losses or generate more credit enhancement for a given transaction, we believe that they can typically have positive credit implications for securities backed by subprime mortgage loans.

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Investors in subprime mortgage-backed securities are interested in the rating stability and performance of their bonds. In response to the increase in the riskiness of loans made during the last few years and the changing economic environment. From approximately 2003 through 2006, our loss expectations steadily rose by approximately 30%. As a result, bonds that were issued in 2006 and that we rated generally have more loss protection than those with comparable ratings issued in earlier years. We believe that performance of these mortgages would need to deteriorate significantly for the vast majority of the bonds we have rated "A" or higher to be at risk of loss.

I would be pleased to address any questions that you may have.

Testimony before the
Senate Banking, Housing, and Urban Affairs Committee's
Subcommittee on Securities, Insurance, and Investments
at a Hearing regarding
"Subprime Mortgage Market Turmoil: Examining the Role of Securitization"

April 17, 2007
3 p.m.
Dirksen Senate Office Building

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Introduction

I am Kurt Eggert, Professor of Law at Chapman University School of Law in Orange, California. I have written several law review articles on securitization, predatory lending, the subprime market and related topics, and have frequently spoken on these subjects at symposia and conferences. I currently sit on the Federal Reserve Board's Consumer Advisory Council, on which I also advise about these topics. Thank you for allowing me the opportunity to testify on this important topic.

My testimony today will focus on how securitization has transformed the American mortgage market, atomized the loan process, and to a great extent turned the regulation of the subprime mortgage industry over to private entities. Some aspects of the current meltdown of the subprime market, the increased default rate and threat of rising foreclosures, as well as the difficulty of crafting an adequate response to that meltdown, may be attributed to the effects of securitization. One of my articles, "Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine," 35 Creighton L. Rev. 503 (2002), examines in detail the effect securitization has had on the residential mortgage market and how it has contributed to the spread of predatory lending. Some of this testimony is adapted from that article. To understand the current problems in the subprime market, it is first important to understand how securitization works, how it has led to the creation of the subprime market as we know it, and how it is contributing to the turmoil that is currently enveloping that market While securitization has added significant liquidity to the mortgage industry, it has done so at a price, and that price is borne mostly by subprime borrowers. While securitization has created a smorgasbord of new investment possibilities, it has also brought new challenges and dangers to borrowers.

This testimony discusses how securitization has atomized the lending industry, and has allowed the subprime market to be regulated largely by rating agencies and securitizers. I discuss the advantages of securitization, primarily to investors and industry participants, and the hazards of securitization, mostly borne by borrowers. Among the hazards to borrowers are how securitization has allowed thinly capitalized non-bank lenders to access the capital markets and expand rapidly, quickly selling or securitizing their loans so that the loan buyers can claim holder in due course status in a suit by the borrower. Non-bank subprime lenders are regulated primarily by the rating agencies and Wall Street, which seek to protect their own self-interest and that of investors, but do not have as a primary mandate the protection of residential borrowers.

Securitization has also led to loosened and inconsistent underwriting standards. These changing standards first allowed many borrowers to obtain loans that, once the loans reset to a higher rate, the borrowers will be unable to repay. Then, with underwriting standards tightened, many borrowers will become unable to refinance their way out of increasingly inappropriate loans. Securitization also decreases the discretion to modify the loan in meaningful ways to prevent foreclosure, as servicers of the loan are restricted by the pooling and servicing agreement and by their conflicting duties to different investors.

The problems currently facing the subprime markets and borrowers in those markets have been well documented in recent Congressional testimony. The number of subprime borrowers defaulting on their loans shortly after origination has risen unexpectedly in recent months. As many adjustable rate loans reset to higher payment rates, the default rate may continue to grow. According to a recent study by the Center for Responsible Lending, as many as one in five recent subprime mortgages will end in foreclosure, with new hybrid mortgage products being one of the primary causes for the foreclosures. That study also indicated that as many as 2.2 million subprime borrowers either have already had their homes foreclosed or face the loss of their homes in the next few years, at the cost of $164 billion. Ken Rosen, an economist at the University of California, recently predicted that as many as 1.5 million borrowers could have their homes foreclosed, and that these foreclosures could significantly affect property values. Doug Duncan, chief economist of the Mortgage Bankers Association, has predicted that over one hundred lenders might fail in the coming months. Worse yet, we appear to be in relatively uncharted waters, given that we can only guess at the foreclosure rates of so far untested pools of mortgages with payments due to reset in the coming months.

Even before the recent subprime turmoil, securitization has permitted default and foreclosure rates in the subprime market that many find excessive and dangerous. Because securitizers have been able to price and spread the risk of defaults and foreclosures, and demand increased interest rates to justify that risk, they have accepted default and foreclosure rates year in and year out that might damage a depository institution, both reputationally and financially. While the recent "market correction" appears to be limiting some of the most risky lender practices, so far it has not changed many of the practices that have put borrowers at risk.

The Process of Securitization

Securitization is the process of aggregating illiquid assets, such as a large number of notes secured by mortgages or deeds of trust, and then selling securities backed by those assets. The securities thus created can trade on an open market in a way that would be difficult if not impossible for the illiquid assets that back the securities. Because the securities are typically backed by large pools of loans, the investors minimize the risk of default of individual loans by spreading that risk among many loans and many investors.

A typical securitization of a loan secured by a residence might proceed as follows. A borrower seeks the services of a mortgage broker in order to obtain a loan, and the broker either brokers the loan with a third party or originates the loan under its own name using another entity's funds. Either way, the loan is usually soon held by the provider of the funds. The holder may then either resell the loan to another financial institution that will securitize it, or the lender may add the loan to a pool for securitization. The loan is added to a pool of numerous other loans, which may come all from one lender or from a multitude of lenders.

The holder of the loans then transfers them to another entity, and then to a special purpose vehicle (an "SPV"), typically a trust that has the sole purpose of holding the pool of mortgages. Then, securities are created which are backed by the loans. These securities can be crafted numerous ways, depending on what attributes of the securities will appeal to investors. The unitary interest in the loans is divided into different classes of securities, each class representing a different aspect, or "strip," of the loans. The strips, or classes of securities, are also called "tranches," which is French for "strips." For example, one tranche might have the right to the first repayment of principal until the claims of that tranche are satisfied. Another tranche might not be entitled to any payment until the rights of all other tranches have been satisfied. The different tranches obviously would have different risk characteristics, and those with priority would be less risky than those that have to wait for payment. The tranches can also divide the payment of interest from the payment of principal.

Working with the seller to package the loan pool and its resulting securities are an underwriter and a rating agency. These examine the loans assembled in the pool and return to the originator loans that do not meet the risk standards set for the pool. The underwriters and rating agencies do not examine every loan, but instead sample some loans and rely, perhaps excessively, on detailed representations by the originators of the loans. Most pooling agreements give the intermediaries the right to force an originator to take back any loan that did not actually qualify for the loan pool, the inclusion of which would cause a breach of the originator's representations. Therefore, the originator of the loans may be forced to take back a loan if the borrower defaults.

The securities are typically rated by a national, independent credit-rating agency, unless the home mortgages are backed either by the U.S. government or by a government-sponsored entity. The credit quality of the different tranches of securities can be improved by various techniques of credit enhancement that reduce the risk of loss to the purchasers of the securities. Credit enhancements can be either internal, meaning they depend on the assets or credit of the originator, such as providing additional assets to the securitization pool, or external, involving the credit or assets of a third party, such as an insurer or a bank issuing a letter of credit. Credit enhancements can be so effective that they allow even delinquent and foreclosed loans to be securitized.

Once the securities are rated, they can be sold to investors. This sale is typically accomplished by private placement or public offerings. The buyers may include mutual and pension funds, insurance companies, other institutional investors, and private individuals.

The investors typically are relatively passive once they have had the opportunity to review and approve the offering documents, the loan pool's ratings, and any third party guarantees and have purchased the securities. The collection and distribution of the payments of principal and interest are made by servicers, companies who specialize in this collection and distribution of income and principal from pools of loans. The servicer is employed by the SPV and, since most SPVs are trusts, the trustee is legally at the helm, directing the activities of the SPV. However, the servicer typically is in charge of collection efforts.

Servicers are typically in charge of handling defaults and arranging foreclosures where necessary. If there is sufficient equity in the house securing the mortgage, the investors could conceivably make money on the foreclosure process, since the holder of the loan is often the sole bidder during the foreclosure sale and typically bids only the amount of the outstanding balance on the loan. In some states, the lender could foreclose on the property, purchase the property at an unreasonably low price that does not even pay off the lender's loan, and then seek a deficiency judgment against the borrower for the amount remaining on the loan.

The "Atomization" and Deregulation of the Residential Mortgage Industry

Securitization has accomplished what is known as the unbundling of the loan industry, disassembling the lending process into its constituent elements, and allowing a separate entity to undertake each element. Traditionally, lenders performed all of the functions of a loan: finding the borrowers, preparing the documentation for the loan, funding the loan, holding the mortgage during the course of the loan, and servicing the loan throughout its life. Securitization has, in the words of Michael G. Jacobides, "atomized" this process, so that one distinct entity, more often than not a mortgage broker, originates the loan, while another, perhaps a mortgage banker, funds the loan, and still another may securitize the loan and sell it to investors. These investors, through their ownership of securities issued by the SPV holding the mortgage in trust with a pool of other mortgages, claim the capital represented by the mortgage, while a separate set of entities, such as a master servicer under the trustee's direction, services the loan, accepting the mortgage payments and foreclosing if necessary.

This separation of the mortgage process confers on each entity in the chain a plausible deniability as to the actions of the others. The securitizer can claim to be unconnected to the broker and unaware of any of his activities, however improper. The SPV and the owners of its securities can claim to be holders in due course and protected from any accountability for the fraud of the mortgage broker, through their ignorance of any such fraudulent behavior. The mortgage broker can accurately claim, once the loan is out of his hands, that he can no longer help the borrower if the servicer attempts to foreclose.

Before the rise of securitization, borrowers typically dealt with large finance companies, which funded their own loans and held the loans in their own portfolios. Because these lenders continued to hold the borrowers' paper, were closely regulated, and were required by regulators to maintain sizeable assets, the finance companies had diminished incentive to commit outright fraud against the borrowers, as borrowers retained any defenses they had to the loans and the borrowers could also seek damages against the finance companies.

With the rise of securitization, the origination of subprime mortgages has largely been turned over to mortgage brokers and thinly capitalized lenders who are less regulated than their predecessors. National banks and their subsidiaries, which must comply with federal oversight regarding both safety and soundness and also consumer protection, made less than 10% of the subprime loans originated last year. By comparison, non-bank lenders made almost half of the subprime loans in 2006. Such lenders avoid the more conservative underwriting standards and other stricter regulation mandated for depository institutions, whether the depository institutions are state or federally chartered. State-regulated non-bank lenders and brokers are the least regulated lenders.

Although many non-bank lenders are nominally regulated by the states, there is little state enforcement of underwriting standards of such non-depository institutions. Instead, such non-bank lenders that securitize their loans are mostly policed by the rating agencies, which regularly rate lenders for their financial soundness and legal compliance, servicers for their financial soundness and ability to service the loan pools under their supervision, and the loan pools themselves for their risk characteristics, among other aspects. Wall Street and rating agencies, rather than state regulators or even lenders, largely decide what types of borrowers obtain subprime loans and how the loan products offered to borrowers are designed. According to Harry Dinham, president of the National Association of Mortgage Brokers, "In the end, Wall Street creates a demand for particular mortgages; underwriting criteria for these mortgages is set to meet this demand and this underwriting criteria, not the mortgage originator, dictates whether a consumer qualifies for a particular loan product." In this way, securitization has largely privatized the regulation of the subprime industry, as rating agencies have a much greater hand in regulating subprime lenders, determining underwriting standards, and approving new products than any governmental agency. However, unlike governmental agencies, rating agencies work both in their own financial self-interest and otherwise primarily at the behest of investors and do not have the mandate to ensure consumer protection. Under this de facto regulation, borrower default and foreclosure are significant to the extent that they affect investors.

