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Thank you and good morning. My name is Howard Mulligan. I am a partner in the New York office of the international law firm of McDermott Will & Emery. For the last fourteen years, I have been engaged in representing issuers, underwriters, servicers, bond insurers and rating agencies in securitization and other structured finance transactions, including the securitization of home mortgages. I am pleased to be here to testify, based on my experience, with regard to issues related to the role of the secondary market in sub-prime mortgage lending. I commend the Committee on Financial Services for calling these hearings.

Overview

Home ownership is widely viewed as a salient feature of the American cultural landscape. Federal law reflects the importance of home ownership in the United States by encouraging and assisting deserving families in endeavoring to purchase a home. The capital markets have also contributed substantially to expanding the availability and reducing the cost of mortgage credit by coupling investors and home buying families through the process of mortgage securitization. Home mortgage credit is more widely available today and at a relatively lower cost than ever before, due in no small part to securitization and secondary mortgage market activity.

Approximately $10.2 trillion of family mortgage debt was outstanding at the end of 2006. In the past few years, the mortgage-backed securities market has emerged to be the largest of all the fixed income markets. At approximately 70 percent overall, home ownership is close to, if not having surpassed, its highest level in history. It is clear to any astute market observer that the liquidity provided by securitization and the secondary market has facilitated these positive developments.

Mortgage securitization is the process of packaging and bundling mortgagees' monthly principal and interest payments of home mortgage loans and using these payments to back mortgage-backed securities, which are sold to institutional investors, such as pension funds, insurance companies and mutual funds in either private placements or public transactions. Mortgage securitizations are structured and implemented in accordance with the requirements and expectations of national rating agencies.

In a myriad of ways, securitization transactions have made mortgage loans more available and affordable to American consumers.

First, securitization taps on a wide and deep reservoir of capital sources to fund the mortgage lending market. Institutional investors both inside and outside the United States generally do not want to hold individual mortgage loans in their investment portfolios because of the risk attributable to an unrated ordinary consumer. However, because of the risk mitigants and rating enhancers inherent in the scaffolding of structured finance transactions, these well heeled institutional investors are active buyers of mortgage-backed securities, making their funds available to American families buying homes. The ability of mortgage lenders to sell mortgages in the secondary market promptly, efficiently and with substantial certainty increases funds available to lend and significantly reduces consumer borrowing costs.

Second, mortgage backed issuances provide a way for mortgage originators to sell the loans that they originate which, in turn, creates capital for the extension of new loans. Before securitization became prevalent, banks funded mortgage loans through their customers' deposits, and mortgage credit was determined, in most instances, by the volume of bank deposits. Today, because of the outlet of securitization and the flexibility that such transactions provide, banks, mortgage companies, financial service companies and other lenders have the option of selling loans into the secondary market, rather than retaining such loans on their books for their entire term.

Third, securitization not only mitigates, but specifically tailors, the risk of investing in mortgages. The professionals that structure mortgage backed transactions have formulated innovative methods (including derivative enhancements and other synthetic techniques) of segmenting the risks associated with investing in mortgages and creating securities that allow investors to assume the precise level of risk (and corresponding coupon) to which individual investors are comfortable.

Fourth, in disbursing mortgage related securities across a wide array of purchasers, including purchasers outside of the United States, the widespread securitization of residential mortgage loans has decreased the risk of regional mortgage holdings in local banks. Because mortgage backed issuances are less concentrated, the risk of borrower default has been allocated more efficiently and, as a result, is less dependent on, and correlated to, individual localized real estate markets.

State Initiatives Regarding the Sub-Prime Market

Securitization helps provide capital for both "prime" mortgages (to mortgagees with relatively good credit) and "sub-prime" mortgages (to mortgagees with weaker credit). The sub-prime lending market offers borrowers who fail to qualify for prime rate mortgages the chance to fulfill the proverbial American dream, providing the loan necessary (albeit at a higher rate and often subject to more restrictive covenants) to own a home.

The sub-prime lending market can, however, be a perilous venue for the vulnerable borrower. In this side alley for the structured finance market, a person with poor credit, few options, and perhaps little financial wisdom might easily find himself the victim of so called predatory lenders eager to take advantage.

Beginning with North Carolina in 1999, many states began passing so called anti-predatory lending legislation, purportedly designed to strengthen and fill in the perceived gaps left by federal law. At least 47 state and local jurisdictions now regulate sub-prime lending. Despite the genuine best intentions of the state legislatures, however, the laws affecting the lending industry have, in most cases, hurt the very borrowers they were intended to protect. These unintended consequences are illustrated in a number of ways.

