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Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives

Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit
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Thank you Chairman Ney and Chairman Bachus for holding this hearing and the opportunity to testify today on the role and importance of securitization in the mortgage industry. My name is Cameron Cowan. I am a partner at the law firm of Orrick, Herrington, and Sutcliffe. Within Orrick, I serve as the managing director of financial practice and as a member of the firm's executive committee. I am also a member of the American Securitization Forum's (ASF) executive committee and I chair the ASF's Legislative and Judicial Subcommittee. The ASF, an affiliate of The Bond Market Association, is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as investors, issuers, underwriters, dealers, rating agencies, insurers, trustees, servicers and professional advisors working on transactions involving securitizations.

For the last 16 years, my law practice has focused on structured finance—also known as securitization. My knowledge of subprime and predatory lending generally comes from the perspective of the secondary market. In my testimony today, I will focus on the securitization process, the growth of the industry and the many benefits securitization brings to consumers (including subprime borrowers), investors and issuers.

History and Overview of Securitization

Securitization is the creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets. It has grown from a non-existent industry in 1970 to $6.6 trillion as of the second quarter of 2003. Financial institutions and businesses of all kinds use securitization to immediately realize the value of a cash-producing asset. These are typically financial assets such as loans, but can also be trade receivables or leases. In most cases, the originator of the asset anticipates a regular stream of payments. By pooling the assets together, the payment streams can be used to support interest and principal payments on debt securities. When assets are securitized, the originator receives the payment stream as a lump sum rather than spread out over time. Securitized mortgages are known as mortgage-backed securities (MBS), while securitized assets—non-mortgage loans or assets with expected payment streams—are known as asset-backed securities (ABS).

To initiate a securitization, a company must first create what is called a special purpose vehicle (SPV) in the parlance of securitization. The SPV is legally separate from the company, or the holder of the assets. Typically a company sells its assets to the SPV. The payment streams generated by the assets can then be repackaged to back an issue of bonds. Or, the SPV can transfer the assets to a trust, which becomes the nominal issuer. In both cases, the bonds are exchanged with an underwriter for cash. The underwriter then sells the securities to investors. Unlike other bonds, securities backed by mortgages usually pay both interest and a portion of the investor's principal on a monthly basis.

Mortgage-Backed Securities

The first mortgage-backed securities arose from the secondary mortgage market in 1970. Investors had traded whole loans, or unsecuritized mortgages, for some time before the Government National Mortgage Association (GNMA), also called Ginnie Mae, guaranteed the first mortgage pass-through securities that pass the principal and interest payments on mortgages through to investors. (Ginnie Mae is a government agency that guarantees securities backed by HUD- and Veterans Administration-guaranteed mortgages.) Ginnie Mae was soon followed by Fannie Mae, a private corporation chartered by the federal government—along with Freddie Mac—to promote homeownership by fostering a secondary market in home mortgages.

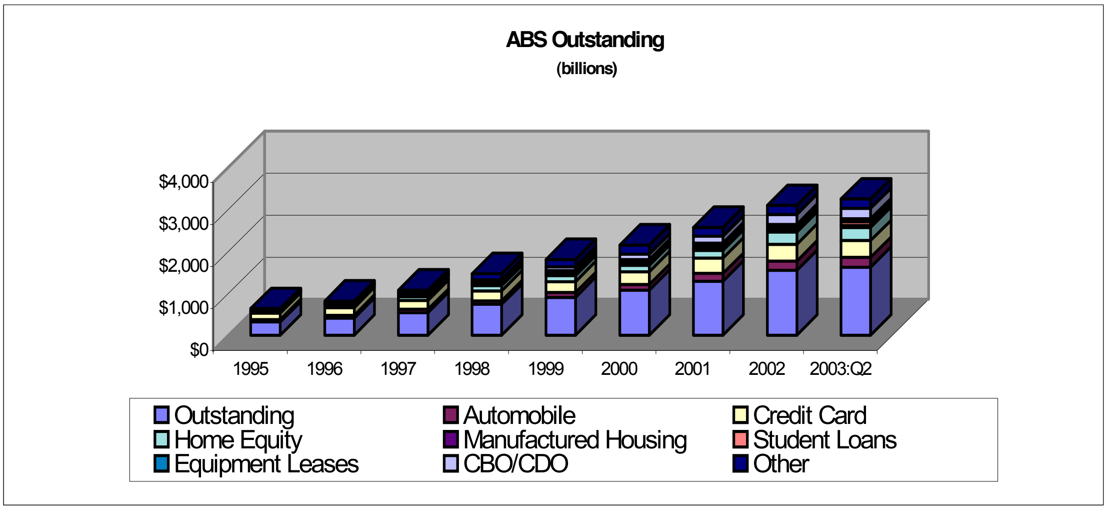
Pass-throughs were a dramatic innovation in the secondary mortgage market. The whole-loan market, the buying and selling of mortgages, was relatively illiquid. This presented a risk to mortgage lenders who could find themselves unable to find buyers if they wanted to sell their loan portfolios both quickly and at an acceptable price. Holding the loans also meant exposure to the risk that rising interest rates could drive a lender's interest cost higher than its interest income. But trading whole loans meant a raft of details and paperwork that made the business relatively costly. MBS changed that. By combining similar loans into pools, the government agencies are able to pass the mortgage payments through to the certificate holders or investors. This change made the secondary mortgage market more attractive to investors and lenders alike. Investors now had a liquid instrument and lenders had the option to move any interest rate risk associated with mortgages off of their balance sheet.