As de facto regulators of the subprime industry, rating agencies have significant flaws. The decisions of rating agencies are not sufficiently transparent, nor is there typically a documented method to appeal those decisions formally. While governmental agencies are monitored by elected officials, rating agencies are not regulated in any meaningful way regarding their effect on borrowers. Rating agencies also have an institutional interest in preventing the passage of laws that might slow the securitization of subprime loans. In fact, rating agencies have acted to discourage the creation of strong anti-predatory lending laws at the state level, have threatened to withhold ratings in states with such laws, and have done so to protect investors. In this way, rating agencies have not only become the regulators of the subprime industry, but to some extent have become a super-legislature, overruling or seeking to overrule state lawmakers regarding what types of anti-predatory lending laws may be passed. Columnist Thomas Friedman said, perhaps half in jest, "There are two superpowers in the world today. There's the United States and there's Moody's Bond Rating Service ... And believe me, it's not clear sometimes who's more powerful."

Rating agencies and other securitizing entities have an interest in increasing the number of loan pools that are securitized, since that is how the securitizers increase their income. This self-interest encourages rating agencies and other securitizers to focus excessively on the quantity of loans securitized, in contrast to traditional regulatory agencies, which focus more on the quality of loans made by depository institutions. Rating agencies do of course also examine the quality of loans in the pools that they rate. However, the recent loosening of underwriting standards and the accompanying defaults demonstrates that

that examination has not been sufficient.

Securitization thus emphasizes quantity of loans over quality in several parts of the securitization process. To the extent that originators of loans can transfer the risk of default to investors or minimize that risk, then securitization encourages originators to make as many loans as possible, provides them with the funds to make the loans, and reduces the risk of poor loans. At the same time, securitization rewards the de facto primary regulators of those same originators for that increase in the quantity of loans, furnishing another incentive to value quantity over quality.

The Advantages of Securitization, Primarily to Investors and Lenders

An advantage of securitization to the originator of loans is its extreme usefulness as a leveraging tool. By almost immediately securitizing its loans, a lender can receive payment for those loans quickly rather than waiting perhaps thirty years for repayment. The lender can use this infusion of capital to make a new round of loans. Quick churning of loan principal allows even institutions with little capital to make many loans, lending in a year much more money than they have. This leverage is particularly useful to smaller, disreputable companies that otherwise would have difficulty funding many loans.

Securitization has also benefited investors by giving them a rich banquet of new and varied investment possibilities, structured by the poolers of the assets to appeal to the different risk, diversification and income tastes of the investors. Securitization allows investors to reduce their information costs by relying on the rating agency. However, because of the complexity of how pools may be structured, the new mortgage products that can be securitized, and the potential for unstable economic conditions, past performance of other pools may not accurately reflect the risk inherent in new securitizations. Rating organizations have regularly upgraded or downgraded the ratings they have assigned to mortgage pools as the repayment and default rates have differed from expected. While historically, more loan pool ratings have been upgraded than downgraded, with the recent rise in defaults in loan pools formed in the last two years, rating agencies may have to significantly downgrade ratings for numerous loan pools.

Securitization has also benefited investors by allowing them to purchase an interest in the high interest rate loans or otherwise dubious loans that have been associated with predatory lending, while avoiding much of the risk of defaults and delinquencies that is associated with those loans. Investors are protected from much of this risk by two methods. The first method is the use of various contractual forms of recourse between the originator or seller of the loan and the entity that purchases them in the securitization process designed to protect the buyers of the loan at the expense of the sellers. Recourse can take several forms. The seller of the loans may make representations or warranties that, if violated, require the seller to repurchase the loan. Or the seller of loans may be contractually required to make cash payments to buyers or to repurchase the loans in the event of borrower default or to set up reserve accounts that fund losses. There are also more complicated schemes involving subordinated interests or excess servicing fees. These forms of recourse for the most part require the continued existence of a relatively solvent seller, of course.

Where the originator of the loan has gone bankrupt or otherwise disappeared, the loan buyers must depend on their second line of defense, the holder in due course doctrine. Under the holder in due course doctrine, bona fide purchasers of loans are protected from many of the defenses that the borrower might have against the originator. Therefore, the new holder of the note might be able to foreclose even though the borrower was the victim of many forms of fraud. A buyer may choose to rely on the holder in due course doctrine even where the loan seller is still in existence, where, for example, a single loan pool contains a large number of loans from one originator, so that forcing the originator to buy back all of the problematic loans could force the originator into insolvency. Or the buyer may conclude that it would be easier to rely on the holder in due course doctrine and foreclose against the borrower than it would be to force the seller to take back a problematic loan.

Even those commentators that sing the praises of securitization rarely mention in any great detail the effect of securitization on the homeowners whose loans have been securitized. At most, they have argued that, by obtaining access to lower cost capital markets, lenders will be able to offer loans at lower interest rates or with otherwise better terms to borrowers. Securitization by government-sponsored entities ["GSEs"] does seem to be positively correlated with lower interest rates for the borrowers with the best credit whose loans are sold to GSEs. While the GSEs claim that their securitization has led to lower interest rates, it is possible that securitization may not decrease interest rates. Instead, falling interest rates may lead to increased securitization, rather than the other way around.

The Downside and Dangers of Securitization, Primarily to Borrowers

Often ignored in the literature on the wonders of securitization are the ways it can cause significant harm to borrowers. First of all, securitization has encouraged lending by thinly capitalized lenders that can easily go out of business when trouble hits, stranding the borrower to deal with investors who can claim protected status as bona fide purchasers of the loans. Already, during the current subprime turmoil, even major subprime lenders have declared bankruptcy, and more than thirty subprime lenders have done so or otherwise gone out of business during the recent subprime turmoil. Many more subprime lender bankruptcies are likely in the offing. Such bankruptcies strip borrowers of much of the ability to sue the loan originators for redress for fraud or other violations of consumer protection arising from the origination of the loan.

Simultaneously, securitization encourages the most rapid creation of an assignee with holder in due course status by causing the originator of the loan to sell the loan almost immediately. Being a holder in due course is a defense to many of a cheated borrower's claims. Gone are the days when a lender would normally hold the loan for its full term, allowing recourse by a defrauded borrower. Instead, lenders now might hold the loan for only a few weeks, assigning it almost immediately to be securitized. Often, the loan will be sold before the first payment is even due, so that if the homeowner/borrower learns that her payments are much larger than had been represented to her, that defense has already been cut off as to the current holder of the note by the holder in due course doctrine. This combination (initial loan made by a thinly capitalized, poorly regulated lender who immediately negotiates the loan to a securitizer, so that the investors in the securities can claim holder in due course status) is a recipe for irresponsible and unethical lending, if not outright fraud.

Loosened or Inconsistent Underwriting Standards

Securitization has encouraged the decline of stringent underwriting and has caused underwriting to be strikingly inconsistent over the past few years. Careful underwriting reduces foreclosure by deterring lenders from making loans to borrowers unable to repay the loan. Consistent underwriting allows borrowers to plan, deciding, for example, to take out a loan that might require them to refinance, with the understanding that they can predict whether they will be eligible for refinancing in coming years. With inconsistent underwriting, borrowers who expected to refinance may find themselves stuck with a loan they cannot repay, unable to refinance it because underwriting standards have tightened in the interim.

As originators immediately sell their loans and face less risk of loss even if a borrower defaults, the originators have less motivation to spend time and effort screening potential loans for default, thus increasing the risk of lending to borrowers who will not be able to repay the loans. While banks once relied on subjective, individual, lender-driven underwriting, securitization instead depends on systemic controls that can be objectively verified, such as automated underwriting systems. In this way, banks step away from their great strength, which was the effectiveness and efficiency of their information gathering and regulation systems, in both selecting which loans to make and controlling those loans once made, and in using their long-term relationships with borrowers. With less lender supervision, borrowers are more likely to default on their loans and risk foreclosure, though the default and foreclosure would likely occur long after the original lender has assigned the loan. In the world of securitization, with its ever-churning markets, there are few long-term relationships, but only the financial equivalents of one-night stands.

This reduction of effective underwriting has been widely blamed for the current turmoil in the subprime markets. While underwriting standards have been at risk for years, the last two years have witnessed a dramatic shift in loan underwriting, first a loosening of standards so that more loans could be made, and then a recent tightening of underwriting standards.

After the mortgage market boomed in 2003 and then dropped off, originators looked for new markets in which to sell their loans. To reach new borrowers who would not have been eligible for carefully underwritten, fixed rate loans, lenders began push-marketing adjustable rate loans with low teaser rates, so that the initial payment requirements of the loans were far below that of fixed rate loans. These loan products, called hybrids and combining initial fixed rates with later adjustable rates, were often designed so that after the initial, "teaser" rate had expired, the borrower was required to repay the loan at above-market interest rates. When the loans reset, the loan payments can increase dramatically. Such loans are appealing to the secondary market because they can sometimes trap unwary borrowers who are not able to refinance above-market rate loans, while borrowers who refinance quickly may have to pay sizeable prepayment penalties. Adjustable rate mortgages (ARMs) have taken over the subprime market, with ARMs being almost 80 percent of those subprime loans that were securitized in early 2006. Many of these are so-called 2/28 or 3/27 loans, loans that reset quickly after a short initial fixed rate of two or three years, with 28 or 27 years of an adjustable rate loan.

By moving from fixed rate to adjustable rate loans, the subprime market has transferred much of the risk of changing interest rates from the holders of notes to borrowers. Successfully managing this risk may well be beyond the expertise of many subprime borrowers, as it would require them to understand how changing market interest rates might change their payment amount, what the risks of such changes are, and how likely they are to be able to recognize and refinance their way out of any difficulties caused by rising interest rates.

Some loans have different payment options, so that the borrower could pay so little that the loan would have negative amortization. These loans are much more complex than the straightforward fixed-rate loans that they replaced, and borrowers often enter into such loans without understanding how high their loan payments might become after the loan resets or how their different payment rates might affect them. The disclosure system, initially designed for relatively simple fixed-rate loans, does not function adequately for these complex loans and even with the best-designed disclosures, the mechanics of these loans may be difficult for some borrowers to understand. Furthermore, these loans have been too often underwritten based on the teaser rates, so that borrowers were considered eligible for loans even where they could not make the full payments once the loans reset to their higher rates. Such underwriting dooms to foreclosure those borrowers who are unable to refinance or sell their houses.

Underwriting standards have shifted dramatically in the last few years. Underwriting standards loosened, and lenders became more willing to accept loans with risk layering features, or multiple aspects that increase risk of default added one on top of the other. For example, lenders made many loans with little or no documentation, even though this requires the lenders to rely on unverifiable assumptions regarding the borrowers' ability to pay. In addition, lenders allowed loans to close with simultaneous second mortgages, which further increase the risk of default while at the same time reducing the borrowers' equity in the property and increasing their monthly mortgage payments. Simultaneous seconds do not provide the lender with the risk mitigation that private mortgage insurance (PMI), would give, even though simultaneous seconds are used largely to replace the need for PMI. Adding further risk in subprime loans, subprime lenders often do not require the escrow of funds for property taxes and hazard insurance, increasing the likelihood that subprime borrowers will fail to set aside sufficient funds for such purposes.

Lenders justified this risk layering with their use of risk-based pricing, using sophisticated and proprietary programs designed to determine the risk layered into the loan and increase the cost of credit as the risk increases. While increasing the cost of credit may protect lenders and investors in the secondary market, it does so to the detriment of borrowers, who may have no idea that they are paying higher interest rates because of the risk layering by lenders. Unfortunately, for much of the subprime market, there has been little significant regulatory guidelines dictating underwriting standards, and no one looking out for the interests of borrowers in determining what underwriting standards would be used. Instead, underwriting was determined by lightly regulated mortgage originators under the eye of rating agencies and other securitization participants. However, until late 2006, rating agencies and other entities involved in securitization did little to require careful underwriting and instead largely relied on the risk minimization built into the securitization process and the higher credit prices extracted from borrowers.

