Testimony of Martin S. Hughes

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Hearing on

**Housing Finance Reform: Fundamentals of a**

**Functioning Private Label Mortgage-Backed Securities Market**

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**Introduction**

Good morning Chairman Johnson, Ranking Member Crapo, and members of the Committee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange. I appreciate the opportunity to testify on what can be done to accelerate the return of a robust private secondary mortgage market.

**Background on Redwood Trust**

Redwood Trust commenced operations in 1994 as an investor in residential mortgage credit risk. We do not originate or directly service residential mortgages. We currently operate a prime jumbo loan conduit through which we acquire individual closed loans from banks and mortgage companies, primarily for pooling and sale through our Sequoia private securitization platform, which creates and issues mortgage-backed securities ("MBS").

Senior investors in MBS issued through our platform have protection from credit risk as a result of our investment in the subordinate securities issued in each securitization, which enables the senior securities to obtain triple-A ratings. Although this has not been the case for most issuers of MBS, in Dodd-Frank parlance, having "skin in the game" has always been a component of our business model, which demonstrates our alignment of interest with senior investors.

From 1997 through 2007, Redwood securitized more than $35 billion of mortgage loans through 52 securitizations. The average loan size was $372,000 and, interestingly, 27% of the securitized loans were prime loans with balances under Fannie Mae and Freddie Mac's (the "GSEs" or the "Agencies") conforming loan limit. Since we resumed the securitization of newly originated jumbo mortgage loans in 2010, we have securitized an additional $8 billion of loans in 20 transactions. As a result of our securitization and investment activities, we feel well qualified to comment on the state of the private residential mortgage market and the steps needed to increase the participation of the private sector in the broader housing finance market.

To supplement our jumbo mortgage loan business, we recently received our Seller/Servicer licenses from both Fannie Mae and Freddie Mac and we intend to add Agency conforming loans to our product menu. Additionally, we invested in Freddie Mac's recently issued Structured Agency Credit Risk (STACR) notes. This was the first Agency transaction completed as part of the strategic initiative of distributing credit risk from the GSEs into the private sector. Furthermore, we look forward to working with the Agencies to find ways for Redwood to invest in the "first loss" credit risk on the loans we sell to the Agencies, thereby putting the Agencies in a "second loss" credit position.

If we achieve our goals, our business would include investing in the credit risk on both jumbo prime loans (through private securitization) and Agency conforming loans (through contractual arrangements with the Agencies and investments in STACRs and similar investments).

**Overview**

Broadly speaking, I view the mortgage market as having two distinct sectors. The first is the government supported sector, which includes the FHA/VA, Fannie Mae, and Freddie Mac. The other is the private sector, which consists of portfolio lenders, primarily banks, and private label MBS issuers, such as Redwood Trust.

Each of these sectors has made vital contributions to the development of the mortgage market over time, for the benefit of millions of homeowners. However, in the wake of the financial crisis, Congress is now appropriately considering how to reform and improve each sector. My testimony will focus on the private label MBS sector of the mortgage market, although it is not possible to discuss reform of one sector in isolation of consideration of reforms in the other sector, as the two impact each other significantly.

The U.S. mortgage market needs multiple financing sources to ensure there are deep sources of liquidity for good borrowers to readily obtain affordable mortgage loans. I would argue that it is critically important for private label MBS to return and play a significant role in mortgage finance, as it has in the past. This can be accomplished by bringing traditional institutional senior investors back to the private label MBS market to efficiently address borrowers' credit needs.

I firmly believe that over the long-term, private label mortgage securitization is a very efficient form of mortgage financing. As a Federal Reserve staff working paper described securitization, it "has the potential to lower the cost of credit to businesses and households by reducing financial institutions' funding costs" and "it can produce securities that cater to the risk-return preferences of investors." Through the securitization process, an investor is able to buy assets that match their appetite for risk, using variables such as duration, interest rate risk, and high or low credit risk. This tailoring of risk is what draws trillions of dollars into the US mortgage market.

Many have speculated on why private label MBS is not fully flourishing today while other asset-backed markets for commercial MBS and credit cards have rebounded. There is no single answer to this question. There are a variety of factors that must be considered to explain the current state of the private label MBS market. Some of these factors will self-correct over time, while others will require structural and legislative change.

