MEMORANDUM

To: Commission File No. S7-08-10

From: Katherine Hsu
Senior Special Counsel
Office of Rulemaking
Division of Corporation Finance
U.S. Securities and Exchange Commission

Date: September 21, 2010

Re: Proposing Release on Asset-Backed Securities (Release Nos. 33-9117; 34-61858)

On September 16, 2010, Paula Dubberly, Katherine Hsu, Eduardo Aleman, Rolaine Bancroft, and Jay Knight of the Division of Corporation Finance; Wesley Bricker of the Office of the Chief Accountant; Eric Emre Carr and Stanislava Nikolova of the Division of Risk, Strategy and Financial Innovation; and Bryant Morris of the Office of General Counsel met with Chris Katopis and Trista Roehl of the Association of Mortgage Investors (AMI). Vince Fiorillo, James Harrington, and William Sidford of AMI participated by phone. Among the topics discussed was the Commission's April 7, 2010 proposing release regarding asset-backed securities. Handouts are attached to this memorandum.

Attachment

ASSOCIATION OF MORTGAGE INVESTORS

WRITTEN STATEMENT

ON BEHALF OF

THE ASSOCIATION OF MORTGAGE INVESTORS (AMI)

BEFORE THE

HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

FORECLOSURE PEVENTION PART II: ARE LOAN SERVICERS HONORING THEIR COMMITMENTS TO HELP PRESERVE HOMEOWNERSHIP?

JUNE 24, 2010

by CHRIS J. KATOPIS, Executive Director

Introduction

Chairman Towns, Ranking Member Issa**,** thank you for permitting the Association of Mortgage Investors (AMI) to submit the following written statement for the committee hearing record.

The Association of Mortgage Investors (AMI) commends you and the other members of the full Committee for your leadership in pursuing responsible and effective oversight, your vigilance in helping to keep Americans in their homes, and your tenacity in the development of effective tools against the foreclosure crisis. Since the AMI's formation as the primary trade association representing investors in mortgage-backed securities, including university endowments and pension funds, it has been developing a set of policy priorities that we believe can contribute to achieving this goal. The AMI was founded to play a primary role in the analysis, development, and implementation of mortgage and housing policy to help keep homeowners in their homes and provide a sound framework that promotes continued home purchasing.

Mortgage investors share your frustration with the slow pace of efforts to provide homeowners and the entire housing market with meaningful and permanent relief. We are hopeful that substantial solutions can be implemented more quickly, and we believe that our interests are aligned with homeowners. The Association of Mortgage Investors supports initiatives designed to help homeowners get out of bad mortgages and into sound mortgages that will allow them to stay in their homes and build equity at the same time.

The Role of Mortgage Investors in the Marketplace

It is important to note that mortgage finance has been instrumental in reducing housing costs and helping citizens achieve the American dream of homeownership. In the 1970s, the mortgage finance industry was in its infancy. In fact, at the time the market consisted solely of two products – those backed by Ginnie Mae and Freddie Mac. The advent of the mortgage-backed securities market resulted in de-regionalizing or nationalizing real estate investment risk, increasing liquidity to mortgage originators, and lowering barriers to home ownership. Securitization was a key factor in improving regional real estate markets. New York State is a case in point. In the 1970s, most New York depositories were flush with cash but had a hard interest rate limit on mortgages. The result was a flow of California mortgages to New York and a flow of dollars to California. New York was an unattractive and non-competitive local market. With securitization, the New York market became national and mortgage funds were more readily available. Since the 1970s, mortgage backed securities have increased lending levels, with even state housing agencies benefiting from the mortgage securities structuring techniques.

Mortgage investors are aligned with both homeowners and the government in our shared goals of keeping Americans in their homes and rebuilding and maintaining a vibrant real estate market. In fact, the maintenance of a healthy securitization market is a vital source of access to private capital for mortgages as well industries such as autos and credit cards. Moreover, an efficient securitization market provides more and cheaper capital to originators, which allows them to issue more loans to additional borrowers. The use of mortgage-backed securities equitably distributes risk in the mortgage finance industry, and prevents a build-up in a specific geographic region or a specific type of underlying asset. These features, and many others, are those of a market which makes access to capital cheaper and thus spurs more mortgage lending.

