

**WRITTEN TESTIMONY OF NEW YORK BANKERS ASSOCIATION
PUBLIC HEARING OF ASSEMBLY STANDING COMMITTEE ON
INSURANCE**

**FINANCIAL GUARANTY INSURANCE AND REPRESENTATIONS AND
WARRANTIES IN SECURITIZED DEBT TRANSACTIONS**

Wednesday, February 16, 2011
10:00 AM - 2:00 PM
Assembly Hearing Room 1923
250 Broadway, 19th Floor
New York, NY

The New York Bankers Association (“NYBA”) submits this written testimony in connection with the public hearing of the Assembly Standing Committee on Insurance (the “Committee”) on financial guaranty insurance and representations and warranties in securitized debt transactions.

NYBA is comprised of the community, regional and money-center commercial banks and thrift institutions in New York State. Our members have assets in excess of \$9 trillion and employ more than 200,000 New Yorkers. A number of NYBA members participate in some or all aspects of asset-backed securitizations, including originating, servicing, purchasing, selling and securitizing residential mortgage loans. Our members also invest in residential mortgage backed securities (“RMBS”). Certain of our members make representations and warranties in RMBS transaction documents, including representations and warranties concerning the mortgage loans contained in RMBS portfolios. Certain members-and they may be the same members - also purchase residential mortgage loans or shares of RMBS based upon transaction documents that contain representations and warranties about the loans. Our members thus are involved on both sides of these transactions. All of our members are interested in ensuring that representations and warranties in RMBS transactions, together with all other contractual terms, are fair, accurate, and reflect the allocation of risks agreed to by the parties.

We understand that the purpose of the hearing is to explore whether legislation may be needed to ensure or enhance protections of third parties who insured or have direct exposure to RMBS. This is an important topic that has been, and continues to be, the subject of significant litigation in New York state courts between mortgage originators, including certain of our member banks, and certain financial guarantee, or “monoline,” insurers. We appreciate the efforts of Chairman Morelle and the Committee in exploring this topic, and thank them for the opportunity to appear here today.

Pending litigation between monoline insurers and banks involves both the nature and accuracy of certain representations and warranties in RMBS transactions and the ability of monoline insurers to fulfill their obligations to make payments to RMBS investors. New York state courts are developing all of the relevant facts about what happened in these transactions, and investing substantial time and resources to do so. NYBA urges this Committee to await the outcome of that litigation before adopting new legislation.

Further, Congress has taken steps, such as the Dodd-Frank Act, that impose many statutory and regulatory changes on the securitization process. The federal government continues to act in this area, most recently with regard to government-sponsored entities (“GSEs”) such as Fannie Mae and Freddie Mac. Until we see the effect of these regulatory and judicial efforts, we believe it would be premature to impose further constraints on what is an important area of our national economy.

Should the Committee decide to pursue any initiatives in this area at this time, however, we believe that the Committee must examine all of the issues surrounding monoline insurance of RMBS transactions, not just issues regarding representations and warranties made by mortgage originators, if it is to develop a comprehensive understanding of the matter.

THE SECURITIZATION PROCESS

Many mortgage lenders use the securitization process. “Securitization” refers to the process of grouping together similar assets that generate revenues, and then selling the rights to receive a portion of those revenues to investors. In the case of mortgage-backed securities, pools of mortgage loans are sold to a trust, giving the trust the right to receive monthly mortgage payments from borrowers. The trusts in turn sell notes to investors that entitle investors to receive a portion of the revenue generated by the monthly borrower payments.

Many securitization transactions rely on one or more forms of credit enhancement, in which third parties with special securitization expertise and experience take on certain risks in exchange for fees. Credit enhancers with special securitization expertise and experience can add value because individual investors in securitization transactions may not have the necessary information, resources, expertise, or experience, or may not have a sufficiently large investment, to make it economically worthwhile to evaluate the credit quality of the underlying financial assets or to assess the riskiness of the transaction. Furthermore, even if an investor in a securitization transaction can accurately assess the risk, the investor may not wish to bear that risk. For example, certain investors have a preference for higher rated securities. When there is such third-party credit enhancement, investors will look first to the cash flows from the mortgage loans in the RMBS portfolio for repayment, and, if collections of those cash flows are insufficient, to the third-party credit enhancer. This minimizes the risk to investors in the securities.