Later in this testimony, I will offer specific recommendations for possible structural and legislative changes. But first, I would like to offer the following broad observations about the market:

- **As a result of increases in the conforming loan limit, there are fewer non-Agency jumbo loans being created.**

- **The GSEs have had a significant pricing advantage over the private MBS market. This advantage has been reduced as guarantee fees have increased over the past two years.**

- **Pre-crisis, major banks were significant issuers of private jumbo MBS (especially for 30-year fixed-rate loans). These banks now have over $2 trillion in excess reserves at the Federal Reserve and have made an investment decision to hold significantly more jumbo loans in portfolio to build their asset base and increase net interest income, rather than securitize or sell the loans. For example, in 2012, jumbo loan originations totaled $200 billion and private label MBS securitizations totaled only $3.5 billion.**

- **Traditional senior investors still have questions of confidence regarding whether their rights and interests in the MBS they purchase will be respected and, consequently, that their investments will be safe and secure.**

- **My last observation is a Catch-22. For private label MBS financing to attract more investors willing to invest at attractively priced levels, the asset class needs to be larger and more liquid. But in order to attract more investors, the asset class first needs a larger critical mass, so investors will see the value in dedicating resources to analyze and monitor the sector.**

**The Current Private MBS Market**

The mortgage loans that are currently being securitized through our platform are probably more similar than many perceive to the loans currently being guaranteed by the GSEs, except for the average loan amount, as noted in the table below.

| Loan Characteristics for First Half 2013 Business Volume | | |
|---|---|---|
| | **Redwood's Platform** | **Fannie Mae** |
| Average: | | |
| Interest Rate | 3.85% | 3.55% |
| Loan Amount | $800,000 | $208,234 |
| FICO | 772 | 756 |
| Loan-to-Value (LTV) Ratio | 66% | 75% |

The GSEs have done a very good job of building loan quality. A large percentage of the loans currently guaranteed by the GSEs would meet Redwood's guidelines and, while our primary focus has been on the prime jumbo mortgage market, we are prepared to securitize prime loans of any size if the conforming loan limits are reduced.

We believe that if and when the conforming loan limits are lowered, both banks and securitization sponsors will step in to finance loans above the lowered limits at affordable rates, and the typical jumbo loan characteristics will increasingly resemble conforming loan characteristics. As for credit quality, the credit performance of our post-crisis securitizations has been stellar. No investor in the senior securities has incurred a credit loss and currently we have only one loan that is more than 60 days delinquent.

Interest rates to borrowers on conforming versus jumbo loans are narrowing closer to historical norms. On September 25, 2013, Redwood was purchasing prime 30-year fixed-rate jumbo mortgages within a rate of 4.875%. This compares to Wells Fargo's prime 30-year fixed-rate Agency conforming rate of 4.375% for the same date. The spread between these two rates of 0.50% is about 0.25 percentage points higher than the historical average. That also represents a dramatic improvement from the 2.00 percentage point spread that was in effect at the peak of the financial crisis in 2008. The current spread is solid evidence that private capital will provide borrowers with loans on reasonable terms if investors are presented with well-structured securitizations that also have a proper alignment of interests between the sponsor and the senior investors.

**How to Build a Robust Private MBS Market**

Focus on Investor Concerns

Investors are the single most critical variable to consider as you take steps to promote a robust private MBS market. Simply put, investors have the money, and without their participation, there is no market. Many potential senior MBS investors, who previously had significant asset allocations to invest in private MBS, now have little or no participation at all. This is unfortunate because the financial world has ample liquidity and investors are combing through different asset classes in search of safe, attractive yields. On a relative value basis, there is no logical reason why private MBS should not play a much larger role as an attractive investment class, as it was in the past.

So how is confidence restored among investors? Broadly speaking, I believe we need to first address investors' demands for better risk mitigation, transparency, and alignment of interests throughout the mortgage chain. Redwood's transactions prove that it can be done. We have listened to investors and worked hard to meet their new requirements for investing in private MBS by putting together transactions that included comprehensive disclosures, better and simpler structures, new enforcement mechanisms for representations and warranties, and skin in the game.

