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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.