Association of Institutional INVESTORS™

TESTIMONY OF JOHN GIDMAN

ON BEHALF OF THE ASSOCIATION OF INSTITUTIONAL INVESTORS

BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

October 1, 2013

Chairman Johnson, Ranking Member Crapo, Members of the Committee, thank you for inviting me to testify here today in support of your overall efforts toward housing finance reform and specifically regarding fundamentals of a functioning private label mortgage backed securities (PLS) market.

My name is John Gidman. I am an Executive Vice President of Loomis, Sayles & Company in Boston, Massachusetts, and am testifying here today in my role as President of the Association of Institutional INVESTORS (the Association). The Association is an organization of some of the oldest and largest institutional investment advisors in the United States. All our firms have a fiduciary duty to put our clients' interests first. Put simply, it's not our money.

Our member firms manage investments for more than 80,000 pension plans, 401Ks, and mutual funds on behalf of more than 100 million workers and retirees. Our clients include companies and labor unions, public and private pension plans, mutual funds, and families who depend on us to help them provide for their retirements, to have funds available to educate family members, and to support their financial aspirations.

Our clients are able to rely on us to prudently manage their investments in part due to the fiduciary duty we owe these organizations and individuals. We recognize the significance of this role and my testimony today is intended to reflect not just the views of the Association but the financial interests of the companies, labor unions, municipalities, workers, and retirees we ultimately serve.

We recognize the vital role robust housing finance markets play in our society. These markets traditionally provided generations of families, across a variety of income levels, pathways to gain home ownership. For decades, this defined the American Dream. Much of this mortgage financing has ultimately been provided by pension plans, 401(k)s, and similar funds whose investors valued collateralized income. Through these investment mechanisms, workers and retirees relied on the strength and depth of these markets to provide them income they needed for retirement.

LESSONS LEARNED FROM THE HOUSING CRISIS

Institutional investors, like all participants in the mortgage market, have learned many lessons from the financial crisis. We learned that the stress of high unemployment and the decline in housing prices exposed certain structural weaknesses in the securitization framework.

We recognize the critical role trustees play in the functioning of PLS mortgage markets but believe that they were not and are still not legally compelled, nor financially incented, to appropriately safeguard the interests of the trusts they represent.

We are keenly aware that the incentives of the originator and the buyer of the risk were not and are still not aligned, because the originator typically sells all, or nearly all, of their economic interest in the securitization. This is a fundamental difference from other securitization markets, such as automobile or credit card markets, where the issuer retains significant first-loss risk and has very strong incentives to underwrite conservatively.

Institutional investors see that documentation was not and still is not standardized and that the strength of representations and warranties varies depending on the issuer.

Institutional investors also consider that the enforcement of existing contracts was and is still weak, particularly where vertically integrated financial institutions often serve as issuers, trustees, originators, and servicers, creating conflicts of interests and incentives not to identify deficiencies that harm investors' trusts.

As a result of these structural weaknesses, little has improved in legacy residential mortgage backed securities (RMBS) reporting, enforcement of representations and warranties, or oversight of servicer performance. A typical monthly report today for legacy RMBS securities is not transparent as to who is servicing the loans, on what basis particular actions were taken by the servicer, or even regarding reconciling cash that came in and out of the trust. Recently, large portions of the legacy RMBS market have also seen servicing duties transferred from one firm to another, without investor consent or effective challenges from trustees, even in situations where investors would have likely been opposed to such a change.

OVERVIEW OF THE CURRENT PLS MARKET

The absolute volumes of new issuances remain a very small fraction of what they were before the 2008 crisis. However, today, the quality of the collateral underlying the PLS market has generally improved. New issue RMBS markets have reopened as of 2011, and grew in 2012 and 2013, but with issuances primarily in the "Jumbo Prime" space, or high credit quality loan balances well above the conforming limits.

The fundamental structural and process weaknesses for non-agency RMBS securitization have not been fixed in the current PLS market. The issuance process itself is very opaque. Ratings continue to be shopped, issuers are still incentivized to water down representations and warranties, and continued variability in structures and documentation make the market more challenging for investors and raise the costs of funding.

Additional uncertainty has also been added to the market due to concerns that make it harder for investors to price risk, which consequently makes it harder for investors to justify investing in the sector. Included among the factors increasing uncertainty are: (a) the potential use of eminent domain by local governments to seize mortgages held in interstate trusts; (b) assignee liability; and (c) settlements, such as the Department of Justice's and various states Attorneys General settlement – the National Mortgage Settlement – using PLS trusts' funds to remedy allegations of inappropriate, unlawful, or illegal behavior on behalf of the issuer or servicer – behavior in which investors had no role.