Today's mortgage market consists of approximately $11 trillion in outstanding mortgages. Of that $11 trillion, $5.4 trillion are held on the books of the GSEs as agency mortgage-backed securities (issued by one of the agencies) or in whole loan form. Another $3.6 trillion are on the bank balance sheets as whole loans or securities in their portfolios, of which $1.1 trillion are second liens (home equity loans/lines of credit or closed end second mortgages). Of the $1.1 trillion outstanding second mortgages, only 3.7% of the total (or $41 billion) is held by private investors in securitized form. The remaining $1.5 trillion in first lien mortgages reside in private label mortgage-backed securities.

Those "private label" (non-Federal agency) securities are put together by investment banks that pool the mortgages into a trust. That trust is built around a document called a Pooling and Servicing Agreement. This provides investors the rights and protections relating to the mortgages that make up the securitization and the terms and duties that are owed to the investors by the trustee of the security and the servicer of the individual mortgages. Within this Agreement, there are numerous representations and warranties regarding the quality of the mortgages that are included in the trust and the lending practices that were followed in the mortgage origination process. It is important to note that, historically, investment in these mortgage products has been attractive, in part, because they are governed by binding contracts that lend to the stability and predictability that investors desire. Like any purchaser, investors expected the sellers of mortgage securities (which were often large banks) to stand behind their promises. Unfortunately, this critical component of the mortgage securities market has broken down.

With a restored, vital and healthy securities market, we will be able to attract more private capital into mortgage investments and, in turn, provide more affordable mortgages for potential home buyers.

HAMP and a Long-Term Solution to Prevent Foreclosures

While the Administration's HAMP was delayed in implementation and the number of permanent modifications does not appear to be on track to meet its stated goals, we wish to emphasize several specific issues that impacted the goals of the Administration, Congress and distressed homeowners.

HAMP offers a potential solution to the looming foreclosure threat facing 1.4 million distressed homeowners. It will only be an effective and sustainable program if the permanent modifications do not again default. The recent program numbers show a modest growth in the program's permanent modifications, now exceeding 340,000 permanent modifications, as well as reducing payments by 14% or $514 per month. Yet despite this progress, recent studies suggest that the threat of re-default under HAMP is very real, especially within a one-year time frame.[1] Further, it may threaten to undermine the long-term success and effectiveness of the program. Accordingly, AMI emphasizes that any program must account for affordability (*i.e.*, the borrower's ability to pay) and negative home equity. When properly structured, the program can offer the solution that is sought by policy-makers and homeowners.

The ability of a responsible borrower to pay a subsequently modified mortgage is critical for the success of any relief program. For AMI, one of the most concerning aspects of the Administration's current relief efforts is using reliable criteria for applicants who are likely to succeed in the program. One key criterion is the debt-to-income (DTI) calculations used in assessing a borrower's modification program application. Several critics contend that the DTI calculations do not adequately factor in the borrower's non-mortgage debts to the payment calculation (*e.g.*, auto loans, credit cards, etc.). This approach lacks

[1] James R. Hagerty, *High Default Rate Seen for Modified Mortgages*, WALL STREET JOURNAL (June 16, 2010) (citing Fitch Ratings, Ltd. Research data).

the holistic view needed to ensure that a borrower has an actual *ability to pay* a modified mortgage, and again is likely to lead to a re-default in the near future.

Bank Servicers and the Second Liens Issue

The major impediment to the viability of the program is the volume of second mortgages or second liens outstanding and the uncertainty as to how those second liens will be handled under the program**.** Traditionally, there is no such uncertainty because first lien mortgage holders had a clear understanding of the priority of second liens. The second lien problem exists because many banks and their affiliated servicers offered additional forms of financing to consumers, such as home equity loans and other second mortgages. As indicated earlier, the vast majority remain on the balance sheets of our nation's largest financial institutions and these second mortgages are a major financial burden for homeowners.

In fact, the four banks that service approximately 40 percent of mortgages held roughly $419 billion of second liens on their balance sheets as of December 31, 2009. Under temporary loan modification programs such as Making Home Affordable, banks are able to defer the recognition of losses on the second lien portfolios. In fact, the current HAMP program actually improves the cash flow available to the second mortgage at the expense of the first mortgage and defers the immediate loss that would be recognized in a foreclosure, short sale or short refinance. Although the largest institutions have now signed up for the 2MP second lien modification program under HAMP, that one year old program has yet to be implemented.