Growth in the pass-through market inevitably led to innovations especially as originators sought a broader MBS investor base. In response, Fannie Mae issued the first collateralized mortgage obligations (CMO) in 1983. A more complicated twist on pass-throughs, CMOs redirect the cash flows of trusts to create securities with several different payment features. The central goal with CMOs was to address prepayment risk—the main obstacle to expanding demand for pass-throughs. Prepayment risk for MBS investors is the unexpected return of principal stemming from consumers who refinance the mortgages that back the securities. Homeowners are more likely to refinance mortgages when interest rates are falling. As this translates into prepayment of MBS principal, investors are often forced to reinvest the returned principal at a lower return. CMOs accommodate the preference of investors to lower prepayment risk with classes of securities that offer principal repayment at varying speeds. The different bond classes are also called tranches (a French word meaning slice). Some tranches—CMOs can include 50 or more—can also be subordinate to other tranches. In the event loans in the underlying securitization pool default, investors in the subordinate tranche would have to absorb the loss first.

As part of the Tax Reform Act of 1986, Congress created the Real Estate Mortgage Investment Conduit (REMIC) to facilitate the issuance of CMOs. Today almost all CMOs are issued in the form of REMICs. In addition to varying maturities, REMICs can be issued with different risk characteristics. REMIC investors—in exchange for a higher coupon payment—can choose to take on greater credit risk. Along with a simplified tax treatment, these changes made the REMIC structure an indispensable feature of the MBS market. Fannie Mae and Freddie Mac are the largest issuers of this security.

Asset-Backed Securities

The first asset-backed securities (ABS) date to 1985 when the Sperry Lease Finance Corporation created securities backed by its computer equipment leases. Leases, similar to loans, involve predictable cash flows. In the case of Sperry, the cash flow comes from payments made by the lessee. Sperry sold its rights to the lease payments to an SPV. Interests in the SPV were, in turn, sold to investors through an underwriter.



Source: The Bond Market Association

Since then, the market has grown and evolved to include the securitization of a variety of asset types, including auto loans, credit card receivables, home equity loans, manufactured housing loans, student loans and even future entertainment royalties. Credit card receivables, auto and home-equity loans make up about 60 percent of all ABS. Manufactured housing loans, student loans and equipment leases comprise most of the other ABS. And the industry continues to look for new assets to securitize such as auto leases, small-business loans and "stranded cost recovery" ABS. (The latter refers to bonds backed by fees some newly deregulated utilities have won authority to include in future billings as an offset of previous investment.)

How Securitization Works

ABS and MBS represent an interest in the underlying pools of loans or other financial assets securitized by issuers who often also originate the assets. The fundamental goal of all securitization transactions is to isolate the financial assets supporting payments on the ABS and MBS. Isolation ensures payments associated with the securities are derived solely from the segregated pool of assets and not from the originator of the assets. By contrast, interest and principal payments on unsecuritized debt are often backed by the ability of the issuing company to generate sufficient cash to make the payments.

Origination and Servicing

The assets used in securitizations are created—or originated—in a number of ways. When a lender extends a loan or acquires another revenue-producing asset such as a lease, they are creating assets that can be securitized. Other assets, such as the balances due on credit card accounts or a corporation's accounts receivable can also be securitized. Because they initiate the securitization chain, the lenders, credit card companies and others are also called originators. Originators often retain a connection to their assets following a securitization by acting as a servicer—the agent collecting regular loan or lease payments and forwarding them to the SPV. Servicers are paid a fee for their work. Some originators contract with other organizations to perform the servicing function, or sell the servicing rights.

Asset Transfer or the "True Sale"

In the vast majority of securitizations, it is critical that the transfer of assets from the originator to the SPV is legally viewed as a sale, or "true sale." The proceeds of the securities are remitted to the originator as the purchase price for the assets. If the asset transfer is not a "true sale," investors are vulnerable to claims against the originator of the assets. The cash flows backing the securities or the assets themselves could be ruled a part of the originator's estate and used to satisfy creditors' claims if a true sale did not occur. Legally separating the assets also protects the originator.