We do not believe that the PLS market is robust enough, given the current structural risks, to sustainably absorb significantly more supply, especially if the supply includes deals with lower subordination levels or collateralized by loans from borrowers with less pristine credit and lower down payments (higher loan-to—value ratios). In other words, we are talking now about the vast gulf between home mortgages averaging between $250,000 to $300,000, supported by the agencies, and those for homes over $1,000,000 owned by borrowers with pristine credit and high equity.

Buy-and-hold institutional investors will either require much higher yields – yields that are likely to render credit unavailable to those middle-class borrowers most in need of it – or will likely not participate in sufficient size to support the market without significant structural reforms.

CURRENT PLS MARKET BORROWING CHARACTERISTICS AND LOAN LEVEL DATA

As I alluded to, from a credit perspective, the types of loans currently being securitized are of a very high quality. Typically, the loans have a 66% average loan-to-value and a 760 average FICO score, with very few second liens and no mortgage insurance, so borrowers have 20-50% equity in the property. In the majority of deals, only the senior (typically AAA- rated) part of the securitization is being sold, so the amount of risk being taken by the private market is relatively small. The average home price of the mortgages being securitized is over $1,000,000. These high prices, combined with large down payments and very high credit quality, has led to a situation where the current PLS standards cannot be used to finance mortgages for the majority of Americans. It should be noted that the PLS market did provide loans of average and even below-average credit quality before the crisis and there is likely funding available to do so, if investors become convinced that the issues exposed by the financial crisis have been addressed.

The following table shows the volume and average credit characteristics of Jumbo Prime issuance from 2011 through 2013.

	2011	2012	2013 YTD
Total original Pool Balance	670,664,551	3,882,196,475	10,349,236,597
# of Pools	2	11	25
Avg. Loan Balance	885,781	875,280	796,488
Avg. FICO	773	770	768
Avg. Loan-to-Value	59.7	66.0	65.7
Avg. Combined Loan-to-Value	63.5	67.5	67.0
Full Doc (%)	100.0	100.0	100.0
Debt-to-Income	28.6	30.6	30.1
Primary Residence (%)	94.7	93.4	94.2
Purchase (%)	37.6	41.0	35.1
Source: KBRA Rating service, as of 9/15/2013			
Note - average statistics are calculated as straight-average by pool			

There is also a need for continued access to robust loan level data. Prior to the crisis, investors did receive some loan level data for RMBS. Today, data for new issue deals contains more information and more accurately represents credit risks. However, we do not have access to the actual loan documents. We believe that full access to actual loan documents is important and this data should not be restricted by requiring the use of expensive commercial data services. Immediate, free access to the actual loan documents should be reasonable, as the documents are readily available and investors in the trust legally own the documents as owners of the loans. However, even with complete data sets or access to the loan documents, we believe our information will never be as perfect as the originators' information. To level the playing field and promote an open and transparent market, we believe other factors, such the creation of a fiduciary duty for trustees, better quality reporting, and standardized representations and warranties are more important to investors than loan-level data.

General Thoughts on Housing Reform

While the PLS market has improved since the financial crisis, in our view, meaningful regulatory and operational changes must be made before the market can fully recover. Institutional investors *want* to be able to invest in the mortgage sector, on behalf of our clients, as the credit quality of newly originated mortgages has improved. However, as fiduciaries, we cannot put our investors' savings and assets at risk in bonds that have a significant and unquantifiable downside risk.

Therefore, we fully support Congress' efforts to reform the mortgage market. In doing so, we believe Congress should consider the agency market and the PLS market as part of one inter connected mortgage finance system. We believe that any regulation or legislation that reforms one market needs to consider the impact on the other market. Today, institutional investors favor investing in the agency market because there are fewer unknowns and many of the key investor concerns are mitigated when dealing with that market. The PLS market can redevelop, but the private market's reliance on the government sponsored enterprises (GSEs) will not organically decrease unless there are safeguards put in place to protect the PLS market.

S. 1217, the Housing Finance Reform and Taxpayer Protection Act, which was introduced earlier this year by Senators Bob Corker (R-TN) and Mark Warner (D-VA), and is co-sponsored by six other bipartisan members of the Senate Banking Committee, addresses some of the Association's concerns and generally we think this legislation moved the debate in the right direction.

The bill's risk sharing mechanism offers a promising solution that we believe could work if investors' need for a fiduciary standard for trustees is mandated. In July 2013, Freddie Mac issued the first risk-sharing deal in the RMBS market, called STACR 2013-DN1. We believe it was a positive sign that institutional investors were willing to take subordinate credit positions on this portfolio of agency mortgages, indicating that institutional investors may also be willing to take on risk under a Corker-Warner system.