In these negative equity scenarios, the second lien would receive no proceeds in a foreclosure action. On the other hand, the modification program allows this uncollateralized obligation to remain outstanding and on the books of the financial institution as a performing asset, even though the homeowner has no equity in their home. Our analysis of 44.1 million first lien loans from a primary credit bureau database indicated that, of all second lien mortgages, only 3 percent are current with a corresponding first lien mortgage that is delinquent.

Investors' Solutions to Foreclosure Crisis

The AMI believes that any successful solution to the housing crisis must address two key components: affordability and negative equity.

Negative equity and near negative equity mortgages account for nearly 28 percent of all residential properties nationwide. There are approximately 15 million borrowers who owe more than their homes are worth. About a third of those mortgages are already in default and potentially in need of assistance. The highest concentrations of these negative equity mortgages are in Nevada, Arizona, Florida and Michigan. Negative equity is not going away soon; the numbers suggest the contrary. In the last year, the number of "underwater" loans has remains around 24% (11.2 million).

The nation's foreclosure crisis must be solved by addressing both the problems of *"ability to pay"* and *"willingness to pay".* The interests of homeowners and mortgage investors are completely aligned. A homeowner who cannot afford his mortgage and who owes more than his home is worth runs a very serious risk of losing the home through foreclosure. In order to provide relief to both homeowners facing possible foreclosure and the entire housing market, a program must be introduced that reduces principal to provide affordability and equity to homeowners that are underwater in their mortgage and in financial distress.

To be successful, a loan modification or principal reduction program must be designed to ensure that the risk of default is minimized. The only way to effectively accomplish this is to reduce the homeowner's overall debt to ensure that their "debt-to-income" ratio is sustainable. This involves reducing mortgage balances on all liens on the property, first mortgage, and other subordinate liens.

Furthermore, as provided in the Administration's recently announced FHA short refinancing program, this involves a rigorous qualification process and underwriting that ensures that the homeowner has the best chance to make their payments and stay in their home.

Mortgage investors maintain that any true relief must come from significant principal forgiveness on first and second lien mortgage debt in connection with the refinancing of the overextended homeowner into a new, low interest rate mortgage. This is a position that we have communicated to key policymakers from Capitol Hill, to the Departments of the Treasury and Housing and Urban Development, and with Community Housing Advocates.

The solutions offered prior to Treasury's past announcement failed to address the entire consumer debt burden, and overlooked entirely the impact of negative equity. While a loan modification involving principal forbearance, term extension or temporary rate reduction as provided in the original HAMP program may provide temporary relief, by not addressing negative equity homeowners would be trapped in a mortgage that cannot be refinanced and a house that cannot be sold. Further, for those who seek mobility to pursue new employment opportunities, they would no longer feel "trapped" by their mortgage and would be able to sell without enduring a life-altering loss on the sale.

We further believe that as part of America's long-term, sustainable housing solutions, any government relief programs, such as HAMP, must be designed upon realistic assumptions. For example, the programmatic design must include sound econometric modeling which accurately forecasts which responsible, distressed homeowners are not at a high risk of re-default. Unfortunately, after a HAMP modification, the average homeowner is still burdened with such a high level of debt that they will not qualify for FHA or HUD mortgage underwriting standards. Because these homeowners are destined to default given their non-mortgage debt load, it is not good federal housing policy to place struggling homeowners into such a dire position. The vast amount of available data concludes that they will eventually default. We support addressing these issues and finding a permanent solution for homeowners overburdened with non-mortgage debt loads.

Administration's Newest Proposal: Principal Reduction, FHA Short Refinance

The Association of Mortgage Investors is supportive of the framework of the program announced earlier this year by the FHA to reduce principal through a refinancing program for homeowners who are "underwater" on their mortgage. This program, if properly implemented, can provide relief for qualifying homeowners and contribute to the housing market's stabilization and the economy as a whole. However, that successful implementation cannot be presumed, because there are still numerous details that must still be determined by the Treasury and HUD/FHA that could either minimize or increase the execution risks of the entire program. We fear that these implementation logistics could easily be overlooked.

As we have noted in our proposals for principal reduction over the last year, any effective market solution must involve all market participants. Everyone must share the burden. Solutions cannot be a windfall for certain stakeholders and terrible for others. The AMI agrees that taxpayer funds should not be used for principal writedowns.

