

Testimony of
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Introduction

Good Morning, Chairman Reed, 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 the state of the residential mortgage securitization market and look forward to responding to your questions.

Overview

My testimony is focused on restoring a fully functioning private-sector residential mortgage finance market. Currently, about 90% of all new mortgage originations rely on government support.¹ Given the fact that there is \$9.6 trillion of outstanding first lien mortgage debt,² this level of public subsidization is simply not sustainable. That being said, reducing the current level of governmental support, whether immediately or gradually over time, will have severe consequences for the housing market if the private sector is not prepared to step in with investment capital to replace a diminished level of government backing.

The consequences of failing to attract sufficient private-sector capital to this market include a contraction in the availability of credit to home buyers, an increase in mortgage rates, and continued decreases in home prices. Furthermore, these problems in the housing market may have broader negative effects on the overall economy.

The main sources of private-sector capital that previously financed residential mortgages include banks, mutual funds, pension funds, and insurance companies. For the non-banks, the transmission mechanism for providing this financing was through their investments in triple-A rated residential mortgage-backed

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

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

securities (RMBS). My testimony will recommend how to bring these “triple-A investors” back to this securitization market, thereby enabling the government to reduce its role in the mortgage market without negative consequences.

Background on Redwood

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

Recent Securitization Activity

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

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

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

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

The Private Mortgage Securitization Outlook for 2011

The outlook for non-government or private-label residential mortgage securitization volume backed by newly originated mortgage loans (“new securitizations”) in 2011 remains very weak by historical standards. Year-to-date through April 30, 2011, only one new securitization totaling \$295 million has been completed, and that was our deal. We hope to complete two more securitizations in 2011 and

securitize between \$800 million and \$1.0 billion for the year, and to build upon that volume in 2012. There are no good industry estimates for new private securitization volume in 2011, as the market is still thawing from its deep freeze. While we would welcome other securitizations in 2011 to provide additional third-party validation of the viability of securitization, the yearly volume will almost certainly be a small fraction of the \$180 billion average annual issuance completed from 2002 through 2007, when the market began to shut down.³

Major Hurdles to Private Mortgage Securitization Activity

1) Crowding out of private sector

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

Critics will argue that Redwood's transactions were backed by unusually high quality jumbo mortgage loans and are therefore not representative of the market. In fact, that argument proves the point that the government is crowding out private label securitizations, by maintaining an abnormally high conforming loan limit and by subsidizing the guarantee fees that the GSEs charge issuers. No private sector securitizer can compete with that – we can only securitize the small volume of prime quality loans

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

beyond the government's reach. We are ready to purchase and securitize prime mortgage loans of any loan amount, and can do so at an affordable rate once the government creates a level playing field.

We strongly advocate testing the private market's ability to replace government-dependent mortgage financing on a safe and measured basis. A first step would be to allow the scheduled reduction in the conforming loan limit in high cost areas from \$729,750 to \$625,500 to occur as scheduled in September 2011. We believe there is ample liquidity in the banking system to allow banks to step into the breach, while financing through private residential mortgage securitization regains its footing.

Additionally, the Administration should follow through on its plan to increase guarantee fees to market levels over time to eventually level the field between the private market and the GSEs. A gradual government withdrawal from the mortgage market over a five-year period will enable time for a safe, attractive, robust private label market to develop.

As the housing market begins to recover, we support further measured reductions on a periodic basis in the conforming loan limit as a means to increase the share of the mortgage market available to the private sector. We note that with housing prices now down in excess of 30% from their peak in mid-2006,⁴ it would seem logical to consider reducing the conforming loan limit by a similar amount over time.

2) Balance Sheet Capacity of Commercial Banks

The second hurdle to increased private securitization activity is the unprecedented amount of liquidity in the banking system. With \$1.5 trillion in excess liquidity and historically low funding costs, there is no

⁴ S&P/Case-Shiller Home Price Index press release dated April 26, 2011.

financial incentive for bank originators to securitize loans. Instead, banks are eager to retain their non-GSE eligible mortgage loan originations for their balance sheet loan portfolio in order to earn the attractive spread between their low cost of funds and the rate on the loans. To the extent that banks are selling non-agency loans, they are generally selling longer duration mortgages to reduce their interest rate risk. We expect this issue to resolve itself when the Fed eventually withdraws the excess liquidity from the banking system.