The legislation also provides helpful language to address investor concerns with the PLS market regarding issues like standardization of documentation and enforcing representations and warranties. Title II, Subtitle C of S. 1217, in particular, reflects many of the transparency and oversight principles that we believe are vital to increasing investor confidence in the mortgage market. We appreciate the inclusion of these provisions and hope they are part of any other GSE reform legislation considered by the Committee.

S. 1217, however, did not address several fundamental investor concerns. These issues include: (1) creating a fiduciary duty for trustees and servicers; (2) addressing the assignee liability provisions included in Section 1413 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), now implemented by the Consumer Financial Protection Bureau (CFPB) in its Ability-to-Repay Rulemaking; and (3) limiting the ability of local municipalities to use eminent domain to seize residential mortgages held in trusts across state lines. Some of these concerns were highlighted by the crisis; others have arisen since the crisis. Each must be addressed by any mortgage market reform package that progresses through Congress, if one of the goals of the legislation is to incentivize private capital to return to the PLS market and stay in times of market stress. Each of these issues is addressed below.

FIDUCIARY DUTY FOR TRUSTEES AND SERVICERS

Investor confidence is a foundation of the PLS market, therefore investors should have proper recourse to the parties. However, since the financial crisis began, a failure in the structure of the PLS market has been apparent: trustees do not have a regulated fiduciary duty to bondholders.

To address these concerns and create better investor confidence, any mortgage market reform legislation should include trustee fiduciary duties to oversee the maintenance of trusts and enforce put-back obligations for faulty loans with regulatory oversight and private causes of action for breaches.

Recent developments have underscored the lack of trustee fiduciary duty as the ongoing critical gap in the PLS marketplace. Situations like last year's Attorneys General mortgage servicing settlement (the AG Settlement), where investors were not involved in the negotiations, and when faced with a significant conflict of interest, trustees and servicers were able to sacrifice the assets of trust investors in favor of their own bottom line. Without a clear fiduciary duty for trustees, trustees and servicers are incented to act as they did under the settlement. Servicers have overwhelmingly favored writing down loans owned by private PLS pension and fund investors rather than writing down principal on loans owned by the banks.

The AG Settlement, while unprecedented, is also not an isolated example of a situation where trustees or servicers act in their financial interest rather than in the best interests of investors. Recently, for example, there have been media reports that a large vertically integrated bank may settle an $11 billion deal with state and federal regulators related to investigations into the bank's sale of RMBS that were packed with bad loans. This amount reportedly would include $4 billion in relief for struggling homeowners, similar to the AG Settlement, and it is not clear at this point whether this settlement would allow that bank again to meet its obligations by using funds from PLS trusts. Like the AG Settlement, investors have not been involved in the negotiations, and if the settlement allows it, that bank would be incented to meet at least part of its obligations with trusts' assets, therefore assets of American savers, because no one has a fiduciary duty to act in the best interests of the trusts' investors – in effect, the $4 billion would be paid by American workers and retirees out of their pension assets.

Implementing a fiduciary duty for trustees would also spur further investment in the market, because investors would be assured that the trustee was acting in the best interests of the trusts' investors and incentives were properly aligned. Further, a fiduciary standard would improve the quality of trusts, as only good mortgages would be placed into the trusts, and mitigate conflicts of interest for situations where the same entity serves as both servicer and trustee.

In addition to incentivizing private capital to return because investors' rights would be better protected, creating a fiduciary duty would also reduce the incentives that currently exist to invest with the GSEs. Under the current model, the GSEs are often more attractive because they are partners to their own contracts. Investing with the GSEs ensures that an entity, the GSE, has proper recourse if there is a problem. By creating a fiduciary duty, private capital will be encouraged to continue investing in the PLS market, ultimately increasing the market share for the private market and reducing the government footprint.

ASSIGNEE LIABILITY

We believe that assignee liability once implemented and as currently defined in regulation will lead institutional investors to avoid the PLS market.

The Dodd-Frank Act and the CFPB's subsequent regulations create a path for a defaulting borrower to sue the lender for irresponsible lending. We agree with this principle and believe that it is good to hold originators accountable for predatory lending. However, the statute and regulations also create assignee liability, which essentially means that if the originator sells the loan, the buyer of the loan can be sued even though they were not the lender that made the bad loan in the first place. In the case of the PLS market, the trustee for the transaction would be the lawsuit target, and any legal, settlement, and damage costs would come out of collateral cash flows.