Investors can turn only to the SPV for payments due on the ABS and MBS, not to the general revenues of the originator.

Special Purpose Vehicle and the Trust

The SPV can either be a trust, corporation or form of partnership set up specifically to purchase the originator's assets and act as a conduit for the payment flows. Payments advanced by the originators are forwarded to investors according to the terms of the specific securities. In some securitizations, the SPV serves only to collect the assets which are then transferred to another entity—usually a trust—and repackaged into securities. Individuals are appointed to oversee the issuing SPV or trust and protect the investors' interests. The originator, however, is still considered the sponsor of the pool.

Underwriter

Underwriters—usually investment banks— serve as intermediaries between the issuer (the SPV or the trust) and investors. Typically, the underwriter will consult on how to structure the ABS and MBS based on the perception of investor demand. The underwriter may, for example, advise the SPV to issue different tranches each with specific characteristics attractive to different segments of the market. Underwriters also help determine whether to use their sales network to offer the securities to the public or to place them privately. Perhaps most importantly, underwriters assume the risk associated with buying an issue of bonds in its entirety and reselling it to investors.

Credit Enhancement

Credit enhancement is common in securitization transactions. Depending on the nature of the transaction and the type of assets, the securitization pool may need such support to attract investors. Enhancement or support can come from the assets themselves or from an external source. Examples of internal enhancements include subordinating one or more tranche, or portion, of the securities issued. This practice places the claims of one tranche over another. Any defaults affecting the securities must be absorbed by a subordinate tranche before the senior tranche is affected. Over-collateralization of asset pools is also used to enhance credit. This occurs when the amount of assets placed in a securitization pool exceeds the principal amount of bonds issued.

External credit enhancements can include a surety bond or a letter of credit from a financial institution. Both options serve as guarantees that investors will receive the payments associated with the securities. GSEs enhance the credit of the MBS they issue by guaranteeing the timely repayment of principal and interest.

Credit Rating

Virtually all ABS and MBS are rated by independent rating agencies whose analyses is watched closely by investors as a guide to the credit quality of the securities. In almost all cases, rating agencies monitor the performance of the securities on an ongoing basis.

Dealers

Just as in other bond markets, dealers play an important role once an issue is initially distributed. For most bond investors, liquidity—the ability to easily buy or sell a security—is an important characteristic. By offering prices at which they will buy or sell bonds to the investment community, dealers provide this service. Bonds typically trade more actively closer to their date of issue. Because bond investors—usually institutional investors such as pension funds and insurance companies—hold most bonds to maturity, trading in bonds declines as they draw nearer to their stated maturity date. The issuance volume of a certain bond, a bond's credit rating and whether it was issued publicly or privately can also affect liquidity. All ABS and MBS are traded on the dealer-based, over-the-counter markets so liquidity depends in part on the ability and willingness of dealers to maintain an inventory, or make a market, in a certain bond.

Benefits of Securitization

Less Expensive, More Broadly Available Credit

The public benefits of securitization are evident in a number of ways. Chief among these is the contribution of securitization to lower borrowing costs both for individuals and corporations. The existence of a liquid secondary market for home mortgages increases the availability of capital to make new home loans. Financial institutions that realize the full value of their loans immediately can turn around and re-deploy that capital in the form of a new loan. This is often the most efficient way to raise new funds in the capital markets and the savings are passed on to the borrower.

Consumers other than homebuyers also benefit from lower borrowing costs. Securitization can lower a firm's financing costs as well. MBS and ABS are often designed to carry a higher credit rating than the originating firm would otherwise realize for other types of bonds. Higher credit ratings mean the security is less risky and translates into a lower interest rate for the originator as investors do not demand the same risk premium. The originator passes the savings on to the consumer in the form of lower lending rates.

Securitization also aids in the geographic dispersion of capital to areas that may otherwise be deprived of credit options. Traditionally, depository institutions have provided credit in the areas where they accepted deposits. By securitizing loans, however, the lender generates capital for new loans that may come from a different location. This linkage to the capital markets broadens the range of regions where depository institutions obtain capital to provide credit.

By subjecting the lending decisions of financial institutions to valuation by the capital markets, securitization also encourages an efficient allocation of capital. Financial institutions and others who securitize assets depend, of course, on investors. Investors seek an appropriate return based on a level of risk. If the asset pools are not of a sufficient quality, for example, investors will demand a higher interest rate as compensation. At its most basic level, securitization is the process of isolating risk and repackaging it for investors. This increases efficiency in the capital market by removing intermediary steps between investors and the risk they are assuming. A money manager, for example, may be interested in a mortgage-backed bond that pays interest and principle on a monthly basis, but not in the debt securities issued by the originator of the securitized assets.