RMBS and other asset-backed securitizations are often guaranteed by insurers that specialize in securitization. These insurers are referred to as “monoline” insurers

because their business is in that single (i.e., mono) line of insurance. Monoline insurance has its origin in the municipal bond market. The demand for insurance on municipal bonds initially was limited because defaults by municipalities were considered remote. This perception began to change when New York City nearly defaulted on its debt obligations in 1975 and Washington Public Power Supply System defaulted on \$2 billion of revenue bonds in 1983. By 2007, nearly 50 percent of municipal bonds were wrapped by monolines.

In recent decades, monoline insurers expanded their scope to the rapidly growing securitization markets. (Monoline insurance became particularly common in RMBS of second lien loans, such as home equity lines of credit ("HELOC") and fixed-rate second loans.) The monolines thus took the risk that they would have to pay on the securities they guaranteed, in return for an arm's-length, bargained-for fee. The monolines thus accepted the risk that the mortgage loans underlying the RMBS might not generate sufficient cash flow to pay the securities they insured, regardless of the reason. Indeed, the financial guaranty insurance policies typically stated that the insurer "unconditionally and irrevocably guarantees" the securities issued in the transaction and that such guarantees "shall not be cancelled or revoked by [the insurer] for any reason."

As part of the securitization process, information concerning the loan pools was often reviewed by rating agencies. The rating was essentially an assessment by the rating agency as to the likelihood that a securitization would pay in full. The rating agencies provided non-public, preliminary assessments of the risk associated with the pool of loans. Monoline insurance would often be used to raise the rating on the securitizations. For example, a securitization that would be rated "BBB-" — the lowest rating a security can have and still be considered investment grade — could obtain the highest rating, "AAA", with financial guaranty insurance provided by the monolines. The higher rating would make the investment more attractive to potential investors.

THE MONOLINES HAD ACCESS TO ALL RELEVANT INFORMATION ABOUT THE RMBS THEY INSURED

The multitude of monoline wrapped transactions were negotiated on a level playing field between multi-billion dollar insurance and banking institutions over the course of many years. The monolines proffered their own documents and aggressively negotiated terms. The monolines also demanded and received the right to conduct due diligence on the RMBS transactions before insuring them.

Due diligence is critical to understanding and accurately assessing risk. Because securitization focuses on financial assets, it is important to understand and value the financial assets backing the securities wrapped by the monoline. When those financial assets are mortgage loans, it is important to understand and value such practical considerations as the borrower's credit standing and ability to repay, and the adequacy of the residential property as collateral for the loan.

Due diligence on the underlying financial assets is therefore one of the most important means for monolines to understand and manage risk. Before a securitization transaction closes, a monoline insurer's due diligence may consist of visiting the mortgage originator's offices to meet with management and to discuss applicable servicing practices, collections practices, and credit underwriting practices; reviewing data provided by the originator; examining, among other things, a random sampling of the loan files in the RMBS; and reviewing the originator's reports of the historical and anticipated default rates on the underlying financial assets. After a securitization transaction closes, due diligence can include monitoring the ongoing performance of the financial assets, including examining data regarding payments received on the financial assets, principal amounts that have defaulted, and the status of various reserves.

A credit enhancer, such as a monoline, might also sometimes attempt to have another party, such as the originator, contractually represent and warrant to certain factors. In RMBS transactions, however, the recourse is primarily, if not solely, to particular financial assets backing the RMBS, and not generally to the originator of the assets. Therefore, it is more important and appropriate for a credit enhancer to perform due diligence on, and otherwise monitor, the financial assets in a securitization than to rely on representations and warranties about those assets. Stated differently, representations and warranties may supplement due diligence but should never be a substitute for it.

Some representations and warranties were provided in RMBS transactions for the benefit of the monolines — including statements that the mortgage loans in the securitizations would comply with the originators' underwriting guidelines. We understand that statements such as these are the focus of this Committee.