Underwriting standards changed significantly when subprime loans began to go into default at excessive rates, a tightening of underwriting standards caused in part by an October, 2006 guidance from federal regulatory agencies. That guidance directed regulated institutions to assess borrowers' ability to repay the loan throughout the life of the loan, including at its fully indexed rate and also including balances added because of negative amortization. This tightening of underwriting standards should help new borrowers avoid being trapped in loans that they cannot repay once the loans reset. It is unclear to what extent the de facto regulators of the subprime market have adopted the federal guidance and forced non-bank, state regulated originators to follow that guidance. Many of the risky loan types are still being made, such as 2/28 or 3/27 loans with low teaser rates, option payment loans that allow negative amortization, or loans where the borrower is not required to escrow funds for taxes or insurance. At the same time, the underwriting shift may make it harder for borrowers who already have hybrid loans to refinance those loans when their payment amounts reset. While limiting new problem loans, the shift in underwriting may, ironically, make life more difficult for borrowers who obtained problem loans in 2006 and before.

"Tranche Warfare" and How Securitization Reduces Lenders' Discretion in Resolving Borrowers' Difficulties

Securitization hurts borrowers by making it more difficult for a borrower with financial difficulties to arrange alternative payment terms that involve any change in the borrower's payment stream. Before the advent of securitization, homeowners typically borrowed from their neighborhood banks, which normally held the loans for their entire terms. Because of those long-term, local relationships, lenders were often aware of their borrowers' troubles even before the borrower missed a payment, because the lender might know of a factory closing or of a borrower's severe illness. This relationship allowed lenders to step in early and encouraged resolution of borrower difficulties without the need for formal collection efforts. While a borrower whose loan is held by a traditional bank might have some success in convincing the bank to restructure the loan, too much of this flexibility vanishes once the loan has been securitized. The originator has often washed its hands of the loan and has neither the ability to help nor the interest in helping the borrower change the terms of the loan. The trustee and servicer of the loan, even if either is the original lender, must follow the documented procedures that are normally included in the initial documentation of the securitization. That documentation often limits the discretion to alter the terms of the loans because the securities backed by the loan pool are based on the loans' original terms.

The trustee and servicer typically do have some discretion to create a loan repayment plan, a loan modification, or arrange a short sale. However, the rules providing that discretion may be so vaguely written that they either lead to disputes between investors and servicers or lead servicers to avoid exercising their discretion in order to avoid such disputes. Also, the servicer may be required to wait until the borrower is at least 30 days delinquent before offering the borrower any meaningful relief, even where it is clear to both borrower and servicer that default is likely. The willingness of servicers to work with borrowers is subject to the servicers' conflicting interests, as the servicer may be rewarded either for preventing foreclosures by instituting quick and successful repayment plans or, alternatively, for negotiating short sales by the borrowers or foreclosing as quickly and efficiently as possible. The servicer's willingness to act quickly may also be affected by the fact that servicers often receive whatever late fees are generated by borrowers in distress.

Even in cases where the foreclosure criteria contained in the initial offering of the securities backed by mortgages give the trustee some discretion regarding when and whether to foreclose, and even where the trustee and servicer would want to help out a financially troubled borrower, the underlying structure of the securities creates obstacles to the exercise of that discretion. This is because once the loan has been securitized, it is no longer held as a unitary asset by one owner, but rather has been split into a number of tranches, each tranche representing different interests held by different sets of investors. One tranche might hold the right to any principal repayments made during the first year, another to interest payments during that year, yet another to interest payments the second year, and so on.

Restructuring the loan poses a substantial fiduciary dilemma to the trustee, because it would almost inevitably involve removing some part of a stream of income from one tranche and adding income to another tranche. This "tranche warfare," is a significant brake on the flexibility to restructure a loan. . If not for securitization, a bank could forego mortgage payments for the life of a borrower with little financial detriment, so long as there is sufficient collateral to secure the loan and a sufficient interest rate is added to the principal. But if the loan has been securitized into tranches divided by principal and interest and by the year principal or interest is received, the same agreement to forego payments would strip the tranches receiving early payments of principal or interest of all benefit from this particular loan. Restructuring loans, therefore, would force trustees to choose which of the tranches would receive extra money and which would receive less, leaving the trustee open to claims of favoritism and breach of fiduciary duty.

With the increase in defaults, servicers may be even more constrained. As subprime defaults mount, it may become even more difficult for borrowers to obtain appropriate loan modifications to help them save their houses. On the one hand, lenders and even securitizers have recognized the hazards of increased defaults, and have declared their intent to help borrowers save their homes. For example, EMC Mortgage, a unit of Bear Sterns Co., recently announced the creation of a "Mod Squad," a team of loan modification experts charged with being "more counselors than collectors" in the attempt to help borrowers avoid foreclosure. Other market participants have also announced their willingness to work with borrowers who suffer financial hardships. However, the subprime lenders who today vow to work with borrowers to help them avoid foreclosure may soon be declaring bankruptcy, and so become powerless to intercede.

Loan modifications work best for borrowers whose loan problems are caused by temporary financial setbacks, rather than those who obtained loans that, once they reset, require loan payments greater than the borrowers would be able to repay even without any new financial downturns. For temporary problems, servicers can allow borrowers to defer payments temporarily or establish a payment plan to make up missed payments. For the permanent problem of loan payments that exceed borrowers' ability to pay, relief would likely come only from reducing the principal or the interest rate, delaying payments for extended periods, or increasing the term of the loan, but these more significant changes are unlikely to be undertaken. One rating agency recently noted that loan modifications "are not a prudent alternative for borrowers who are fundamentally unable to afford their homes."

Increasing defaults may make it harder for individual borrowers to obtain relief. First of all, increasing defaults also increase the workload of servicers, requiring them to deal with many more troubled loans. It is not clear that servicers are willing to hire the new employees that the increased defaults may require. Also, perhaps one-third of bond deals restrict the number of loans that can be modified, as noted by Credit Suisse Group based on its analysis of thirty-one securitization transactions backed by subprime loans. For these loan pools, as defaults mount, servicers will be increasingly unable to offer borrowers any significant modifications, absent some change in these rules.

Servicers may also be limited to the extent that the rights to prepayment penalties have been separated from the right to collect principal or interest payments on the loans, where, for example, prepayment penalty rights have themselves been securitized. If so, then a servicer that reforms a loan may be deemed to have refinanced the loan, triggering the prepayment penalty. Because these penalties can be so large, the increase in loan principal that they would cause could undo much of the benefit of the loan reformation.

Regulatory supervision of servicers is limited. Servicers are not depository institutions, and so governmental regulators typically are not concerned safety and soundness issues. Instead, regulation of servicers focuses on preventing outright abuses, such as intentionally causing payments to be posted late, charging improper late fees, improperly force-placing insurance, and starting uncalled-for foreclosures. When the Federal Trade

Commission settled its action against a noted abusive servicer, it incorporated into the settlement a set of best practices that it hoped would be adopted by servicers generally. However, based on recent FTC efforts, it appears that these best practices have not been sufficiently adopted. While GSEs have rewards for servicers who use loss mitigation methods that prevent foreclosure, by and large, government regulators have little leverage to order that specific loss mitigation techniques be used.

The borrower cannot turn for succor to the investors who own the securities that are backed by the borrower's loan, since the investors are passive, beneficial owners, who depend on the trustee and servicer to control the assets. It would be difficult for a borrower even to learn the identities of the investors, let alone communicate with them. The investors are not notified of the default of an individual borrower. Even if investors wanted to overrule a trustee's order to foreclose on a homeowner, the trustee may be forbidden from accepting instructions that conflict with the terms of the securitization agreement. In effect, the securitization process erects a wall between the borrowers and the beneficial owners of the note, preventing them from working out mutually advantageous changes to the terms of the note. Once the deeds of trust are securitized, they enter into what Tamar Frankel has called "a kind of suspended animation," noting that "the sellers of the financial assets are no longer the owners. The buyers are only beneficial owners and the trustee controls the assets but does not benefit from them (except by fees)."

Similarly, securitization removes one sometimes-potent weapon in the hands of a borrower who needs to have her loan restructured. When loans were held by regional or local banks, those banks were susceptible to bad publicity and might be loath to foreclose on the home of, for example, an elderly borrower, especially one who was the victim of fraud. Banks have locally recognizable brand names, so that borrowers can threaten to picket a bank or bring discredit to the brand name unless the bank acts reasonably in helping borrowers resolve their problems. Banks also might have some interest in keeping their customers satisfied, with an eye to obtaining repeat business from the customer or new business from referrals.

Securitization, on the other hand, has allowed the markets to be unbundled, atomizing the mortgage origination and collection process. When a mortgage broker solicits the borrower, an SPV holds the loan, and a servicer collects the payments, whom would a defrauded borrower picket in order to obtain a loan forbearance? The originator may be long gone, as many subprime lenders have recently declared bankruptcy and gone out of business. The SPV is a business entity whose sole purpose is to hold a mortgage pool, and is completely immune from any threats to its good name, which is often something like "Security Pool #351." The servicer is similarly immune to threats or pleading, as it serves solely at the direction of the trustee. The servicer little depends on the happiness or good will of the homeowners who make payments to it, since the homeowners have no choice whatsoever regarding which servicer collects the payments on their loans. The trustee also does not need to keep the good will of the borrowing public, since it gets its business from originators, not the borrowers. Indeed, a reputation as a particularly ruthless collector of debts might well aid the trustee or servicer in gaining new originator clients. Furthermore, the trustee and servicer can always claim to be bound by the foreclosure criteria contained in the initial offering of the securities and absolve themselves of any responsibility to exercise discretion in dealing with a desperate homeowner.

Securitization almost completely depersonalizes the lending process and deprives the borrower of the advantages of a personal relationship with her lender. Securitization eliminates the ability of a borrower to pick his creditor, or even the type of creditor, such as a small bank instead of a large bank or an individual investor, as it sweeps up the vast majority of American mortgages into faceless, almost nameless, unknowable business entities.

The Myth That the Market Protects Borrowers

Defenders of the securitization process and critics of additional regulation have advanced two primary arguments. First of all, they argue that the market corrects itself, and that even though clearly there were problems in the subprime industry in 2006, the industry itself and its private regulators have largely resolved those problems, so that no further governmental action is necessary. Also, they argue that the interests of investors and of borrowers are largely congruent, so that as rating agencies and Wall Street investment houses take pains to protect investors, they will at the same time be protecting borrowers. Both of these arguments have significant flaws.

Concluding that the market corrects itself requires tunnel vision. The subprime industry has tightened underwriting, but many of the risky types of loans are still being made, and it is not clear to what extent ratings agencies have adopted the reforms from the recent federal guidances. Also, recent tightening of underwriting appears like the proverbial closing of the barn door after the horses escape. Subprime's defenders focus on the closing of the door, but once the horses are out, one needs also to round up the escaped horses and fix the latch so that the door will not spring open again. The borrowers who received problematic loans in the last few years cannot be ignored, especially since new underwriting guidelines which help new borrowers may increase the difficulty faced by existing borrowers. In addition, steps should be taken to prevent similar turmoil in the future. While the private regulators of the subprime industry appear presently committed to tightened underwriting, there is no guarantee that such commitment will persist. We could, in the future, see another round of loosening of subprime underwriting, increased defaults, and a subsequent underwriting tightening, to the detriment of the borrowers who received the most problematic loans.

Defenders of securitization have also argued that because investors and borrowers are both injured by foreclosures, their interests are congruent, and as rating agencies watch out for the interest of investors they also benefit borrowers. It is true that both borrowers and investors are harmed by an unexpectedly high rate of foreclosures. Investors depend on rating agencies' ability to predict loss rates in determining what credit enhancements are necessary and what rates of return justify such a risk of default. However, investors' interests diverge from that of borrowers in one important attribute. Investors are often willing to accept a higher rate of default and foreclosure if in return they could be guaranteed a higher rate of return through higher interest rates. But both high default rates and high interest rates harm borrowers, undermining any claim to congruent interests. Therefore, the interests of investors and of borrowers differ dramatically and securitization entities that protect the interests of investors may at the same time be acting to the detriment of borrowers by ensuring a high rate of return by investors.