Securitization reallocates risk at many levels. By shifting the credit risk of the securitized assets (for a price) to ABS and MBS investors, financial institutions can reduce their own risk. As the risk level of an individual institution declines, so does systemic risk, or the risk faced by the financial system overall.

More Options for Investors

As noted above, investors benefit from the legal segregation of the securitized assets. The segregation protects the payment stream on the MBS and ABS from a bankruptcy or insolvency. Higher-rated securitized instruments generally offer higher yields than similar sovereign government issues. The actual size of this yield premium, the yield the securities pay in excess of similar government securities—will depend on the credit quality of the assets and the structure of the transaction. Pension funds—which comprise much of the market for MBS and ABS—pay close attention to this premium as they seek a wide variety of safe fixed income products with attractive yields. Insurance companies, money managers and other institutional investors with needs for fixed-income securities with specific features are also large ABS/MBS investors.

The ability of issuers to vary the terms of securities backed by the same asset pool through different securitization techniques also makes MBS and ABS attractive to investors. In a sense, issuers can tailor the coupon, maturity and seniority of a security according to particular investor's needs. This flexibility not only boosts investor interest in ABS and MBS, but also contributes to more efficient capital markets by ensuring investors and money managers have access to the most appropriate securities.

Flexibility for the Originator

Securitization also benefits the financial institution or corporation that originates the securitized asset. Without securitization, a bank making a home loan usually would hold that loan on its books, recognizing revenue as payments are made over time. To realize the value of the loan immediately, the bank can sell the whole loan to another institution, though this is generally not economical unless the loan is very large. The more efficient option is to pool similar loans together, as discussed above, and enter into a securitization transaction.

The process makes even more sense for originators with assets considered illiquid, such as equipment leases or the balance due on a credit card. The latter comprises an asset class called credit card receivables that account for approximately 20 percent of outstanding ABS. Similar to banks securitizing home loans, credit card companies are able to use the securitization process to provide more credit and manage their balance sheets.

Originators realize another benefit from securitization as the transfer of the asset to an SPV removes it from the firm's balance sheet. This can help the originator improve certain measures of financial performance such as return-on-assets (ROA). A way to gauge a firm's efficiency, ROA tells observers how many dollars are earned for every dollar of assets. Moving an asset off of the balance sheet while simultaneously increasing income has a positive effect on ROA and demonstrates to investors a more efficient use of capital. Banks realize a unique advantage from securitization. Removing loans from their balance sheet can lower regulatory capital requirements, or the amount and type of capital banks must hold given the size of their loan portfolio, to reflect lowered risk.

The segregation of assets that takes place in a securitization can also effectively lower the firm's financing costs. This occurs when the securities issued by the SPV carry a lower overall interest rate than the originating firm pays on its debt. As the firm receives the proceeds from the securitization it has, in effect, achieved cheaper financing than might have been extended to the firm based solely on its own credit rating.

Conclusions

Securitization reflects innovation in the financial markets at its best. Pooling assets and using the cash flows to back securities allows originators to unlock the value of illiquid assets and provide consumers lower borrowing costs at the same time. MBS and ABS securities offer investors with an array of high quality fixed-income products with attractive yields. The popularity of this market among issuers and investors has grown dramatically since its inception 30 years ago to $6.6 trillion in outstanding MBS/ABS today.

The success of the securitization industry has helped many individuals with subprime credit histories obtain credit. Securitization allows more subprime loans to be made because it provides lenders an efficient way to manage credit risk. Efforts to curb "predatory" lending that inhibit the legitimate use of securitization by assigning liability to the purchaser of a loan or some other means, threaten the success of the beneficial subprime market. Secondary market purchasers of loans, traders of securitized bonds and investors are not in a position to control origination practices loan-by-loan. Regulation that seeks to place disproportionate responsibilities on the secondary market will only succeed in driving away the capital loan purchasers provide in the subprime market.

I urge Congress to move with great care as it addresses the problem of predatory lending. The secondary markets are a tremendous success story that has helped democratize credit in this country. Well intended, but overly restrictive, regulation in this area could easily do more harm than good. This is particularly the case when state and local governments craft disparate anti-predatory lending statutes that place different compliance burdens on the secondary market. For this reason, the ASF urges this committee to consider legislation to pre-empt the authority of state and local governments in the area of predatory lending and to construct a safe harbor from assignee liability for secondary market participants.

Thank you again for the opportunity to testify today.