3) Regulatory

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

A) Dodd-Frank Act Implementation overview

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

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

We would also note that regulators took a well intentioned approach to craft a new set of risk retention rules to cover the entire mortgage securitization market which, in theory, should be a more expedient

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

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

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

We believe that restoring the prime segment of the market in a safe yet efficient manner would bring the greatest benefit to the largest number of stakeholders (borrowers, lenders, investors, and taxpayers) and would become more effective and productive than attempting to craft one all encompassing regulatory solution.

B) Form of Risk Retention

We are strong advocates of requiring securitization sponsors to retain risk in order to properly align their interests with those of investors. We support the intent of the joint regulators' NPR on this issue. In fact, it has always been Redwood's operating model to retain the first-loss risk in our securitizations.

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

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

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

C) Qualified Residential Mortgages

We support the intention of the proposed definition of a qualified residential mortgage (QRM), but we believe it is a bit too restrictive. We support the concept of "common sense" underwriting, similar to the standards used by the GSEs for so many years prior to the period leading up to the credit bubble that resulted in low credit losses for many years. We note there is nothing in the NPR that prohibits lenders from making loans that do not meet the QRM standards.

D) Servicer Functions and Responsibilities

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

Other Hurdles to Private Mortgage Securitization

While the focus of this hearing is on the state of the securitization markets and we believe we are moving in the right direction and addressing the securitization issues we need to address, we also need to broaden the focus beyond lenders and Wall Street. If we really want to restore a safe securitization market, we should also address second liens. One of the significant factors that contributed to the mortgage and housing crisis was the easy availability of home equity loans. Plain and simple, the more equity that a borrower has in his or her home, the more likely that borrower will continue to make mortgage payments.

Although the proposed QRM standard will encourage lenders to originate loans to borrowers who have a minimum 20% down payment, there is no prohibition against the borrower immediately obtaining a second lien to borrow back the full amount of that down payment. The addition of a second lien mortgage that substantially erodes the borrower's equity and / or substantially increases a borrower's monthly debt payments increases the likelihood of default on the first mortgage. Many of the current regulatory reform efforts are centered on creating an alignment of interests between sponsors and investors through risk retention or "skin-in-the-game." However, the first and most important line of defense is at the borrower level. If the borrower can take his or her own "skin" out of the game through a second mortgage, what have we really accomplished? The answer is very little. We believe this result will be very discouraging to private-label RMBS investors.

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

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

Impact on Mortgage Rates

Some market participants have been very vocal about the potential negative impact on mortgage rates as a result of the proposed definition of a QRM and / or the phase out of the GSEs. Recent news articles

have speculated that mortgage rates will rise dramatically, by as much as 300 basis points. We don't agree.

We do believe residential mortgage rates could rise modestly – by perhaps 50 basis points – as the government withdraws from the market. The government support effectively subsidizes borrowing rates and it is reasonable to expect these rates to rise somewhat as the subsidy is withdrawn. We nevertheless expect borrowing rates to remain attractive.

For context, in our most recent deal, the average mortgage interest rate for 30-year fixed rate loans backing the securitization was 0.46% above the government-guaranteed rate. As the number and diversity of loans available for private label securitization increases, thereby lowering risk, it is possible that residential mortgage rates could rise by less than 50 basis points relative to government rates.

Another reason we do not believe that mortgage interest rates will increase substantially is the sheer amount of global investment capital looking for ways to generate returns, from bank balance sheets, insurance companies, and mutual funds to non-U.S. financial institutions, hedge funds, and even residential investment trusts. The competition for returns is too great to allow such a rise in mortgage rates, assuming well underwritten loans with proper disclosure and alignment of interests.

Conclusion

When I look ahead – and admittedly you need to jump pretty high – I see a number of positives emerging: safer mortgages that borrowers can afford, the return of loan loss rates to historically low norms for newly originated prime loans, and private capital willing to fund residential mortgages at affordable rate for borrowers through responsible, safe securitization. The first step is to give the private

sector a chance by following through on the Administration's plan to reduce the conforming loan limits and increase the GSE's guarantee fees to market rates at a safe and measured pace.

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