**Testimony of Joshua Rosner before the House of Representatives' Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs.**

**Hearing: "Transparency as an Alternative to Risk Retention".**

**May 11, 2011**

Thank you Chairman Issa, Ranking Member Cummings and members of the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs for inviting me to testify on this important issue

Between 1989 and today, securitization markets, and therefore the capital markets, replaced banks as the lead funding source for home mortgages. The current problems in the real economy, stemming from the opacity and information asymmetry of the asset backed securities (ABS) market[i], are not isolated to private first-lien residential mortgage securitization markets. They extend to other areas of consumer financing like home equity loans, auto loans and other Asset Backed Securities.

The Risk Retention Rules required by Dodd Frank are well intentioned but misguided. Rather than repairing the pre-crisis "Wild West" environment, where rules are more often opaque than clear, regulators and legislators have wrongly chosen to require issuers to hold a slice of every deal they issue. They reason that if issuers retain some ongoing responsibility and financial liability for the underlying loans they sell, lenders and underwriters will have a greater incentive to make better loans or at least make sure that the cost of those loans to borrowers will be priced relative to the risks market participants identify as inherent in the loans.

On the surface, this appears to make sense. If a lender or securitizer knows he will have to drink the poison in the chalice he offers to others, then he would be more careful. If, however, because of his belief in his modeling prowess, his own systemic importance, or his financial strength, the pourer believes that he has an enhanced immunity to poison or that he will be first to receive an antidote, then perhaps he may ignore the disincentives to poison others. More likely, as we saw in the past crisis, the same firms that poisoned their investing customers failed to recognize the power of the poison. After all, the banks that were in most dire need for direct government support were so precisely because they had ingested large quantities of the poison they had sold to others. Often, as we witnessed with Bear Stearns and Merrill Lynch, these firms didn't have the operational controls, available information or resulting ability to fully model their exposures[ii]. To force them to increase concentrations of these held securities will only increase their risks.

As we have seen, even with a relatively small but required 5% retention of each structure, different structures of similar underlying collateral remain highly correlated. Thus, if securitization returns and grows, this part of the Dodd-Frank Act will have the effect of creating a future systemic risk by causing risks retained by already "Too Big to Fail" firms to be transferred to taxpayers, thus aiding the creation of another crisis of several systemically important firms becoming troubled at the same time.

A Better Solution

Nothing has been done to create industry standards or useful and timely disclosures of loan level collateral characteristics. Asymmetry of information between buyer and seller remains the standard. While I advocate repealing the risk retention rule, I would point out that doing so without first addressing these fundamental problems would be unacceptable and increase risk, especially in an environment where legislators and regulators have already reduced to information available to investors through elimination of the Regulation Fair Disclosure exemption for rating agencies[iii].

The primary market for securitizations is different from the equity markets. There is no "red herring" or pre-issuance road-show period during which investors have the ability to really analyze a deal and its underlying collateral. Typically, deals come to market so quickly that investors were forced to rely on rating agency pre-issuance circulars, term-sheets or weighted average collateral data. These tools have proven inadequate[iv]. Moreover, with a lack of pre-issuance collateral disclosure standards deals usually came to market before the collateral pool was even complete.

The Need for Disclosure

To ensure adequate transparency, data on the specific underlying collateral in each pool should be made available for a reasonable period (not less than two-weeks) before a deal is sold and brought to market. Such a requirement would enhance investor due diligence, foster the development of independent analytical data providers, and to reduce reliance on rating agencies[v]. Such an approach would reduce reliance on ratings and support a narrowing spread between price and value in the secondary market.

The automation, standardization, and public disclosure of key collateral information before a securitization is marketed — and at least monthly thereafter, in an electronically manageable and standardized format, is a necessary ingredient to the development of the deep and broad markets necessary to fund our economy. Capital and markets would be less volatile if they could fully model the expected performance of underlying loan level collateral and regularly reassess the deviance from expectation.

Contracts that Work

"Pooling and Servicing Agreements" (PSAs) and "Representations and Warranties" can be several hundred pages long. They define features like the rights to put back loans that had underwriting flaws, the responsibilities of servicers and trustees, and the relationship between the different tranches.

We need to address the lack of uniformity in the contractual obligations between various parties to a securitization. Key terms that define contractual obligations are not standardized across the industry, across issuers of securities with the same type of collateral or even by issuer (each issuer often had several different Pooling and Servicing Agreements and Representation and Warranty Agreements).

The lack of standardization and the length of the documentation effectively created opacity, which contributed to the problems in the securitization market. When panic set

in and investors began to question the value of their securities, they knew that they did not have the time to read all of the different several-hundred page deal agreements.

This reinforced the rush to liquidate positions and supported a “run on the market” that caused securities’ values to fall further than fundamentals justified. After all, what investor would choose to be the last one holding a security whose terms are not easily understood?