In essence, the most recent Administration FHA refinancing proposal has focused on three primary principles:

- First, the qualifying homeowner must be eligible for a HAMP modification and have a mortgage that is "underwater" (where the combined loan-to-value ratio is greater than 100 percent).
- Second, the mortgage investor would agree to permanently reduce (forgive) principal necessary to get the homeowner's mortgage to a 97.75 percent loan to value (LTV) ratio, therefore "restoring equity" at the same time the borrower is refinanced into a new agency-compliant fixed rate mortgage with an agency-compliant monthly payment. Furthermore, if the property has a second lien, the combined debt of the first and second liens cannot exceed 115 percent of loan to value ratio and also cannot exceed 31 percent of the homeowner's debt-to-income (DTI) ratio.
- This is a voluntary program.

Mortgage investors have been willing to realize significant losses in existing RMBS investments to facilitate the refinancing of borrowers from distressed mortgages into newly originated fixed rate mortgages based on the current value of the property. In this proposal, the cost of reducing principal on primary mortgages held by investors would be borne by the investor.

Obstacles to Success of New Administration Proposals

The Administration's proposal is overly vague on how second and other subordinate liens will be treated under the program. For example, it is not clear whether the mortgage servicer can approve a reduction in the homeowner's first lien only to have the holder of the second lien, which is typically the parent company of the mortgage servicer, opt out of the program and thereby avoid any principal reduction.

The problem with that scenario is threefold:

- First, it will ultimately hurt the homeowner, because their total debt-to-income ratio will still be excessive and the risk of default will remain clear.

- Second, it completely ignores the priority of liens and enriches the bank's second lien position at the expense of the senior first lien position which is helped by investors who represent pension funds and foundations. This situation is not only negative for those investors now, but also as it relates to the future of the mortgage finance marketplace – because investors will be reluctant to invest in mortgages with uncertain rules that create additional risk. This risk will ultimately result in increased borrowing costs for future homebuyers.

- Third, despite the intention of FHA's refinance program as having a maximum benefit to homeowners and investors, we fear servicers will not implement this new program and will instead choose a modification that benefits their own interests and leaves the homeowner in a distressed financial position, likely to default in the future.

The experiences in the HAMP program suggest that management of those conflicts is inadequate. Whether it is the reluctance to sign up and then implement the 2MP program or other aspects of the implementation of the current HAMP program, mortgage investors of first lien interests are very concerned that second lien holders will balk at participating in the new principal reduction programs. This will lead to their failure. Critics have suggested that principal reduction programs that provide relief to homeowners on the balances of their mortgage are unfair to other homeowners. While the issue of moral hazard is very real in these extraordinary times, we do believe that the Administration's program begins to help manage this situation. The FHA refinancing program applies first to homeowners who are current on their "underwater" mortgage. Therefore the issue of rewarding people who are not paying their mortgage is resolved.

By engaging in an FHA refinancing, the homeowner will have to qualify for the new mortgage. This involves income verification and dealing with excessive debt issues. One of the best ways to deal with moral hazard is to ensure that the homeowner actually qualifies for the new mortgage and has a greater opportunity of staying current on the new mortgage. If policy makers believe that more needs to be done to deal with a "moral hazard" issue, mortgage investors would be happy to be a part of such dialogue.

Conclusion

Mortgage investors believe that the Administration's program for principal reduction leading to an FHA refinancing is an important step forward. However, with the current lack of detail, investors are extremely worried that there are significant execution risks to the program that are similar to some of the experiences that we have seen in the current HAMP program. This program will need clear implementation instructions to servicers that participation is necessary and must take priority over other options that are in the servicer's self interest, but harmful to homeowners and investors. Anything short of full participation will surely prevent the program from meeting its goals. If second or other subordinate liens are not active participants in a principal reduction program, the homeowner will remain saddled with excessive debt. Furthermore, by not respecting the priority of liens, rebuilding the mortgage market in the future will only be more difficult.

Thank you for the opportunity to share my views and those of the Association of Mortgage Investors with the Committee.

Please do not hesitate to use the AMI as a resource in your continued oversight concerning the many issues under review. We may be reached at 202-327-8100 or by email at katopis@the-ami.org. We welcome any questions that you might have.