First, many of these state initiatives have arguably overreached to the degree that the lending industry cannot operate effectively. These ostensible “protections” often restrict operations and escalate costs for potential lenders, which in turn raises costs for borrowers or even drives impacted or potentially impacted lenders away from the market altogether.

Second, those states that have anti-predatory lending laws use a myriad of different schemes. In order to maintain a national or even regional practice, lenders must gain expertise in the laws of several states. Operating in different jurisdictions requires lenders to make varying, subjective, and often conflicting, judgments for each jurisdiction. The differing state laws add risk (often change of law risk, which cannot be quantified or structured around without great difficulty) and cost to the lenders’ activities, and the lenders then pass these costs on to the borrower.

Third, and perhaps most significantly for the mortgage securitization market, several of the state statutes have arguably had a chilling effect on securitization by imposing assignee liability (extending liability to secondary market loan purchasers). Assignee liability allows a borrower to bring a civil action against not only the lender but also the innocent assignee that purchased the loan in the security market. The specter of assignee liability is intended to encourage secondary market loan purchasers to “police” the secondary market by exercising extensive diligence with a view toward avoiding purchasing bad loans. Unfortunately, the Home Ownership and Equity Protection Act of 1994 (“HOPEA”) and many of the state schemes have established opaque and subjective triggers for assignee liability. Some state laws have imposed liability on assignees based on the conduct of parties that they could not control or subjective determinations of whether the loans were in the “best interests” of individual borrowers. Other state statutes have imposed assignee liability based on vague standards of “suitability.” Each of theses approaches makes the participation of secondary market investors almost impossible, to the extent that these downstream investors were held liable for subsequent potentially arbitrary and capricious determinations that the origination of certain mortgage loans were not in the “best interests of”, or were “unsuitable”, or “inappropriate” for particular borrowers. The resulting uncertainty and extra costs engendered by assignee liability statutes have operated to negate many of the benefits of the mortgage securitization market, thereby restricting the financing and growth of the lending industry to the detriment of consumers.

The experience of various states in enacting, and then subsequently amending, anti-predatory lending legislation has been telling. In 1992, Georgia enacted legislation which was so expansive and stringent in imposing assignee liability that many lenders refused to purchase any Georgia loans and major rating agencies announced that they could not rate any structured finance transaction containing a single loan subject to the Georgia statute. As a result of the reaction of the secondary market and the impact on mortgage originations, Georgia was compelled to amend its aggressive predatory lending statute to remove several of its most onerous provisions. The pattern has been repeated in other jurisdictions that have enacted burdensome anti-predatory lending legislation, such as Rhode Island, New Jersey and Ohio, which have been forced by the reaction of the secondary market to amend the most overreaching and manipulative provisions of their sub-prime initiatives.

The Mortgage Market is Predicated on Legal Certainty

The fundamental goal of a securitization issuance is to impose certainty so that originators can access the capital markets at a less expensive rate and the intent of the transaction is that this capital efficiency can ultimately redound to the benefit of the consumer. In any mortgage backed transaction, investors need to know that (i) the risks they take at the time they make their investments will not be altered by changing the terms of the underlying contracts that back the issuance and (ii) they will not have to bear liability based on the conduct of parties that they do not control or subjective determinations of whether loans were in the "best interest" of individual borrowers. The terms of most securitizations do provide, however, flexibility for servicers to accommodate particular cases of borrower distress. Risk is typically modeled at the time of issuance based on probabilities of default and severities of loss of the underlying mortgages, based on historical data and loan terms remaining as they existed upon the closing of the transaction. The analysis does not include change-of-law risk, which is extremely difficult to effectively calculate and thereby model, but is generally viewed by rating agencies as remote. Consequently, structured finance professionals have not developed techniques of "structuring around" change of law risk. Increasing change-of-law risk will inhibit the flow of funds as investors will not be able to quantify and mitigate the risks they are accepting at the time that they decide to enter the transaction.

In the securitization arena, the banks, finance companies and other institutions responsible for receiving monthly mortgage payments from borrowers and passing them through to investors are called mortgage servicers. In recent months, these mortgage servicers have been tirelessly working with borrowers who are in arrears on their loans to help avoid foreclosures. Such efforts by servicers have been abetted by the flexibility inherent in the typical transaction documents in securitizations, particularly the servicing agreements, which provide servicers with the latitude to modify loan terms and extend deadlines to help distressed borrowers avoid default and keep their homes.

Investors cannot advance funds flexibility and efficiently into a mortgage finance system characterized by a patchwork of different state and local laws which dictate different standards of conduct and liability. A liquid and efficient national mortgage market at its current scale in the United States depends to a substantial extent on relative uniformity of risk and certainty that merely purchasing mortgage loans will not give rise to unmanageable liability or significant loss of investment.