Conclusion

Understanding how securitization affects borrowers, both positively and negatively, is crucial to crafting solutions for the problems facing subprime lenders and borrowers. Some claim that the market can correct itself. However, it is clear that structural characteristics of the securitization process can cause harm to borrowers, and that borrowers are too little protected in a subprime industry that closely heeds the mandates of rating agencies and investors and is too little overseen by governmental regulators.

By and large, rating agencies and Wall Street have supplanted other financial institutions as the driving forces in the subprime mortgage industry. They design the mortgage products, determine the underwriting criteria to be applied, and supervise the selling of loans on the secondary market. To be effective, any regulation that protects consumers from inappropriate loans must affect the actions of the Wall Street players that direct the securitization of subprime loans. A regulatory regime that purports to limit the harmful affects of predatory loans or loans unsuited to borrowers must include not only the lenders that originate the loans, but also the rating agencies and investment houses that create the loan products and determine the underwriting standards, and the servicers who put into effect the loss mitigation techniques that may determine whether borrowers save their homes or lose them to foreclosure.

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Subprime Mortgage Market Turmoil:
Examining the Role of Securitization –
A hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance, and Investment

Written Testimony
of
Christopher L. Peterson
Associate Professor of Law
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April 17, 2007

It is an honor to appear today before this Subcommittee. Thank you for the opportunity to share some thoughts on the turmoil in the subprime mortgage markets. My name is Christopher Peterson and I am a law professor at the University of Florida where I teach commercial law and consumer law classes. I commend the Subcommittee for organizing this hearing and for inviting me to share some thoughts on this important and timely national issue. I have been asked to discuss the instability, widespread foreclosures, and questionable business practices in the current marketplace. In my testimony I will discuss: (1) the basic background history and structure of securitization; (2) how evolving commercial practices have outdated existing consumer lending law; (3) how securitization raises the costs of objecting to unethical and illegal behavior for consumers; (4) how securitization shelters assets facilitating immunity from punishment for illegal behavior; and, (5) some necessary reforms.

I. The Mechanics of the Subprime Mortgage Securitization Process

The nature of securitization cannot be understood without some historical context. To briefly provide that background I suggest picturing the American residential mortgage market as having three basic time periods. In the first period of mortgage lending, which might be thought of as the "two party" period, mortgage loans were generally originated and held by the lender. In this period, which extended from the founding of the Republic through the Great Depression most mortgages were made by a seller of land to help the buyer acquire title. Mortgage lending by financial institutions included cooperative building societies (modeled after similar British institutions), mutual savings banks, private mortgage lending firms, and some insurance companies.

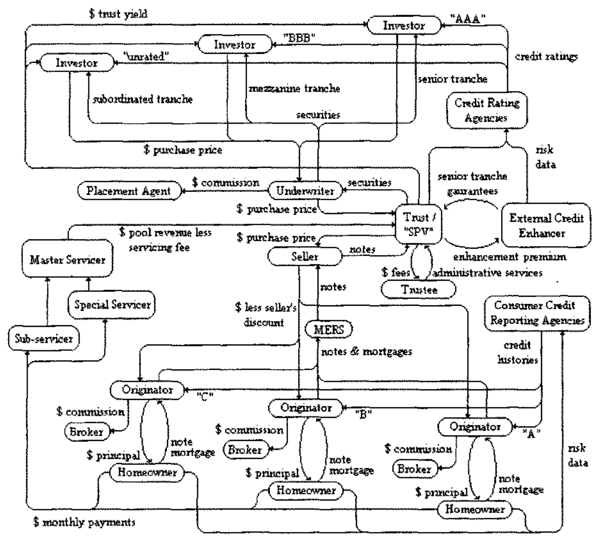
In this era most mortgages required a large down payment of around 40 percent of the home purchase price. Moreover, early twentieth century mortgage loans had terms typically averaging between three and six years. These short repayment durations necessitated high monthly payments often followed by a large balloon payment of the remaining balance due at the end of the loan term. Relatively few families could overcome these financial hurdles. Moreover, lenders had both formal and informal policies discriminating against minorities and women. As a result, none but the most affluent men of European ancestry had reliable and widespread access to home finance.

The second period in American residential mortgage finance, which can be called the "three party" era, followed the Great Depression. When millions of people lost their jobs the prices for goods, services, and land all dramatically declined. Agricultural prices were so low, family farmers could not profit from selling their crops. Demand for goods and the investment capital from the stock market both dried up, forcing manufacturers to lay off workers. In the mortgage lending market, lenders were forced to call in their loans as *half* of all single-family mortgages fell into default. In foreclosure, real estate prices were so low, lenders could not recoup their investment by selling seized homes. Because lenders were understandably reluctant to continue making uncollectible loans, the mortgage finance and housing construction industries ground to a halt.

To restart the economy, Congress stepped in and created a fundamentally new secondary market infrastructure to facilitate residential mortgage finance. Through a series of acts, Congress created federal institutions that provided liquidity for mortgage loans. While a catalogue of these laws, programs, and institutions is beyond the scope of this hearing, it is important to recognize what all of these programs shared and continue to share: a unifying theme of federal government sponsorship and oversight. The three party model of mortgage finance was (and continues to be) characterized by a borrower, a lender, and some government affiliated institution that purchases, insures, or in some way exercises some underwriting oversight in the capitalization of the loan. As a condition of participating in this market, government affiliated institutions have required originating lenders to follow relatively strict and uniform underwriting guidelines that have stabilized the marketplace. Moreover, these underwriting guidelines have created an important hedge against participation in the market by unscrupulous, over-aggressive companies and individuals. In this model, which financed the development of the American middle class, the federal government's leadership created high standards of safety and soundness as well as origination and servicing integrity. It is worth noting that the current turmoil in mortgage lending has, by and large, not affected the prime market overseen by government sponsored enterprises.

The third era of mortgage finance can be thought of as the era of private-label securitization. This period is generally thought to have begun in 1977 when Bank of America and Salomon Brothers (with some assistance from Freddie Mac) first created a trust which pooled mortgage loans and then passed through income from those loans to investors that acquired interests in the trust. After a variety of pricing, tax, and liquidity hurdles were resolved over the course of the 1980s and early 1990s, this market experienced explosive growth. Unlike the two and three party mortgage finance models, the private label securitization model of mortgage finance has ten or more different parties that all play an independent role in originating, pooling, structuring, and servicing mortgage loans. While there is tremendous variety in the way mortgage loans are securitized, Figure A nevertheless provides a graphic depiction that attempts to summarize the flow of capital and information in a typical contemporary private label securitization of subprime home mortgage loans.

Figure A -- Subprime Home Mortgage Securitization Structure



Initially, a mortgage broker identifies a potential borrower through a variety of marketing approaches including direct mail, telemarketing, door-to-door solicitation, and television or radio advertising. The originator and broker together identify a loan which may or may not be suitable to the borrower's needs. The home mortgage will consolidate the borrower's other unsecured debts, refinance a pre-existing home mortgage, or (more rarely) fund the purchase price of a home. In determining the interest rate and other pricing variables, the broker and the originator rely on one or more consumer credit reporting agencies that compile databases of information about past credit performance, currently outstanding debt, prior civil judgments, and bankruptcies. Consumers are given a credit score, often based on the statistical models of Fair Issacson & Co., a firm that specializes in evaluating consumer repayment. Then, the borrower formally applies for the loan. At closing, which typically takes place a week or two later, the borrower signs all the necessary paperwork binding herself to a loan which may or may not have the terms originally described. Some brokers fund the loan directly using their own funds or a warehouse line of credit, while other brokers act as an agent using the originator's capital to fund the loan. In any case, the originator establishes its right to payment by giving public notice of the mortgage through recording it with a county recorder's office. Then, in a typical conduit, the originator will quickly transfer the loan to a subsidiary of an investment banking firm. This subsidiary, which is alternatively called the securitization sponsor, or seller, then transfers the loan and hundreds of others like it into a pool of loans.[1] This pool of loans will become its own business entity, called a special purpose vehicle (SPV). The SPV can be a corporation, partnership, or limited liability company, but most often is a trust. Aside from the mortgages, the SPV has no other assets, employees, or function beyond the act of owning the loans. Under the agreement transferring loans into the pool, the SPV agrees to sell pieces of itself to investors. In a typical transaction, an underwriter purchases all the "securities"—here meaning derivative income streams drawn from payments on the underlying mortgages—issued by the pool. Usually employing one or more placement agents who work on commission, the underwriter then sells securities to a variety of investors with different portfolio needs. In designing the SPV and its investment tranches, the seller typically works closely with a credit rating agency that will rate the credit risk of each tranche. The credit rating agency investigates the credit risk of the underlying mortgages as well as the risks posed from pooling the mortgages together. Credit ratings on each tranche are essential, since investors rely on these ratings in deciding whether to invest in the pool of mortgages. The rating agency will typically require some form of credit enhancement on some tranches to assign them higher investment ratings. Often this enhancement will take the form of a third party guarantee from an insurance company on losses from mortgage defaults and prepayments.

[1] Sometimes the loan will be held in an SPV that is a wholly-owned subsidiary of the originator or the underwriter while awaiting assignment into an independent SPV that will issue securities. *See, e.g.*, Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994) (describing advantages of "two tier" securitization conduit structures).

The seller also arranges to sell the rights to service the loan pool to a company which will correspond with consumers, receive monthly payments, monitor collateral, and when necessary foreclose on homes. Sometimes the originator retains servicing rights which has the advantage of maintaining a business relationship with homeowners. But often servicing is done by a company specializing in this activity. Increasingly, pooling and servicing agreements allow for several different servicing companies with different debt collection roles. A master servicer may have management responsibility for the entire loan pool. Similar to a subcontractor in construction, the master servicer may subcontract to subservicers with a loan type or geographic specialty. The pooling and servicing agreement may also allow for a special servicer that focuses exclusively on loans that fall into default or have some other characteristics making repayment unlikely. Some servicing agreements require servicers to purchase subordinated tranches issued from the mortgage pool in order to preserve the incentive to aggressively collect on the loans. Servicing rights now frequently change hands, often multiple times per year. If, for instance, a servicing company is not meeting collection goals or is charging the trust too much, the trustee may contract with a new servicer.

In many securitization deals sellers and trustees agree to hire a document custodian to keep track of the mountains of paperwork on loans in the pool. A related role is commonly played by a unique company called Mortgage Electronic Registration System, Inc. (MERS, Inc.). MERS, Inc. is a corporation registered in Delaware and headquartered in the Virginia suburbs of Washington, D.C. With the cooperation of the Mortgage Bankers Association of America and several leading mortgage banking firms, MERS, Inc. developed and maintains a national computer networked database known as the MERS. Originators and secondary market players pay membership dues and per transaction fees to MERS Inc. in exchange for the right to use and access MERS records. The system itself electronically tracks ownership and servicing rights of mortgages. Currently more than half of all home mortgage loans originated in the United States are registered on the MERS system.[2]

In addition to keeping track of ownership and servicing rights, MERS has attempted to take on a different, more aggressive, legal role. When closing on a home mortgage, participating originators now often list MERS as the "mortgagee of record" on the paper mortgage.[3] The mortgage is then recorded with the county property recorder's office under MERS, Inc.'s name, rather than the originator's name—even though MERS does not solicit, fund, service, or ever actually own the loan. MERS then purports to remain the mortgagee of record for the duration of the loan even after the originator or a subsequent assignee transfers the loan into an SPV for securitization. MERS justifies its role by explaining that it is acting as a "nominee" for the parties.[4]

The parties obtain two principal benefits from attempting to use MERS as a "mortgagee of record in nominee capacity." First, under state secured credit laws, when a mortgage is assigned, the assignee must record the assignment with the county recording office, or risk losing priority vis-à-vis other creditors, buyers, or lienors. Most counties charge a fee to record the assignment, and use these fees to cover the cost of maintaining the real property records. Some counties also use recording fees to fund their court systems, legal aid organizations, or schools. In this respect, MERS' role in acting as a mortgagee of record in nominee capacity is simply a tax evasion tool. By paying MERS a fee, the parties to a securitization lower their operating costs. The second advantage MERS offers its customers comes later when homeowners fall behind on their monthly payments. In addition to its document custodial role, and its tax evasive role, MERS also frequently attempts to bring home foreclosure proceedings in its own name. This eliminates the need for the trust—which actually owns the loan—to foreclose in its own

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[2] R.K. Arnold, *Viewpoint*, INSIDE MERS (MERS Inc.), May-June 2004, at 1.