Legislation should direct regulators to create a single standardized Pooling and Servicing Agreement governing each collateral asset class whether the issued securities are registered or “over the counter” or “bespoke”. These agreements should be created with the best interests of the investing public, and clarity of contract, at their cores.

Why Standards Matter

Legislative and regulatory standard setters must also focus on addressing a lack of clear definitions in securitization markets. Without a common language and agreement on the meanings of fundamental concepts the value of data is diminished. Conversely, if everybody is using common language – in loan origination or securitization — then it becomes very hard to game the system.

Amazingly, three years after a crisis, there is still no single standard accounting or legal definition of either delinquency or default. Currently, the term ‘delinquency’ can be determined either on a contractual or recency-of-payment basis. Even among firms that would define it on the same basis, each servicing agreement can have different interpretations of the reporting of delinquencies. Some may report advances that a servicer makes to a pool, which could be applied to reduce stated delinquencies, other servicers may not. Like so many of the underlying problems in the securitization market, this “Wild West” mentality needs to be replaced with agreement of terms and standards.

True Sale

In recreating the structured market, we must also clear outstanding legal questions[vi][vii] about matters such as “true sale”[viii][ix]. Without clarifying the clear legal and accounting standards on “true sale”, issuers of a securitization may retain rights to or responsibility for collateral that they thought they sold and the investor in a pool believed himself to have purchased.

Collateral Servicing and Fiduciary Obligations

When a pool of first lien mortgages is created and sold into a trust, a servicer is chosen to service the loans, collect the mortgage payments and direct the cash flows to investors as defined by agreement. While investors in different tranches to the securitization may not always have aligned interests, in light of the significant numbers of mortgages today that have negative equity most of the remaining holders would be willing to write down the principle balance of the loan if they would result in re-performance of collateral. For example, assume a 20% reduction in the principal balance of a mortgage would result in a borrower becoming willing and able to make payments and become current again, on a sustainable basis. This 20% loss, though significant, would surely be preferable to the

potential 70%-plus loss investors could experience upon default and a subsequent foreclosure.

Unfortunately, due to an ill-defined legal relationship between service and investor, along with a large and common conflict of interest between the servicer and the affiliated companies that own most of the servicers, many servicers do not prefer this "less is better than nothing" approach. The largest servicers are owned by large banks –- banks that hold the majority of second liens and home equity lines on the underwater houses[x]. Remember, the second lien is, by definition, subordinated to the first lien. So if the servicer wrote down the principal on the first lien, it would, where the mortgagee is in a significant negative equity position, completely wipe out the value of the second lien and cause the bank to experience a total loss on that loan.

Because of the lack of a fiduciary obligation to the first lien holder, servicers are often motivated to protect their affiliated firm's second lien positions, rather than the first lien holders'. And because of the way the servicing agreements are written, servicers are often able to justify their inaction by hiding behind the disparate obligations they owe to investors in different tranches. Alternatively, they are able to do so by using a "net present value test" that is based on projections of unknowable future scenarios. As a result, both investors and the troubled borrower are held hostage to servicing practices that seek to protect often under-reserved banks rather than act on their expected obligation to investors in the mortgage pool. New rules in securitization should clearly define the servicer's obligations[xi] and require a fiduciary duty to the investor in securitized pools. Perhaps, more effectively, legislation should specifically prohibit financial entities from owning servicing where the servicing results in a conflict[xii].

The hope is that the original promise of securitization, through which banks could originate quality loans and sell them to investors who would be better able to hold the risks of those assets, can be realized. This would free up bank balance sheets to make more loans in support of financial intermediation and economic expansion.

Neither real estate nor the economy itself can find a self-sustaining recovery without first restarting this important tool. Liquidity cannot efficiently find its intended target unless there are credible markets in which participants can foster financial intermediation and through which capital can be transmitted. Expanding the monetary base without an effective means of financial intermediation has resulted in little more than hoarding and a fostering of new asset bubbles as witnessed by the US Treasury market and commodity prices.

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[i] Mason, Joseph R. and Rosner, Josh, How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions? (February 13, 2007), at 30 [available at: http://ssrn.com/abstract=1027472 ](see: ***The consensus view seems to be that faced with slowing demand and shrinking profit margins, subprime lenders tried to maintain volume as the housing market was faltering in late 2005 and 2006 by making riskier loans.*** Those risks are now manifesting themselves in lower profits for issuers, resulting in bankruptcy for some and significantly higher loan loss provisioning for those that remain. RMBS defaults can be expected to result in a significant decline in CDO funding for mezzanine RMBS tranches and, ultimately, a significant decline in funding for residential mortgages. Decreased funding for residential mortgages can be expected to affect housing starts and home purchases, which affect the construction and building and home products industries and are key to economic performance. Reduced economic performance further exacerbates defaults, leading to a feedback mechanism that can produce a prolonged slump in US economic performance.)