In that regard, the bipartisan Responsible Lending Act (HR 1295) introduced on March 15, 2005 (the "Responsible Lending Act"), provides a valuable model in alleviating uncertainty in the secondary mortgage market. Among other ways of promoting uniformity in the secondary market, the bill calls for the establishment of federal preemption of all state laws and would provide the mortgage lending industry with a single national standard with which to comply rather than the current complex milieu of state and local laws that have engendered confusion and a lack of certainty in the secondary mortgage market.

The Imposition Assignee Liability would Impair the Secondary Mortgage Market

Imposing unquantifiable assignee liability on the secondary market for abuses committed by mortgage originators would severely affect investors' willingness to assume mortgage risk for which they might become liable through no fault of their own. This would generate more rather than fewer innocent victims of predatory lending activities and ultimately reduce the availability of capital to the mortgage market. Rather than making secondary market participants the monitors or enforcers for the actions of originators, assignee liability would simply drive investors away from the sub-prime market entirely, severely reducing capital available for sub-prime lending and regressively raising costs for the working families least able to afford home ownership.

Investors and other market participants are ill suited to surveil and monitor laws that apply to originators, nor is that the proper role of the secondary market. By way of analogy, it is noteworthy that the federal securities laws never presumed to impose liability on purchasers of stock for corporate misconduct or malfeasance.

An interesting starting point for reform that is worthy of consideration is the assignee safe harbor provision embedded in the Responsible Lending Act. By operation of the bill, assignees could create a safe harbour against both defensive and affirmative assignee liability claims if the assignee: (i) has policies against purchasing higher-cost mortgages or mortgages that contain lending violations; (ii) requires by contract that the seller represent that it would not make or buy loans with lending violations; and (iii) exercises reasonable due diligence in reviewing purchased loans. Unless the borrower can prove that the assignee had knowledge of a lending violation, damages are limited to actual financial losses and attorney's fees. These provisions, combined with the preemption of the varying state laws by a national standard, provide a clear and effective background upon which the secondary mortgage market can operate. Whether such a safe harbor mechanism would be palatable to the secondary market is still open to debate and subject to further analysis but, in providing at least some degree of predictability, it may at least amount to a step in the right direction.

Mandated Forbearance would be Punitive and Inflexible

The securitization market thrives on certainty and loathes uncertainty. Federal laws with a view toward modifying the terms of mortgages post issuance would unfairly penalize innocent classes of investors who purchased mortgage backed securities predicated on the assumption that the terms set forth in the loan documentation would be applied and interpreted according to the original terms of the documents. Those terms reflect a negotiated and time tested allocation of mortgage credit risk among transaction participants. Most non-prime securitization transactions include provisions that permit some flexibility to modify loans where a default has occurred or is reasonably foreseeable, and customary economic incentives have evolved to ensure loan servicers use that flexibility. Altering reasonable expectations of investors regarding the operation of contracts associated with their investment would dramatically reduce the supply of capital to the mortgage market. In addition, such a federal initiative may also cause uncertainty on the part of the law firms that render the various legal opinions that buttress structured finance transactions.

The documents that govern securitization transactions contain "waterfall provisions" which set forth a priority of payments structure applicable to each (usually monthly) payment date. These waterfall provisions are formulated in such a way that what benefits one class will often harm another. For example, the timing of principal payments, if accelerated, may be beneficial to certain principal-only classes and harmful to other classes, such as interest-only classes. Investors who assumed that any losses would be allocated according to the terms of the transaction documents most likely will have hedge costs and possibly tax consequence if those losses were instead dealt with another way by the operation of officious and unpredictable legislation. There are also potentially negative consequences to waiving defaults or altering standardized collection procedure and experience has clearly indicated that lending regulation aimed solely at reducing the incidence of defaults has had a detrimental impact on secondary market participants. For example, if servicers are unconditionally required to grant waivers of contract terms to mortgage holders, it may provide incentives for others that are not in genuine distress to claim similar benefits. Imposing unforeseeable costs on the market would undermine the certainty required by investors and make future investments in mortgages both less available and more costly to obtain. Moreover, imposing uniform "one size fits all" mandates regarding the proper course of forbearance very often might have negative consequences for the unique challenges and exigencies of an individual borrower.

Suggestions

I concur with many of the suggestions put forward by the American Securitization Forum and the Securities Industry and Financial Markets Association in prior testimony before this Committee. Among these suggestion are as follows:

<u>Assiduous Enforcement of Existing Law</u>

Rather than enacting a plethora of new laws to respond to the current turbulence in the sub-prime market, federal, state, and local agencies should vigorously oversee and enforce existing law and regulation in the origination process, which often is the point where mortgage fraud and abuse take place. There is also a need for consistent and comprehensive enforcement of laws applicable to mortgage brokers, appraisers, engineers, consultants and others involved in loan origination.