[3] Alternatively, the originator may close in its own name and then record an assignment to MERS. Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO. L. REV. 805, 806-7 (1995).

[4] Slesinger and McLaughlin attempt to explain:

> Consistent with mortgage participations where a lead participant holds legal title on behalf of the other participants, and with secondary market transactions where mortgage servicers hold legal title on behalf of their investors, MERS will serve as mortgagee of record in a nominee capacity only. After registration, all subsequent interests will be established electronically.

name, or to reassign the loan to a servicer or the originator to bring the foreclosure.

Altogether, the goal of this complex system was to marshal capital into home mortgage loans. It was thought that securitization would decrease the information costs for investors interested in investing in home mortgages. By pooling mortgages together and relying on a rating agency to assess the securities funded by the pool, investors thought they had a reliable prediction of expected returns without investigating each individual originator and each individual loan. Also, securitization allows loan originators and brokers to make great profit from origination fees by leveraging limited access to capital into many loans. Even lenders with modest capital can quickly assign their loans into a securitization conduit, and use the proceeds of the sale to make a new round of loans.[5] These advantages have increased consumer access to purchase money mortgages, home equity lines of credit, and cash-out refinancing. And while, in general, this is a positive development for American consumers, it has had profound and less beneficial consequences for some borrowers and investors.

II. Current Consumer Protection Laws Presume an Antiquated Model of Consumer Mortgage Finance

Securitization of subprime mortgage loans has proven extremely adept at generating high volume. But, as a system, it has not yet proven capable of reliably providing high quality services to consumers and investors. I believe this problem stems from the legal incentives actors in the system operate under. The one uniform feature of residential mortgage law is its failure to recognize and account for the complex financial innovations that have facilitated securitization structures. Most of the relevant consumer protection law, including the Truth in Lending Act (1968), the Fair Debt Collection Practices Act (1977), the Equal Credit Opportunity Act (1974), the Fair Housing Act (1968), and the Federal Trade

Slesinger & McLaughlin, *supra* note 165, at 806-7.

[5] Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002) (Professor Eggert helpfully characterized this process as "churning").

Commission's holder in due course notice rule (1975) all preceded widespread securitization of subprime mortgages by over a decade. While this time frame is not meaningful in itself, it hints at a fundamental structural problem in the law. The authors of these laws wrote definitions and rules that are poorly adapted to the current marketplace. Left without a meaningful vocabulary amenable to regulation of securitized consumer loans, courts and regulators have struggled to crowbar satisfactory policy outcomes out of legal rules and concepts which only vaguely relate to the commercial reality they purport to govern.

Taking one of many possible examples, the Truth in Lending Act and the Home Ownership and Equity Protection Act only govern the behavior of "creditors". This word suggests a unitary notion of a single individual or business that solicits, documents, and funds a loan. A creditor is currently defined as "the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness."[6] This definition is important since the private cause of action creating the possibility of liability under the act extends only to "any creditor who fails to comply" with the Act's requirements.[7] While this definition resonates with the notion of a lender as we commonly think of it, this notion is increasingly discordant with reality. In the vast majority of subprime home mortgage loans, most of the actual tasks associated with origination of the loan, including especially face-to-face communication with the borrower, are conducted by a mortgage loan broker.[8] Because brokers usually do not fund the loan, they are not the party to whom the loan is initially payable. The absurd result is that the federal statute which purports to promote useful and accurate disclosure of credit prices, does not govern the business or individual that actually *speaks* to a mortgage applicant. Rather, liability for the statute is confined to errors in the complex paperwork that many consumers have difficulty reading and are

[6] 15 U.S.C. § 1602(f).
[7] 15 U.S.C. § 1640(a).
[8] Many mortgage market insiders have begun to discard terms "lender" and "broker" instead using "mortgage-makers". *See, e.g.*, Jesse Eisinger, *Long and Short: Mortgage Market Begins to See Cracks as Subprime-Loan Problems Emerge*, WALL ST. J., Aug. 30, 2006, at C1 ("The worry has been that in the rush to gain customers during the housing boom, mortgage-makers lowered their lending standards. During the boom times, investment banks overlooked these concerns because they had no problem finding buyers for their mortgage and debt products.").

typically ignored in hurried loan closings long after borrowers arrive at decision on which broker and/or lender to use.

This problem is made acute by the fact that in the subprime market mortgage loan brokers and originators have fundamentally inefficient incentives. These actors are not paid out of the monthly payments borrowers make on their loans. Rather brokers and originators are paid out of the closing costs and the proceeds of selling loans to secondary market participants. Generally speaking, the more loans originated the more money the broker or originator makes. Similarly, other things being equal, the larger the loan, the higher the commissions, closing costs, and sale proceeds that a broker or originator earns. These simple facts create strong short term incentive for brokers and originators to cut corners in the underwriting process—creating a dangerous and sometimes fraudulent disparity between company policies and company practices. It also creates an incentive for brokers and originators to encourage consumers to borrow more money than they can afford. Moreover, brokers and originators in the current system have an incentive to put tremendous pressure on appraisers to appraise home values higher and higher in order to facilitate ill-advised loans.

Similar problems exist for many of the other core concepts in the consumer protection law. Subprime mortgage servicers are usually outside the scope of the Fair Debt Collection Practices Act. The great majority of subprime originators are beyond the scope of the Home Ownership and Equity Protection Act. And the secondary market financiers that design the capital engine generating questionable loans are usually beyond the scope of assignee liability rules which purport to create an incentive for investors to police the market. All of these examples illustrate how the secondary market has evolved out of the reach of consumer protection law—in effect deregulating the most important and volatile consumer lending market.

III. Securitization Makes the Process of Objecting to Unethical and Illegal Lending More Costly

for Consumers

Another, equally important, critique of the effect of securitization lies in the impact it has on civil procedure. Discovery, negotiation, and litigation in general are more expensive for consumers with securitized loans than for loans funded by the traditional secondary market. One of the principal characteristics of securitization is that it tends to erect many barriers that prevent consumers from complaining effectively about unethical, unfair, or illegal treatment by loan brokers, originators, or servicers.

In traditional two and three-party mortgage markets, consumers and their counsel had a clearer idea of whom they were borrowing from and who might seek to foreclose upon them if they failed to repay. Service of process, interrogatories, depositions, and negotiations could be expected to involve only one company which was responsible for all, or nearly all, the relationship functions associated with the loan. In comparison, selling a loan into a contemporary structured finance conduit can force consumers to communicate with and litigate against many more business entities. Even simple litigation tasks, such as service of process and requests for production of documents, are much more complicated in structured finance. Whereas forty years ago, a borrower might need to serve one party, to bring the full range of legal claims and defenses to bear on a securitization conduit can require serving ten or more different businesses.[9] This is a daunting task indeed, since at the outset, the consumer will almost always have no knowledge of the name, address or other contact information for many of these firms. Indeed, counsel for the foreclosing party herself probably does not know which businesses were involved in performing the various functions associated with the loan. Phone calls to the loan's servicer are frequently ignored, subject to excruciating delays, and typically can only reach unknowledgeable staff who themselves lack information on the larger business relationships. Indeed, since consumers cannot shop for their servicer,

[9] These include: a broker, originator, MERS, master servicer, sub-servicer, special servicer, trustee, seller, underwriter, and an underwriter's due diligence contractor. If servicing rights have changed hands during the life of the loan, the consumer could require discovery from both old and new servicers.

these companies have virtually no market based incentive to provide useful customer service, such as the provision of vital information or correcting accounting and legal errors. For their part, securitization trustees are not in the business of counseling the thousands of mortgagors pooled in each of the many real estate trusts they oversee. Policy makers must not underestimate the staggering difficulty of reconstructing the facts involved in only one loan. Securitization creates an opaque business structure that consumers have great difficulty navigating.

These characteristics of securitized residential lending are troubling because even marginal increases in the cost of dispute resolution can have a dramatic impact on subprime mortgage borrowers. Consumers who are facing home foreclosure will not have the funds to hire counsel to assert their rights—after all, if they had the money, they would have made their payments. Organizations that provide free legal help, such as legal services organizations and law school clinics uniformly lack sufficient investigatory, paralegal, and administrative support. These organizations simply cannot handle even a small fraction of the volume of default generated by securitization structures even in strong market conditions.

The traditional civil justice system response to this type of disparity in dispute resolution resources has been the class action mechanism. But class actions are not generally viable in foreclosure defense, because each case has individual claims and facts that play out on unique time lines. Furthermore, courts often tend to refuse to certify classes alleging fraud, on the theory that the reliance element is an individual question not common to the class. Moreover, under the questionable guise of the Federal Arbitration Act, some courts have begun enforcing mandatory arbitration agreement clauses which waive altogether consumers' rights to proceed as a class. This development is particularly troubling because it also prevents the common law from innovating new legal incentive structures as a response to securitization, since arbitrators do not publish opinions. Most of the abusive and questionable subprime loan disputes may never reach the court system because they will be dealt with in high cost, secret, private meetings rather than in a transparent public institution following the bedrock principle of *stare decisis.*

In consumer protection law, as in other areas of the law, substantive rights are only meaningful if there is some procedural vehicle for enforcing those rights. Even if securitization did not change the substance of consumer legal rights, the fact that litigation of those rights is much more costly for consumers must be seen as a fundamental disadvantage of securitization in general. Securitization sharpens the mortgage industry's comparative advantage in managing dispute costs. Not unlike a chess grand master making even piece trades down to checkmate after gaining a slight edge, predatory lending strategists can use their advantage in managing litigation costs to hide from judicial scrutiny within large structured finance deals. Higher dispute resolution costs associated with securitization significantly corrode the substantive consumer protection rights cast by our existing law. The result has been that consumers have little or no competent legal advice on how to deal with unfair, unethical, and illegal treatment in the mortgage subprime lending industry. With no watchdogs on the beat, even well-meaning companies have gradually began to grow more, and more comfortable with questionable behavior simply to remain competitive.

IV. <u>Securitization Can be Manipulated to Shelter Assets, Protecting Wrongdoers from Liability for Unethical and Illegal Behavior</u>

Because securitization allows an originator to quickly resell its loans, the originator can make many loans while exposing only minimal assets to liability. As Professor Eggert has explained, this "churning" of capital "allows even an institution without a great amount of fixed capital to make a huge amount of loans, lending in a year much more money than it has."[10] As a result, when a class of predatory lending victims attempts to satisfy a judgment, their damages may far exceed the value of all the lender's assets. If an individual victim succeeds, or is about to succeed in obtaining a judgment, the lender can

[10] Eggert, *Predatory Lending, supra*, at 546 (footnotes omitted).

negotiate a settlement. If an individual or class of victims obtains a large judgment, the lender's management can simply declare bankruptcy, liquidate whatever limited assets are left, and possibly reform a new company a short time later. Management of predatory lenders are indifferent because they are typically paid in full, or even give themselves raises, as their companies plow into bankruptcy.[11]

Moreover, because the securitization conduit divides various lending tasks into multiple corporate entities—a broker, an originator, a servicer, a document custodian, etc.—the conduit tends to prevent the accumulation of a large enough pool of at risk assets to attract the attention of class action attorneys, which tend to be the only actors capable of obtaining system-impacting judgments. Legal aid attorneys and private counsel that bring individual claims often struggle with the length of litigation and the tremendous discovery problems presented in dealing with counsel for each individual entity in the conduit. The FTC and state attorneys general, of course, fare much better, but their limited budgets and personnel guarantee their cases only address the high profile offenders while the vast bulk of the market remain undisturbed.