Correct MBS Structural Deficiencies and Conflicts

The private market will have difficulty growing at the velocity needed without the combined efforts of market participants, Congress, and regulators to correct structural deficiencies and conflicts in securitizations. It is critical that we strengthen the structural foundation that supports securitization so that investor protections are given greater emphasis. In traditional securitization structures, investors have relied on a trustee and a servicer to administer a securitization. The governing documents have not always addressed or contemplated all of the potential situations that could face the servicer or trustee, nor have they always provided an investor-friendly mechanism for initiating and resolving disputes. The following recommendations will correct the structural deficiencies and conflicts:

- **Establish best practices in representations and warranties and other key securitization terms through the creation of a Private Market Advisory Committee (with investors holding a majority of the membership) that is given responsibility for developing new best practice standards. The standards would not be mandatory, but each securitization would be required to clearly disclose any variation from the standards.**

In many cases, representations and warranties have been weak and inconsistent and have been difficult for investors to compare from one sponsor to another and from one transaction to another. In addition, it has been costly or difficult to enforce the originator's or sponsor's obligations to repurchase loans where there has been a breach. We believe the representations and warranties now required by the GSEs serve as a strong benchmark.

- **Establish binding arbitration as a minimum standard for dispute resolution of representation and warranty claim disputes in private label MBS.**

The Agencies are large and powerful institutions that have the ability to effectively enforce representation and warranty claims relating to loans they purchase and guarantee. In the private label MBS sector, however, there has not been a comparable force behind the enforcement of representation and warranty claims. Some originators have resisted or stalled the process for legitimate claims, resulting in costly litigation. These circumstances have led to deep investor mistrust. Furthermore, investors unable to rely on this protection have fled the securitization market and continue to sit on the sidelines. In order to correct this problem, we recommend requiring a formal dispute resolution process for ensuring enforcement– specifically, a binding arbitration standard. New best practice standards for representations and warranties, coupled with binding arbitration, would provide investors with assurance that any allegation of a violation of representations and warranties will be thoroughly investigated and pursued in an efficient manner.

- **Require that securitization trusts create the position of Credit Risk Manager to manage representation and warranty claims and monitor servicer performance and actions.**

The Credit Risk Manager ("CRM") would be an independent third-party unaffiliated with any interest in the transaction and would have two primary responsibilities. The first would be to identify, investigate, and pursue claims for breaches of representations and warranties. This is important in the event the senior investors and the party that owns the first loss security disagree on whether or not to pursue a claim. The second responsibility would be to conduct ongoing surveillance of the servicer's activities and report to the trustee and investors the results of the review. Although a servicer is engaged to service mortgage loans in a securitization pool for the benefit of the investors, the investors have no real way of ensuring that the servicer is performing its duties because no independent review or quality control of the servicer's decisions currently exists. The securitization documentation should provide for the CRM to have the same access to loan information and original loan files as the servicer to ensure that the CRM has the information necessary to perform its responsibilities.

- **Establish clear and objective uniform standards governing the responsibilities and performance of a servicer in its role as a fiduciary of the trust.**

When we focus on the role of servicers in the securitization structure, we note they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting directions. In their role, they are required to operate in the best interest of the securitization trust and not in the interest of any particular bond investor. In practice, without any clear guidance or requirements, they invariably anger one party or another when there are disagreements over what is and is not allowed – with the result of discouraging some senior investors from further investment in private MBS.

- **Prevent servicer conflicts of interest by prohibiting the owner of a second lien mortgage from being the servicer of the first lien mortgage on the same property.**

Currently, most second lien mortgage loans are owned by the same banks that perform servicing on the homeowner's first lien mortgage. Because these banks generally do not own the first lien mortgage they are servicing, they have a strong incentive to place their financial interests as a second lien holder ahead of first lien investors when taking actions as servicer on behalf of a securitization trust. For example, a servicer could refuse to approve a loan modification or a short sale that would benefit both the first lien mortgage holder and homeowner, because doing so would directly harm their financial interest as the owner of the second lien mortgage loan.

Fortunately, there is a simple fix to this problem. Simply prohibit the owner of a second lien mortgage from operating as the servicer of the first lien mortgage on the same property. Servicing a delinquent loan is a nuanced, complicated process and investors must believe that their servicers are acting as honest agents throughout. No amount of disclosure or other half-measures will alleviate these concerns. The only meaningful solution is to definitively break the economic link between first lien mortgage servicers and second lien mortgage holders.

- **Establish servicer performance triggers to serve as benchmarks and as an objective means for possible removal of the servicer.**

Servicers need to live up to servicing performance standards and triggers should be established to give investors the ability to hold servicers to these standards. The triggers, which could be set by the Private Market Advisory Committee I proposed above, might include, among other things, average loss severity, adherence to foreclosure timelines, and average REO liquidation timelines. The triggers should be reviewed on a periodic basis. If a servicer fails a trigger, servicing could be terminated. Mechanisms must be established to facilitate collective action by investors when a trigger event occurs and there is a failure on the part of the trustee to take action.