<u>Consumer Education and Disclosure</u>

Instead of burdensome laws that impose unnecessary risks on secondary market participants, the more advisable path is to provide fulsome opportunities for consumer education and credit counseling to allow borrowers to select the products that are uniquely suited to their needs. Consumer education should be supplemented by uniform and meaningful mortgage disclosures that effectively inform consumers of the risks that they assume when taking out a particular mortgage loan. Not only will consumer education and disclosure uniformity assist borrowers in making informed choices, such protections will also promote greater transparency for a liquid and flexible market that enables lenders and investors to responsibly accommodate consumer needs. In that regard, it is noteworthy that the Responsible Lending Act envisages robust counseling and effective education to borrowers so that they are better apprised of the risks of entry into the mortgage loans and to also grasp a better understanding of the totality of the transactions.

Uniform and Objective Standards Should Govern the Market

A polyglot of inconsistent state and local laws only serves to increase the costs of compliance, inhibits the purchase of mortgages on a uniform basis, generates uncertainty, artificially restricts the flow of capital and ultimately harms the very consumers these well intentioned laws were designed to protect. Congress should act to adopt uniform national lending standards applicable to mortgage originators that are clear and objective without imposing any undue restrictions on the secondary market. To best benefit non-prime borrowers, such standards must be national in scope and include broad preemption of state and local laws.

With regard to imposing uniform and objective market standards, the Responsible Lending Act may provide a useful starting point. The Responsible Lending Act establishes federal preemption of all state laws and provides for one national standard with which to comply rather than the complex mosaic of state and local laws that have increased cost and complexity.

The Market's Response Has Been Effective and Should be Allowed to Continue

Both the lending and investment markets have responded proactively to the rise in delinquencies among sub-prime borrowers over the course of the past six months and many of the practices that led to poor performance now so abundantly apparent in the originations of 2005 and 2006 have been jettisoned. A number of sub-prime lenders have withdrawn from the market entirely. Those lenders who remain have tightened their lending and underwriting standards. Investors have become more cautious about the types of securities that they buy. By application of the forces of the marketplace, prices for certain securities backed by sub-prime loans have fallen, reflecting the heightened risk associated with the increase in delinquencies. Portfolios are being scrutinized more diligently at even higher levels as the attributes of the loans that suffered early payment defaults are becoming well known. As previously discussed, mortgage servicers have been taking advantage of the flexibility inherent in typical securitization documents to assist troubled borrowers in avoiding delinquency and foreclosure.

If federal regulators were to restrict credit severely at this particular juncture they would run the risk not only of denying future borrowers credit, but making it extremely difficult for existing borrowers who are about to endure rate increases to obtain reasonable re-financings of their mortgages when their rates reset. Overly expansive legislation could exacerbate the already significant stress in the sub-prime market.

Conclusion

A uniform, national lending standard will promote competition and market efficiencies and will reduce the cost of home ownership. Implementation of such a sweeping legislative initiative would make it easier for financial institutions and their in-house counsel to navigate the legal landscape. Among other liberating effects, lending industry professionals may clear their files of the numerous diverse and often conflicting laws (and legal opinions regarding compliance with those laws) previously necessary for a national lending practice. For many lenders operating within strict local laws, the regulatory chokehold upon their activities will be loosened.

In drafting national standards, Congress should promote risk-based pricing, avoid prohibitions or excessive restrictions on certain types of mortgage products, steer clear of any suitability standards and enhance the regulation and oversight of mortgage brokers. National standards should be clear and concise and not assign unquantifiable liability to the secondary market for originators' practices.

Ultimately, the public policy challenge for regulators, professionals in the secondary market and consumer advocates is to strike the delicate balance between counteracting abusive predatory mortgage lending practices and ensuring that borrowers who may not be able to obtain loans in the prime market do have ready access to credit.

Hope for a better future – both economic and social – could be on the horizon in both the lending industry and the economy in general in the wake of passage of a uniform national anti-predatory lending reform law based on some of the more securitization/secondary market friendly provisions set forth in the Responsible Lending Act. With stories relating to sub-prime issues now dominating the headlines of business pages, professionals in the lending industry as well as those engaged in securitization and the secondary markets await the decision of Congress, which will soon be called on to decisively seize on this exceptional opportunity to enact legislation with a view towards providing consistency, transparency and certainty in the mortgage lending marketplace, as well as ensuring consumer protection and promoting home ownership.