These contentions are bolstered by the disturbing number of bankruptcies amongst subprime brokers and originators. Consumer advocates have complained that the subprime mortgage origination market has been saturated with "fly by night" lending operations.[12] These critics argue that individual business persons have learned to flip loans and then disappear, leaving consumers with no remedy.[13] A

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[11] The Orange County Register reported:

> Executives at the region's controversial subprime lenders, including BNC Mortgage and First Alliance, provided investors with fresh reasons to dislike the industry. While BNC profits fell 24 percent, CEO Evan Buckley and President Kelly Monahan took home whopping pay increases of 79 percent and 83 percent, respectively. The folks over at First Alliance were just as cheeky. As earnings tumbled 71 percent, and government probes into the company's allegedly predatory practices widened, top executives took no pay cut.

James B. Kelleher & Jennifer Hieger, *Generous Executive Pay Often Fails to Bring Generous Shareholder Results*, ORANGE COUNTY REG., June 12, 2000, *available at* 2000 WLNR 6366186.

[12] Bert Caldwell, *Borrowing trouble: Predatory Lenders Rely on Consumer Desperation; Ignorance, by Deliberately Boosting Credit; and Offering Unrealistic Loan Terms*, SPOKESMAN REV. Jan. 20, 2002, at D1 (Washington State Executive Director of the housing consortium explaining that "dozens of companies move in and out of the local refinance market, doing 20 deals one year, just one the next. Some agents and brokers draw fees from multiple companies. 'It's kind of like hitting a moving target . . . .'")

[13] NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES, § 6.6.1.1 (2001 & Supp.). *See also* Tamara Loomis, *Predatory Lending Law Has Investment Firms in Arms*, 229 N.Y. L. J., March 27, 2003, at 1 ("Consumer groups say assignee liability is critical in the fight against predatory lending because many of the loan originators are shady individuals who

common pattern has developed where mortgage loan originators follow a boom and bust cycle. Indeed, in recent years, many of the nation's largest subprime lenders have followed this model, "leaving a vast number of subprime borrowers without any remedy" for predatory lending.[14] Literally "hundreds of small and mid-size mortgage banks" periodically go bankrupt.[15] As for the largest lenders, between 1988 and 2000, most of them helped themselves to judgment lien immunity from borrower lawsuits with respect to a staggering 125 billion of home mortgage dollars by declaring bankruptcy.[16] Unlike consumer borrowers, investment analysts fully recognize this boom-bust cycle, and cautiously dissect where in the cycle any given lender is at a given point in time.[17] The result is that when a judgment or series of judgments might substantially shape origination practices, these judgments will usually be defeated by the insolvency of the offending lender. The latest round of bankruptcies among subprime mortgage originators is simply a continuation of a systemic pattern created by the legal incentives in the industry.

In the older three party mortgage markets, the strict underwriting guidelines associated with government sponsored enterprises significantly limited the number of predatory lending victims. Why make a predatory loan if the only significant source of liquidity for the loan—the federal government—would refuse to purchase or guarantee it? In the new market place, mortgage loan originators serve not only an intake function—using marketing strategies to line up borrowers—but also a filtering function. As thinly capitalized originators make more and more loans, *claims against the lender accumulate, while the lender's assets do not.* The lending entities are used like a disposable filter: absorbing and deflecting origination claims and defenses until those claims and defenses render the business structure unusable. At

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flip the loans and disappear.").

[14] Eggert, *Predatory Lending*, *supra*, at 603.

[15] Robert Julavits, *Warehouse Lenders Struggle Through Merger Boom*, AM. BANKER, Oct. 23, 2000, at 9A..

[16] *See also* Erick Bergquist, *Preparing for a Bad-Loan Boom*, AM. BANKER, Oct. 6, 2000, at 1 ("Since the liquidity crisis of October 1998, most of the major subprime mortgage lenders have filed for bankruptcy. Given that these failed lenders have issued $125 billion of mortgage- and asset-backed securities over the past three years, . . . it would not be a surprise if 10% to 20% of the loans underlying those securities go bad.").

[17] *See, e.g.*, Laura Mandaro, *Wamu Goal: 500 Café Loan Sites*, AM. BANKER, June 21, 2001, at 1 (analyzing whether Washington Mutual boom will lead to a bust); Aaron Elstein, *Analysts: No End in Sight to Consolidation: Panelists Doubt Thoroughness of Due Diligence, Question Large Writeoffs*, AM. BANKER, July 23, 1998, at 16 (analyzing investment credit risk from overpriced

the point when exit costs are less than the marginal expected utility of using a business entity subject to the wrath of the court system, the lender declares bankruptcy and/or reaches a questionable settlement neither of which preserve the homes of those who were wronged nor deter future predatory conduct. The result: the individuals who engage in predatory behavior and the individuals who engineer capital structure to facilitate that behavior are judgment-proof.

V. What Should be Done? Necessary Reforms to Restore Balance in the Mortgage Market

Unfortunately, there is no simple, silver bullet solution to the current mortgage market problem. For example, I do not believe that an agreement by key industry insiders to new best practices will change these structural problems. Nor do I believe that a "wait and see" approach of hoping that stabilization in home prices will solve these problems. The recent downturn in home prices only exposed the underlying inefficiencies in the market that have been festering for some time. Instead, I believe it is time for the Congress to consider adopting *comprehensive reform* of the nation's consumer lending laws.

In my view, these reforms should include four policy areas: servicing reform, disclosure and closing reform, price regulatory reform, and liability reform.

A. Congress Should Adopt Comprehensive Reform of Consumer Mortgage Servicing Law

These reforms should include applying federal standards that attempt to prevent servicer errors and misbehavior. Servicers should be required to maintain complete and accurate files on all mortgage loans, including information on the loan's history, assignments, and servicing rights. Moreover, because of the opacity of the current marketplace, consumers ought to have the right to view all the documentation in their loan file. Servicers and nominees should only be allowed to bring foreclosure actions on behalf of the holder of a loan when that holder has agreed to allow the consumer to assert claims or defenses

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subprime mortgage loans).

available against the holder against servicer or nominee. Moreover, at a minimum, the federal Fair Debt Collection Practices Act should be amended to govern all collection of home mortgage loans.

B. Congress Should Pass Comprehensive Reform of the Consumer Credit Disclosure and Closing Law

The Truth-in-Lending Act and the Real Estate Settlement Procedures Act should be integrated to provide consumers with a seamless, easily understood, scientifically tested price tag for all mortgage loans. Consumers must be able to learn the best pricing and terms a lender can offer up front, while the consumer is still shopping for the best deal. To this end, Congress should eliminate RESPA's misleading and toothless "good faith estimate". In its place Congress should require that lenders and brokers provide guaranteed closing cost quotes. Truth in Lending regulations should be amended to tighten the finance charge definition. The policy behind the finance charge regulations should come to reflect expenses incurred by the borrower rather than charges received by the lender. Finally, Congress should consider expanding the required borrower counseling for reverse mortgages to all subprime mortgages.

C. Congress Should Reform Federal Usury Preemption Laws

Under current federal law, there is no limit to the prices lenders can charge families for residential mortgages. Congress preempted interest rate restrictions on residential mortgages in an inflationary era when many states still insisted on general usury laws that are generally thought to be too low by modern standards. To this end, preempting state interest rate limits for residential mortgages was a good idea. But there is a reasonable middle ground between complete preemption and no preemption at all. In the home mortgage market, Congress should consider preempting state price limitations, but only those limitations which dip below a reasonable yield spread. There is no satisfactory justification for preempting state price regulation on mortgage loans with interest rates of more than eight percentage points above comparable term treasury notes. Moreover, it is time for Congress to restore the common-sense rule that in cross-state-border lending, the consumer's home state pricing law applies, rather than the bank or thrift's home state law. The Supreme Court's price exportation doctrine established in *Marquette National Bank of Minneapolis v. First Omaha Service Corp.*[18] has served the useful purpose of helping clear the way for the establishment of a national credit economy. Nevertheless, the important public policy of deterring the most extreme consumer lending abuses has suffered as a result. Today's leaders are should be ready to find a middle ground prohibiting the most dangerous and anti-social loans while facilitating the credit we as a society have come to embrace. Setting federal preemption floors would give states the opportunity to experiment with new methods of constraining predatory lending, while simultaneously preventing state governments from undermining lending within widely accepted limits.

D. Congress Should Adopt Comprehensive Mortgage Market Liability Reform

As a first step, either Congress or the Federal Trade Commission should expand the time-tested FTC holder-notice rule to cover all home mortgages, rather than just those that finance the acquisition of consumer goods or services. This rule has governed automobile financing for a generation, without inhibiting the flow of credit. Still, while amending the FTC holder-notice rule to include home mortgages would bring mortgage assignment law out of the nineteenth century, it would not bring the law up to date. The FTC holder-notice rule, along with promising proposals to create tiered assignee liability rules based on the extent to which assignees comply with due diligence standards,[19] both hold investors responsible for the misdeeds of other businesses. Most investors have little opportunity to learn about predatory practices associated

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18. 439 U.S. 299 (1978).

19 Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?* 15 HOUSING POL'Y DEBATE 715 (2004).

with pool loans. Stepping-up assignee liability is an improvement over the current legal system which tends to allocate losses from predatory lending to victims. But assignee liability rules merely shift predatory lending losses to investors. The change is, in effect, a transition from blaming the victim to blaming the patsy. Policy makers must come to terms with the notion that contemporary predatory mortgage lending is an economic artifice with two classes of casualties: consumers *and* investors. For this reason, proposals which create unlimited assignee liability may go too far by forcing relatively innocent investors to bear the brunt of large punitive damage awards. Is it fair to punish investors with unlimited punitive damage awards because they relied on unmet promises of due diligence from sellers and underwriters? It is true that investors could, in theory at least, bring lawsuits against these architects of a securitization deals seeking indemnity for damages. But judicial economy counsels against this approach. In order to levy damages on the responsible party, two separate victim classes would be required to win two separate lawsuits. The high transaction costs of such an enforcement system seem likely to undermine its deterrent value. The FTC's holder-notice rule steers a responsible middle road on this question by capping investor liability at the amount paid by a consumer under the loan in question.

This is not to say, however, that uncapped punitive damages have no place in deterring predatory mortgage lending. Rather, the full weight of judicial sanctions against predatory commercial behavior should be born by the businesses and individuals that abet, conspire, or co-venture that behavior. Congress should adopt legislation requiring that where securitization underwriters or sellers either knew or should have known that they were assisting in the securitization of illegal loans, those investment banks should bear imputed liability for aiding and abetting that conduct. This rule would reverse the current incentive of the architects of securitization deals to avert their eyes to the seamy details of loans they channel to investors.

In conclusion, subprime mortgage market lacks the steady and consistent influence of the federally sponsored secondary mortgage market infrastructure that served our country so well throughout most of the twentieth century. Because there is no public actor exercising an underwriting function, the subprime mortgage market must rely instead on the rule of law. Unfortunately, this is precisely what is lacking in the current regulatory environment. What imperfect consumer protection legislation we have, has been rendered moot by commercial change. Moreover, even if our consumer laws meaningfully applied to subprime loans, the opacity of securitization deals makes successful consumer enforcement of their rights cost prohibitive. Finally, the capital structure of subprime mortgage lenders tends to render the most culpable parties immune from judicial sanctions. While no one wishes to return to the two-party mortgage market where consumers had little access to home loans, the current system of lawless illusory underwriting is not satisfactory either. Congress must lead the way in creating a system that corrects the current legal system's perverse incentives. Otherwise, the subprime market will continue to suffer from inefficiency and injustice.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM DAVID SHERR

Q.1. We are aware that there are various parties involved in securitization structures, and it has been said that at times the interests of one party might vary from the interests of others. Are there situations where the best interest of the borrower (remaining in their home) might be in conflict with the interest of another participant? Can you explain a situation where that might be the case? What are some ways in which we can ensure that parties work toward a common solution that benefits both the borrower and the investor?