- **Control the systemic and loan level risks relating to second lien mortgages by giving first lien holders the ability to require their consent to a second lien if the combined loan to value ("CLTV") with all other liens will exceed 80%.**

During the housing bubble, homeowners extracted record levels of home equity through second lien loans. Second lien loans also acted as a substitute for cash down payments to purchase houses. At the peak in 2006, these loans totaled $430 billion.

The rise of home equity lending increased the monthly payment obligations for borrowers and reduced the amount of equity remaining in their homes, leaving borrowers vulnerable to home price declines. As a result, 38% of the borrowers who used these loans found themselves underwater (or owing more than the value of their houses), compared to only 18% of those who did not. Even for well-underwritten, prime loans, the presence of a second lien correlated with increased defaults by as much as 114%.

The rise of second liens has had another, less-widely understood effect: it substantially increased losses for investors and chilled their interest in investing in newly issued MBS. To understand why, it is necessary to understand how investors evaluate mortgage loans. While a borrower's credit report, income verification, and other underwriting factors are important to investors in evaluating credit risk, perhaps the most important factor is the amount of a borrower's equity, or the borrower's down payment. The amount of a borrower's equity is probably the most predictive factor of a borrower's future performance: borrowers with 20% or more equity have lower default rates, while those with no equity are quicker to default and walk away from their home.

Second liens undermine an investor's ability to analyze risk by making down payment information unreliable. Imagine this scenario: a borrower applies for a first mortgage with a 40% down payment – this is a loan that would historically have very low default risk. As a result, the borrower is offered a great loan at a low rate. One week after taking out the loan, the borrower takes out a second mortgage from a different lender for the remaining 40% of the property value. The borrower no longer has any equity and the default risk and potential loss severity on the first lien is higher than before. This is not a fantasy scenario: approximately 70% of borrowers in prime, privately securitized mortgages issued between 2004 and 2007 took out second liens subsequent to obtaining a first mortgage.

This level of uncertainty has a highly consequential impact on how investors assess mortgage related investments. Since investors have no way of knowing which borrowers will cash out their equity, they must assume that everyone will. This uncertainty leads private investors to demand higher rates in return for the increased risk, and the cost of homeownership goes up for everyone.

We believe that placing some reasonable restrictions on the origination of second lien mortgages will restore investor confidence and speed the transition of the mortgage market away from taxpayer exposure. We propose that first lien holders have the ability to require their consent to a second lien if the combined loan to value ("CLTV") with all other liens will exceed 80%. If the consent is not given, then the borrower can still obtain a home equity loan, but will need to refinance the first mortgage (and pay off the first lien holder) using a standard cash-out refinance loan product. This proposal would allow borrowers to tap into their equity, while preserving a level of protection for investors in first liens. This new restriction is intended only to protect first-lien lenders, and investors, from excessive equity being extracted later, without their knowledge or consent.

- **The government should begin to reduce its participation in the mortgage market, gradually and at a measured pace by reducing the conforming loan limits.**

For many years prior to the financial crisis, the government mortgage market (GSEs, Federal Housing Administration, and Veterans Administration) and the private mortgage market have co-existed to serve the needs of borrowers. In the aftermath of the financial crisis, the government's share of the mortgage market has increased to approximately 90%. If the conforming loan limits are reduced, I believe the private market would aggressively compete for those loans that exceed the new limit without any market disruption, similar to when the temporary increase in the conforming loan limit (from $625,500 to $729,750) was allowed to expire in September 2011.

- **Remove the uncertainty caused by unfinished regulations.**

The incomplete status of regulations required by the Dodd-Frank Act has constrained the development and growth of the private MBS market. Markets require certainty about the rules of operation so that regulatory compliance can be assured. Investors will continue to be cautious about entering the private MBS market out of concern that final regulations might soon turn a good business decision into a bad one. Markets typically manage to adapt to new regulations and continue operating under the new rules. The private label MBS market is no different.

**Conclusion**

The U.S. mortgage market is a complex system with many parts and key participants. Each plays a supportive role in creating a highly liquid and efficient market. The private MBS market will once again assume a major role, alongside the government supported sector, as the issues I have discussed begin to get resolved. Thank you.