Such lawsuits are also not limited to the loan amount. Rather, potential damages awarded against the PLS trust, as the assignee, could equal to the sum of all finance charges and fees paid by the borrower (up to three years' worth from the origination of the loan), plus actual damages, court costs, and attorneys' fees. We expect that damage awards could amount to thousands of dollars *per loan*, and a typical RMBS bond includes thousands of loans. Thus, an investor could face millions of dollars in losses from this liability on each bond. Furthermore, as trusts often have the ability to pay more than small originators, we believe that assignee liability could actually have the unintended consequence of *weakening* the liability of the originator, because plaintiffs' attorneys will focus the lawsuits on the entity with the deepest pockets.

Given this potential liability, assignee liability risk may already be affecting the PLS market, even in advance of the CFPB's ability-to-repay requirements going into effect in January 2014. Institutional investors in this market are not close enough to the origination process to determine for themselves if all loans are exactly as advertised at the time of purchase, and so institutional investors are not willing to take on the risk that they could be sued for others' actions. Further, although Dodd-Frank and the CFPB's regulations include a safe harbor for a certain subset of qualified mortgages (QMs), this does not assuage our concerns because even if the safe harbor qualifications are met, asset managers will be forced to expend resources to establish the applicability of the safe harbor in every case where the borrower asserts that the ability-to-repay requirements were violated, regardless of the merits of the claim. Unless legislative changes are made, we expect that the PLS market will deteriorate further once these rules go into effect in January.

To address these concerns, we are supportive of any efforts to reduce the risk of assignee liability under Dodd-Frank and the CFPB regulations and to increase access to the ability-to-repay safe harbor. The best way to accomplish this goal would be by including language to eliminate assignee liability completely. Removing assignee liability would not reduce the protections afforded homeowners under the ability-to-repay provisions, but rather would ensure that only those that are responsible for generating the loans will be held accountable for the loans that they generate. Under such a system, incentives will be properly aligned and institutional investors would not be held responsible for the bad acts of other players. Alternatively, although less ideal, the legislation could include a provision that would ensure that the CFPB must expand its ability-to-repay regulations to allow more loans to meet the conclusive safe harbor standard.

EMINENT DOMAIN

It seems in every crisis, there are powerful and well-connected opportunists that prey again on the victims. Certain jurisdictions are considering implementing a program designed and aggressively marketed by a private fund whereby a city would rent out its local eminent domain power to seize performing high quality mortgage loans, held in interstate trusts, in order to restructure the mortgages at a profit for the city and the fund's investors. This unprecedented and misguided use of local eminent domain power could hurt the retirement savings of workers and retirees from across the United States, who currently invest in mortgages that would be seized, and significantly damage the overall PLS market.

Under the fund's plan, cities would seize current performing mortgages that are in trusts held by pension plans, 401(k) plans and mutual funds across the United States and managed by our members. If mortgages are taken by eminent domain, we will take action to protect the assets of our clients.

As fiduciaries, we have a duty to ensure that the investments we make on behalf of our clients are in their best interests. Therefore, after eminent domain is used, we will be forced to weigh the possibility that future mortgage contracts will not be upheld and our clients will lose value in their investments. Ultimately, we believe it will be difficult to continue investing in the mortgage markets if any local community uses eminent domain to seize assets out of interstate trusts.

Given these concerns, the Association believes any GSE reform legislation should include language similar to the language in H.R. 2733, the Defending American Taxpayers from Abusive Government Takings Act of 2013, which was included in the PATH Act (H.R. 2767). These provisions would prohibit the GSEs from purchasing, the Federal Housing Administration from insuring, and the Department of Veterans Affairs from guaranteeing, making, or insuring, a mortgage that is secured by a residence or residential structure located in a jurisdiction where eminent domain has been used to take a residential mortgage. We are also in favor of expanding the Home Affordable Refinance Program (HARP) to homeowners whose mortgages are held in PLS trusts, to provide these homeowners with relief.

CONCLUSION

As the Committee continues to consider housing finance reform, we hope our perspectives support your efforts. Each of our suggestions is intended to help promote a vibrant secondary mortgage market, accomplish your goal of reducing the government footprint in the mortgage market, and avoid adverse consequences that will ultimately affect the millions of American investors who rely on the continued vitality of these markets in order to save for their families' needs. We thank the Committee for its continued work and for focusing on this difficult issue. As the Committee progresses in its work, we stand ready to provide information and assistance as a voice for the millions of Americans who rely on these markets.

Thank you for the opportunity to participate in today's hearing.