A.1. The interests of all participants in the mortgage securitization process are generally aligned. Everyone wants homeowners to be able to make the monthly payments on their mortgage loans. Nobody wins when the only viable option for managing a loan is foreclosure, not borrowers who could lose their home, nor bondholders who rely upon loan payments as the basis for returns on their investments.

Typically interests remain aligned even when a loan is in distress. Because foreclosure hurts everyone, the interested parties already are motivated to do exactly what your questions ask—work toward a common solution that benefits both the borrower and the investor. For example, loan servicers currently are engaging in early intervention for "at risk" borrowers, and are modifying loan terms when possible so as to increase the likelihood that borrowers will be able to make their monthly payments.

Notwithstanding all the efforts to avoid foreclosures, there unfortunately are situations where no reasonable modification of a loan can be made that would increase the likelihood of borrower repayment, and foreclosure becomes the only practical option. At that point, the interests of borrowers may diverge from the interests of other participants in the securitization process who depend upon some payment flow from borrowers. But that divergence is reached only after a long road on which everybody works together to keep borrowers in their homes.

Q.2. What do you view as the major impediments towards you being able to work out flexible arrangements with troubled borrowers whose loans reside in securitization structures? For example, some have referred to the REMIC rules, others have mentioned accounting rules, while others have pointed to limitations in the deal documents. Can you provide further clarity on this subject?

A.2. Certain impediments to loan modifications already have been removed. For example, the securitization industry was concerned about the accounting treatment of loan modifications under Financial Accounting Standard 140, but guidance issued by the Securities and Exchange Commission this past July has eliminated that concern. Other factors that have been pointed to as potentially creating impediments do not in practice hinder loan modifications. The REMIC rules permit modification as long as a loan is in default or reasonably likely to go into default. Similarly, most deal documents do not impede modifications, as they provide servicers with ample flexibility to work with borrowers. To the extent that servicers have lacked any significant powers to modify, market forces will lead to enhanced flexibility in future contracts.

As for ways that the government could increase flexibility to modify loans, it has been suggested that tax treatment should be modified to provide that forgiveness of principal is not taxable to borrowers.

Q.3. There has been considerable discussion in the financial press about loan putbacks due to early payment default. Please provide a definition of an early payment default putback. Why would investors who are being paid to assume the risk in these securitization structures be allowed to "put" these loans back to another party? Can you give us some idea as to how many loans were put back during 2006 because of early payment default? In your view, what does an increase in early payment default putbacks tell us about the underwriting standards used in making these loans? Also, what percentage of loan purchase agreements is made with recourse? How many loans were put back during 2006 because of recourse agreements?

A.3. Contractual provisions for "early payment default" putbacks vary, so there is no single definition. In general, such provisions require the seller of a loan to repurchase it from the purchaser when the purchaser does not timely receive the first and/or second monthly payment on that loan following the sale. A rationale for such provisions is that an early payment default could be an indication of fraud in the lending process, and that responsibility for detecting and avoiding such fraud should lie with the seller of the loan. In addition to the possibility of fraud, an increase in early payment defaults could reflect a deteriorating economy, a declining housing market, or insufficiently rigorous underwriting standards.

With respect to loans acquired or otherwise owned by Lehman during 2006, Lehman estimates that approximately 2.0% of such loans have been subject to repurchase claims as a result of breaches of representations or warranties made in connection with the origination or sale of such mortgage loans. Most of such repurchase claims would be the result of "early payment defaults."

Substantially all of the mortgage loans that are purchased by Lehman are purchased subject to recourse agreements pursuant to which the seller makes certain representations and warranties regarding the mortgage loans. The pool of residential loans purchased by Lehman during 2006, without recourse to representations and warranties, would be de minimis.

Q.4. An examination of Pooling and Servicing agreements outlining the contractual duties of mortgage servicers for securitized loans reveals, for example, a 5–10% cap on loan mediation generally based on the total number of loans in the pool as of the closing date. Please explain the rationale behind these caps. Are you aware of any specific loan pools where these caps were maxed out and whether rating agency permission would have been necessary to exceed the caps? When caps are maximized, what is the process and likelihood for obtaining permission to exceed the caps?

A.4. Lehman typically does not use caps for loan modifications on its residential mortgage deals. Nor is it aware of any other deals where a cap on modifications has been exceeded.

Q.5. When mortgage originations and securitization are done by vertically integrated firms, where are the checks and balances to prevent inappropriate actions that could harm borrowers and investors?

A.5. Vertical integration in the mortgage securitization business benefits both consumers and investors. When a financial institution, such as Lehman, sells mortgage-backed securities to sophisticated investors, its success depends largely upon the quality and ultimate performance of the loans underlying those investments. By participating in the origination process through vertical integration, financial institutions are situated to implement origination controls that result in loans that are likely to perform over the long term. Moreover, financial institutions such as Lehman derive great value from maintaining their reputation in the business community. This reputational concern creates yet another incentive for such institutions to originate quality loan products.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM DAVID SHERR

FORECLOSURE PREVENTION STRATEGIES

Q.1. Last week, the Joint Economic Committee of Congress issued a report called "Sheltering Neighborhoods from the Subprime Foreclosure Storm" that found that foreclosure prevention is much less costly than actual foreclosures, for all parties involved. We found that one foreclosure can cost all stakeholders up to $80,000, while foreclosure prevention services by a non-profit can cost as little as $3,300 on average. In your testimonies today, we have learned that because half of these loans have been securitized, loan modifications of securitized sub-primes could be much more difficult, and perhaps even more costly. I have two questions that hope to get at the heart of this difficulty and figure out how we can better align incentives toward loan modifications that keep vulnerable families in their homes.

Q.2. My follow-up question is to Mr. Sherr from Lehman Brothers: Mr. Sherr, you mentioned in your testimony that you expect the banks, as many of the largest sub-prime loan servicers and holders of mortgage loans, to engage in "home retention" practices in an effort to avoid foreclosures.

Given the large percentage of exploding ARMs that were underwritten to borrowers that can not afford them at their fully-indexed rates, will these "home retention" practices include some form of debt forgiveness for borrowers that were proven victims of predatory lenders? In other words, when a loan modification results in a conclusion that the home owner was deceived into a loan that was mathematically designed to fail them after the teaser rate resets, is home retention even possible without forgiving the portion of the debt that the homeowner would have never qualified for under acceptable underwriting standards?

A.1. & 2. Your question focuses specifically on loans originated fraudulently and without regard for the borrower's ability to make payments after the initial interest rate resets to a higher rate. A borrower who was defrauded into entering into a loan could pursue various legal remedies against the perpetrator of the fraud. Moreover, the borrower might be able to retain his or her home by exploring workout options. Where feasible, servicers could modify a loan that resets at a high interest rate, so as to increase the likelihood that the borrower could make reasonable monthly payments. Lehman is working with the servicing community to increase the number of borrowers who may be appropriate candidates for some form of loan modification. As a separate matter, financial institutions, such as Lehman, are helping to deter unscrupulous lending practices before they begin, through enhanced diligence of mortgage originators.

Q.3. Finally, Mr. Sherr you spoke about the industry using "home retention" practices to avoid foreclosures. Can you and your colleague Mr. Sinha talk to us in more detail about particulars of what your firms are doing on the "home retention" front?

Have you all discussed the need for a private market "rescue fund"?

A.3. Lehman has implemented an extensive set of "home retention" practices that emphasize early intervention and flexible options. For example, Lehman sends notification letters to borrowers in advance of a substantial increase in their interest rate. In those letters, Lehman encourages the borrowers to call Lehman's Home Retention Department before the reset if they believe that they will not be able to make the increased payments. The Department also unilaterally reaches out to borrowers in delinquency to discuss workout options. In order to make sure that distressed borrowers get the help they need, Lehman recently has expanded the Home Retention Department's hours of operation and is increasing staff to enhance counseling availability.

As warranted by the circumstances, Lehman makes various strategies available to distressed borrowers. Forbearance plans allow delinquent borrowers to reinstate their accounts over several months by paying more than the monthly contractual payment. Special forbearance plans suspend or reduce contractual payments to allow borrowers to solidify arrangements to reinstate past due amounts. Loan modifications provide adjustments to note terms, such as reductions in interest rates and extension of maturity dates. These are but a few of the types of strategies offered to distressed borrowers by Lehman.

As a separate matter, Lehman has committed to contribute $1.25 million to the National Community Reinvestment Coalition during the next three years. NCRC will use this money to help distressed borrowers restructure their loans and to educate prospective borrowers about mortgages.

REGULATION

Q.4. As you all know on the panel, federal banking regulators published guidance on alternative mortgage as well as sub-prime hybrid adjustable mortgage products last year and more recently have issued a new statement on these products for comment. Does the guidance apply to your firms in each of its capacities—lender, issuer, and underwriter of sub-prime and alternative mortgage products?

Given your status as a Consolidated Supervised Entity (a broker-dealer that meets certain minimum standards can apply for this status. It gives them the ability to use alternative methods of computing net capital), do you think the SEC should be involved in the process of developing future guidance on these mortgage products in order to ensure that securities companies that are non-bank regulated entities are covered?

A.4. Lehman appreciates the leadership exercised by the federal financial regulatory agencies through their guidance on nontraditional mortgage products. That guidance applies to Lehman when it makes or purchases loans. Lehman also notes that, because much of its origination activities occur through Lehman Brothers Bank, those activities are subject to review by the Office of Thrift Supervision.

Lehman believes that the agencies that issued the guidance, rather than the SEC, should continue to take the lead in regulating mortgage products. The SEC nonetheless has an important role with respect to the mortgage securitization process—protecting investors in mortgage-backed securities. And the SEC has been active in that area, especially through its adoption in 2005 of Regulation AB, which codified decades of guidance and practice in the regulation of publicly registered asset-backed securities.

Q.5. What level of due diligence do purchasers of sub-prime loans conduct to ensure the products they are buying meet underwriting requirements and or state/federal laws?

Follow up:

Given the level of due diligence that is conducted, would the purchaser not be in a good position to guard against bad loans entering into investment pools from the very beginning?

A.5. Purchasers of sub-prime loans, such as Lehman, start their diligence by examining the lenders themselves. Before Lehman enters into a relationship with a lender, it spends time learning about that lender, its past conduct and its lending practices. After that review is completed, Lehman's diligence turns to the specific loans that are offered for sale, often relying on third party due diligence providers who have expertise in reviewing loan files. The percentage of a loan pool that gets tested is greater when Lehman first enters into a relationship with a lender than when Lehman has a longstanding relationship with a lender who has demonstrated good practices. The sample testing focuses on, among other things, whether the loans were underwritten in accordance with designated guidelines and complied with applicable laws. When loans fail the review, they generally are removed from the loan pool.

All this diligence helps to detect poor lending practices. But the key to guarding against fraudulent or unduly aggressive loans lies with regulation of the interaction between loan originators and borrowers. Loan purchasers do not participate in those interactions. Because it is the originator, not the purchaser, who interacts directly with the borrower, it is that interaction that should be the focus of efforts to reduce unscrupulous practices.

CREDIT QUALITY

Q.6. As we all know, the sub-prime industry is an important one—sub-prime mortgage credit market has expanded access to credit for many Americans. Today, we have seen many Wall Street firms move from not only providing capital for sub-prime loans, but also to owning sub-prime lending companies outright. My question to the investment banks on the panel is do you believe this shift to ownership is improving credit quality and performance of sub-prime loans? What more can the industry do to improve credit quality and the performance of sub-prime loans?

A.6. As discussed in response to Senator Reed's question about vertical integration, Lehman believes that ownership of subprime loan originators by financial institutions increases the integrity of mortgage loan products, thereby benefiting borrowers and investors alike. That said, since the original hearing on this matter, there have been significant changes in the mortgage industry, particularly in the subprime segment. The volume of new subprime loans has decreased substantially. In connection with that pullback in the market, Lehman has closed the operations of its subprime originator, BNC Mortgage. Nonetheless, as an industry observer, Lehman believes that credit quality in the subprime area has been improving due to the tightening of underwriting criteria.