In this regard, it is important to note that underwriting guidelines are just that — guidelines, or indications, to how the loans would be originated. Mortgage originators could and would make exceptions to their guidelines when other factors existed that might compensate for an otherwise qualified borrower's inability to obtain a loan. (For example, perhaps a borrower had a FICO score of 690, and the particular loan program he was applying for required a FICO score of 700. The underwriter might still be able to approve the loan if a compensating factor existed, such as the borrower was putting 25% down on the purchase price or had substantial assets.) It was common practice for information regarding such exceptions to be disclosed to the monolines in the guidelines themselves and through the prospectus supplements for the RMBS deals.

In RMBS transactions, it was also a standard assumption by the parties that a certain number of mortgage loans would not comply with the stated representations and warranties. In fact, the transaction documents provided for remedies to address that situation. These remedies included a process whereby the mortgage originator or RMBS sponsor would re-purchase, cure or substitute loans that did not comply with stated representations and warranties. It is our understanding that NYBA member

banks have engaged in — and continue to engage in — this re-purchase process with the monolines in good faith.

The monolines received extensive information about the RMBS they insured and were given the opportunity to conduct extensive due diligence before issuing the insurance policies. For example, it is our understanding that in most deals, the monolines received an extensive loan tape that contained upwards of 60 fields of data for each of the thousands of loans in an RMBS portfolio. (If printed out, one of these loan tapes would be approximately 2,000 pages.) This data included FICO scores, appraised values, combined loan to value ratios, whether the loans were made pursuant to full documentation programs or less rigorous programs such as “stated income” or other reduced documentation programs (*i.e.*, the borrower had to submit little paperwork or income or asset verification), etc. With this information, the monolines could compare loan tape data to the written guidelines to determine to what extent loans in a particular RMBS portfolio varied from the guidelines. Further, the monolines had the right to request loan files for all the loans in the RMBS they insured.

MACROECONOMIC FACTORS, NOT LENDERS’ FAILURES TO ADHERE TO GUIDELINES, CAUSED THE MONOLINES’ LOSSES

According to data provided by NYBA member banks, the vast majority of the loans in the monoline-wrapped RMBS have performed. In many deals, over half the loans in the portfolios already have been paid in full, and most of the remaining loans (30% to 35%) continue to be current. In most of these RMBS deals, no more than 15% to 20% of the mortgage loans are in default, but this a very high level by historical standards.

This result is not surprising, given that America has just gone through the worst economic recession we have seen since the 1930s. Between 2006 and 2008, the U.S. economy fell into a recession deeper than any it has experienced since the Great Depression. As a result, unemployment rates skyrocketed as millions of Americans lost their jobs. In addition, there was an unprecedented decline in home values. According to the Case-Shiller Home Price Index, home prices reached their peak in June 2006 and then fell for 30 consecutive months, for a total decline of 28 percent.

As a result of these and other macroeconomic conditions, including rising borrower default rates, declining home prices and rising unemployment, the performance of RMBS suffered historically unprecedented declines. Homeowners who faced difficulty making their mortgage payments could not refinance as they could in prior years, when home prices were increasing. Nor could homeowners cover their outstanding mortgage obligations by selling their homes, because the value of the house was less than the mortgage balance. Had home prices continued to increase as they had in previous years, the delinquency and default rate of the securitized mortgages (and therefore the performance of mortgage-backed securities) would have been consistent with historical performance despite any alleged deficiencies in the underwriting process. .

It should be noted that the primary risk that monolines took — that housing prices would collapse — was not even covered by representations and warranties.

CONCLUSION

As the Committee knows, several monolines have brought lawsuits against many mortgage originators, including several members of NYBA. The financial institutions are defending these litigations vigorously, and expect to win in a court of law. At the same time, several monolines have filed for bankruptcy protection or been placed in receivership or under supervision by their regulating departments of insurance. Other monolines have engaged in extensive restructurings. Financial institutions and other institutional investors have filed lawsuits challenging some of these actions, including the February 2009 restructuring by MBIA. We reiterate our request that while these disputes are pending in the courts, this Committee avoid enacting new laws that could harm this business and impose further burden and risk on the New York financial industry.

We thank Chairman Morelle and the Committee for the opportunity to appear today and welcome the opportunity to answer any questions.