[ii] FCIC Report at 259 [available at: http://fcic.law.stanford.edu/report ]-(see: "Former CEO O'Neal told FCIC investigators he had not known that the company was retaining the super-senior tranches of the CDOs until Lattanzio's presentation to the Finance Committee. ***He was startled, if only because he had been under the impression that Merrill's mortgage-backed-assets business had been driven by demand: he had assumed that if there were no new customers, there would be no new offerings. If customers demanded the CDOs, why would Merrill have to retain CDO tranches on the balance sheet? O'Neal said he was surprised about the retained positions but stated that the presentation, analysis, and estimation of potential losses were not sufficient to sound "alarm bells.'*** Lattanzio's report in July indicated that the retained positions had experienced only million in losses. Over the next three months, the market value of the super-senior tranches plummeted and losses ballooned; O'Neal told the FCIC: "It was a dawning awareness over the course of the summer and through September as the size of the losses were being estimated".)

[iii] http://www.sec.gov/rules/final/2010/33-9146.pdf

[iv] Rosner, Josh and Joseph R. Mason, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 3, 2007), at 84 [available at:
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475 ](The potential for prolonged economic difficulties that also interfere with home ownership in the United States raises significant public policy concerns. Already we are witnessing restructurings and layoffs at top financial institutions. More importantly, however, is the need to provide stable funding sources for economic growth. ***The biggest obstacle that we have identified is lack of transparency. The structural changes noted in our previous draft largely went unnoticed by RMBS investors until only recently. We argue that those changes went unnoticed largely because of the existing complexity and valuation difficulties underlying today's RMBS markets.***
But policymakers and ratings agencies are still reluctant to examine some of the key frictions that have caused the present mortgage mess....
And there is still no focus on monitoring bank funding markets. The feared outcome is nothing less than a 21st century bank run, this time from CDO investors rather than depositors".) [Hereinafter Rosner and Mason May 2007].

[v] Rosner, Joshua, Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts (Winter 2009). Journal of Structured Finance, Winter 2009. Available at SSRN: http://ssrn.com/abstract=1354608

[vi] Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 Am. Bankruptcy Inst. L. Rev. 287, 293 (noting that asset backed securities have grown from a relatively insignificant $1 billion market in 1985).

[vii] See, e.g., Jessica L. Debruin, Recent Developments in and Legal Implications of Accounting for Securitizations, 56 N.Y.U. Ann. Surv. Am. L. 367, 382 (1999), available at: http://www1.law.nyu.edu/pubs/annualsurvey/documents/56%20N.Y.U.%20Ann.%20Surv.%20Am.%20L.%20367%20(1999).pdf ("The Tenth Circuit in particular has been highly criticized, though not yet reversed, for its decision in a case involving true-sale analysis. Faced with a sale of accounts, the court in Octagon Gas Systems, Inc. v. Rimmer applied the provisions of Article 9 of the UCC to determine that the transaction constituted a security interest rather than a true sale.").

[viii] See, e.g BMeyer, Countrywide Mortgage settles with Ohio, 7 others, Oct. 6, 2008, available at: http://www.cleveland.com/nation/index.ssf/2008/10/countrywide_mortgage_settles_w.html (Author's note: If the Company has the right to enter into a settlement, for its benefit, and make commitments of third party investors in a supposedly legally isolated Trust, then it appears this action may again open the unresolved legal question of whether a securitization could ever be legally treated as a "true sale" as opposed to a disguised financing.)

[ix] Mason & Rosner May 2007 at 33 (see: "In December 2000, LTV Steel filed for voluntary Bankruptcy protection under Chapter 11 in the US Bankruptcy Court of Northern Ohio. ***In their filing the Company asked the court to grant an emergency motion to allow them to use the collections from the securitizations and claimed that the transactions were not "true sales" but rather "disguised financings". The Court granted the Company's motion though it did not rule whether or not the securitizations were "true sales"***. Although this case could have caused the rating agencies to take the same position as the Georgia law, of ambiguity making it difficult to rate the risks to noteholders they chose not to. In fact, one of the agencies appeared to pressure attorneys to avoid commenting on the matter in legal opinions. "Standard & Poor's insisted that attorneys submitting true-sale opinions to the rating agency stop referring to LTV, noting that the court never made a final decision and that such citations inappropriately cast doubt on the opinion. Seven months later, in a delicately worded press release, S&P withdrew that prohibition—apparently because lawyers refused to ignore such an obvious legal land mine".)

[x] Data available at http://www2.fdic.gov/sdi/

[xi] "OPEN LETTER TO U.S. REGULATORS REGARDINGNATIONAL LOAN SERVICING STANDARDS", December 21, 2010 available at: http://www.scribd.com/doc/45723130/Securitization-Standards-Letter

[xii] H.R. 4953--111th Congress: Mortgage Servicing Conflict Elimination Act of 2010."
GovTrack.us (database of federal legislation). 2010. March 28, 2011
<http://www.govtrack.us/congress/bill.xpd?bill=h111-4953 >