LIABILITY

Q.7. There has been a significant amount of discussion about the role Wall Street has in the sub-prime market. There has also been a great deal said about the imposition of assignee liability to purchasers of loans. Do you feel assignee liability would play a significant role in guarding against "bad" loans being made by lenders and ultimately ending up in investor pools? If so, what level of "assignee liability" do you feel is appropriate?

A.7. Imposition of assignee liability would lead to an undesirable tightening of credit for prospective homeowners. The State of Georgia's experience with its assignee liability law illustrates this point. Soon after that law was passed, a major rating agency announced that it would no longer rate mortgage-backed securities subject to Georgia law. The rating agency reasoned that the assignee liability law created unquantifiable risk for anybody who touched the loans, including issuers and investors. Without sufficiently high ratings, mortgage-backed securities would not be purchased by investors, many of whom, such as pension funds, can only purchase investment grade securities. In light of the prospect that credit availability would be severely reduced for its citizens, Georgia amended its law to delete assignee liability.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM WARREN KORNFELD

Q.1. How do the credit risk profiles of recent subprime borrowers differ from past borrowers?

A.1. As we discussed in our written testimony, the risk profiles of recent subprime borrowers differ from those in the past. Through

2005 and 2006, in an effort to maintain or increase loan volume, many lenders made it easier for borrowers to obtain loans. For example, borrowers could:

- obtain a mortgage with little or no money down;
- choose to provide little or no documented proof of income or assets on their loan application;
- obtain loans with low initial "teaser" interest rates that would reset to new, higher rates after two or three years;
- opt to pay only interest and no principal on their loans for several years, which lowered their monthly payments but prevented the build-up of equity in the property; or
- take out loans with longer terms, for example of 40 years or more, which have lower monthly payments that are spread out over a longer period of time and result in slower build-up of equity in the property.

Often a loan was made with a combination of these characteristics, which is also known as "risk layering". The weaker performance of 2006 subprime mortgage loans in part has been due to the increasing risk characteristics of those mortgages.

Q.2. Do rating agencies have adequate data to assess credit and market risk posed by recent subprime borrowers and some of these exotic or experimental products? If so, what new types of data are you using? Do you examine from what entities the loans are originated?

A.2. Moody's cannot represent what types of data other rating agencies attain in analyzing subprime mortgage securitizations.

For Moody's part, it is important to note that, in the course of rating a transaction, we do not see loan files or data identifying borrowers or specific properties. Rather, we rely on the information provided by the originators or the intermediaries, who in the underlying deal documents provide representations and warranties on numerous items including various aspects of the loans, the fact that they were originated in compliance with applicable law, and the accuracy of certain information about those loans. The originators of the loans issue representations and warranties in every transaction. While these "reps and warranties" will vary somewhat from transaction to transaction, they typically stipulate that, prior to the closing date, all requirements of federal, state or local laws regarding the origination of the loans have been satisfied, including those requirements relating to: usury, truth in lending, real estate settlement procedures, predatory and abusive lending, consumer credit protection, equal credit opportunity, and fair housing or disclosure.

Moody's would not rate a security unless the originator or intermediary had made reps and warranties such as those discussed above. In rating a subprime mortgage backed securitization, Moody's estimates the amount of cumulative losses that the underlying pool of subprime mortgage loans are expected to incur over the lifetime of the loans (that is, until all the loans in the pool are either paid off or default). Because each pool of loans is different, Moody's cumulative loss estimate, or "expected loss," will differ from pool to pool.

In arriving at the cumulative loss estimate, Moody's considers both quantitative and qualitative factors. First, we analyze many characteristics of the loans in a pool,[1] which help us project the future performance of the loans under a large number of different projected future economic scenarios.

The quality and depth of the loan-level data provided by prospective mortgage securitizers are important elements of Moody's rating process. For each new transaction, a data tape providing key information for each loan is processed through our proprietary rating model, Moody's Mortgage Metrics.

As new products are introduced in the market and as originators capture more data, Moody's periodically expands the loan level data that we review to increase the granularity of our analysis; the most recent expansion was April 2007.[2] Generally, in the absence of key information, assumptions are utilized.

The key fields currently used in our standard analysis are listed below in the Appendix. The fields are divided into three groups: "primary", "highly desirable" or "desirable" based on their overall risk weights. For instance, "FICO" is a primary field, while "pay history grade", if provided, would be used to supplement our understanding of a borrower's risk profile. Other highly desirable fields such as cash reserves or escrow help us in further assessing the risk of a loan especially when we try to determine where a loan falls along the Alt-A to subprime continuum.

Another example of a set of highly desirable fields, are the characteristics of the corresponding first lien when analyzing a second lien loan. The characteristics of the first lien have a strong impact on the credit risk and performance of the second lien loan. Moody's expects a closed-end second lien loan behind a fixed-rate first lien loan to have a lower probability of default than a second lien loan behind a first lien Option ARM loan. Again, absent such information about the respective underlying first lien mortgage, conservative assumptions would be utilized to size for the unknown risks.

Next, we consider the more qualitative factors of the asset pool such as the underwriting standards that the lender used when deciding whether to extend a mortgage loan, past performance of similar loans made by that lender, and how good the servicer has been at collection, billing, record-keeping and dealing with delinquent loans. We then analyze the structure of the transaction and the level of loss protection allocated to each tranche of bonds. Finally, based on all of this information, a Moody's rating committee determines the rating of each tranche.

Q.3. Have you analyzed the impact loan modifications would have on mortgage backed securities and the threshold needed to stabilize the portfolios into performing loans?

A.3. To date, the level of modified loans in securitizations that we have rated has been low. We however expect this to change as interest rates on many hybrid adjustable rate loans originated during

[1] As noted earlier, we do not receive any personal information that identifies the borrower or the property.

[2] Please see, "Moody's Revised US Mortgage Loan-by-Loan Data Fields," Special Report, April 3, 2007.

the past few years approach their reset dates.[3] Furthermore, in an environment with fewer refinancing opportunities for borrowers and a slowing housing market, loan modifications are likely to become more prevalent.

A servicer's flexibility in modifying loans that have been securitized is determined by each securitization's legal documentation and by accounting and tax rules. Most securitization governing documents give servicers a degree of flexibility to modify loans if the loan is in default or default is "reasonably foreseeable," but the exact provisions differ from one transaction to another. Moody's recently reviewed the governing documents for the subprime securitizations that it rated in 2006. The vast majority of transactions permit the use of modifications—only approximately 5% of the securitizations contain specific language that does not permit the servicer to modify loans. For transactions where the servicer is allowed to modify loans, approximately 30% to 35% specify that modifications may not exceed 5% of the original pool loan balance or, alternatively, of the cumulative number of loans in the transaction. The balance of the transactions that permitted modifications contained no such cumulative restrictions. Moody's believes that restrictions that limit a servicer's flexibility to modify loans are generally not beneficial to bondholders.

Moreover, in deciding whether to modify the terms of a loan, a servicer will assess whether the loss expected from modifying a loan will be lower than the loss expected from other loss mitigation options or from foreclosure. If so, then a loan modification would lead to higher cash flows for the securitization as a whole and therefore the judicious use of modifications should lead to lower cumulative losses on loan pools backing securitizations. Therefore, the "threshold needed to stabilize the portfolios" is necessarily a case-by-case determination.

Since the purpose of a loan modification is to reduce the loss expected to be incurred on a loan that could potentially go into foreclosure, loan modifications should improve the credit profile of a securitization as a whole. The credit impact of loan modifications on any given class of bonds within a securitization, however, will vary and depend not only on the level of losses that is incurred by the pool, but also by the timing of those losses, by the bond's position in the securitization's capital structure and by the impact of loan modifications on any performance triggers that may exist in the securitization.

Q.4. Could loan modifications help stabilize the housing market generally?

A.4. Moody's does not have the expertise to opine on the impact of loan modifications on the overall housing market.

Q.5. Would you agree that the poorly underwritten exploding ARMs in the Mortgage-Backed Securities make default "reasonably foreseeable"? If not, why not? What analysis has been done to identify what characteristics more specifically define loans with high probabilities of default?

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[3] For a more detailed discussion, please see "Loan Modifications in U.S. RMBS: Frequently Asked Questions," Special Report, June 6, 2007.

A.5. We assume that this question is referring to the probability of default for the individual ARM mortgages rather than the securities that are issued by a structured finance product where the underlying assets are such mortgages. As discussed earlier, when riskier loan characteristics are combined or "layered" the credit risk associated with that loan can increase. (In May 2005, we published on the significant increase in risk posed by the increasing difference between the fully indexed rate and the original rate or the amount of teasing of newly originated loans.[4]) However, the analysis of the default probability of a particular loan is in large part based on historical data with respect to similar types of loans. Importantly, the default probability of such loans will depend not only on the loan characteristics but on the macro-economic environment and the overall state of the housing market. Consequently, MIS believes that while "exploding ARMs" may have riskier characteristics, that fact alone does not determine whether the borrower will default on his mortgage.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM WARREN KORNFELD

Q.1. As you all know on the panel, federal banking regulators published guidance on alternative mortgage as well as sub-prime hybrid adjustable mortgage products last year and more recently have issued a new statement on these products for comment. Does the guidance apply to your firms in each of its capacities—lender, issuer, and underwriter of sub-prime and alternative mortgage products?

Given your status as a Consolidated Supervised Entity (a broker-dealer that meets certain minimum standards can apply for this status. It gives them the ability to use alternative methods of computing net capital), do you think the SEC should be involved in the process of developing future guidance on these mortgage products in order to ensure that securities companies that are non-bank regulated entities are covered?

A.1. These series of questions are not applicable to rating agencies.

Q.2. What level of due diligence do purchasers of sub prime loans conduct to ensure the products they are buying meet underwriting requirements and/or state/federal laws?

A.2. While this question is for the most part outside our area of credit expertise, as a general matter, we believe that purchasers of whole loans have an ability to conduct a certain level of due diligence on the loans and the loan files that they are purchasing. In contrast, investors in the mortgage backed securities do not have the appropriate level of expertise or resources to verify whether loans in a particular pool have satisfied underwriting requirements and or state/federal laws.

Whole-loan purchasers may conduct due diligence on and re-underwrite anywhere from a small portion to 100% of the loans that they are purchasing, and may either use their own staff or a third

[4] Please see, "An Update to Moody's Analysis of Payment Shock Risk in Sub-Prime Hybrid ARM Products," Rating Methodology, May 16, 2005.

party to review loan files. However, they typically do not verify information directly with the borrower. Therefore, the whole-loan purchaser will not know whether any documents have been altered or are missing; and, will not know about the verbal communications between the originator, the broker and the borrower.

Mortgage backed securities investors typically rely on the originator's and/or securitization seller's representations and warranties that the loans are in compliance with all regulations and all laws. However, it is our understanding that more and more mortgage backed securities investors are receiving some non-identifying loan level information and that the larger investors meet periodically with the management of the originators and may conduct on site visits (perhaps annually).

Q.3. Additional Follow-up questions: Given the level of due diligence that is conducted, would the purchaser not be in a good position to guard against bad loans entering into investment pools from the very beginning?

A.3. Moody's does not have sufficient information or expertise to adequately respond to this question.

Q.4. Liability: There has been a significant amount of discussion about the role Wall Street has in the subprime market. There has also been a great deal said about the imposition of assignee liability to purchasers of loans. Do you feel assignee liability would play a significant role in guarding against "bad" loans being made by lenders and ultimately ending up in investor pools? If so, what level of "assignee liability" do you feel is appropriate?

A.4. Moody's role in the market is to provide independent opinions on the creditworthiness of structures or securities. It is not Moody's position or expertise to opine on the appropriateness of legislative action. Our role in the capital markets leads our residential mortgage backed securities ("RMBS") team to take a narrow focus on legislation—namely, can the impact of the legislation be quantified.

With respect to assignee liability laws, in certain circumstances such laws create unlimited assignee liability exposure or vague definitions which, in turn, make analyzing the credit risk associated with a pool of such loans difficult if not impossible. As we have said on previous occasions, laws that provide clear and objective standards and that define the thresholds for exposure are ones that can more readily be dimensioned and analyzed.