Amherst® Securities Group LP

Testimony of:

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I am honored to testify today. My name is Laurie Goodman and I am a Senior Managing Director at Amherst Securities, a leading broker/dealer specializing in the trading of residential mortgage backed securities. I am in charge of the strategy and business development efforts for the firm. As part of our efforts to keep both ourselves and our customers abreast of trends in the residential mortgage backed securities market, we do an extensive amount of data intensive research. I would like to share some of our results with you today.

As a result of my testimony, I hope to leave you with 2 points:

- The housing market is fundamentally in very bad shape. The single largest problem is negative equity.
- The current modification program does not address negative equity, and is therefore destined to fail. It must be amended to explicitly address this problem. And there is no single solution; it is a combination of policy measures. Clearly, the arsenal of solutions must include principal reduction and must explicitly address the loss allocation between first lien investors and second lien investors.

In order to place today's topic into context, it is important to take a step back and take an objective look at the housing market. The Mortgage Bankers Association Delinquency Survey for Q3 shows that 14.1% of borrowers are not making their mortgage payments. This means 7.9 million homeowners did not pay their mortgage in Q3. This is a dramatic increase from several years ago for a number of reasons: (1) borrowers are transitioning into delinquency at a rapid rate, (2) cure rates are extremely low, and (3) the time from when a borrower first goes delinquent and when the home is liquidated has lengthened dramatically.

Given the current trajectory, we estimate that approximately 7 million of these 7.9 million homeowners will be forced into vacating their properties. And this estimate of 7 million units includes only the borrowers that have already stopped making their payments. It does not include the 250 thousand new borrowers per month who stop making their payments. What about modifications? Aren't they supposed to help relieve this? Yes, but they can't help considerably, as their success rate has been low.

The real problem is that default transition rates are high and cure rates are low because the borrower has negative equity in their home. Most borrowers do not default because of negative equity alone. Generally, a borrower experiences a change in financial circumstances, misses a payment on their mortgage and then re-evaluates their financial circumstances. If the home has substantial negative equity, they will choose to walk.

A few numbers will help illustrate this point. At Amherst we did a study looking at all prime borrowers who were 30 days delinquent on their mortgage 6 months ago. We sorted these mortgages by the amount of equity the borrower had in their home. We then came back 6 months later, and looked at whether the borrower was at least 60 days delinquent. For prime borrowers with 20% equity, only 38%

had become 60+ days delinquent. For prime borrowers with substantial negative equity (a combined Loan-to-value ratio of 141-150) 75% had become 60+ days delinquent.

There is a substantial group of people who have argued that the primary problem is not negative equity, it is unemployment. This argument is not supported by the evidence. First, the increase in delinquencies for subprime, Alt-A and pay option ARM mortgages began to accelerate in Q2, 2007. By contrast, we did not begin to see large increases in unemployment until Q3, 2008.

Further evidence of the importance of negative equity comes from another study we recently published entitled "Negative Equity Trumps Unemployment in Predicting Defaults." The results were very striking:

- The combined loan-to-value ratio or CLTV plays a critical role. For Prime and Alt-A loans in low unemployment areas the default frequency was at least 4 times greater for borrowers underwater by 20% than it was for borrowers with at least a 20% equity position.
- If a borrower has positive equity, unemployment plays a negligible role. We found that all borrowers with positive equity performed similarly no matter the local level of unemployment.
- If a borrower has substantial negative equity (mark-to-market CLTV>120), unemployment plays a role, but less than CLTV. If the borrower has a CLTV greater than 120, the default frequency was 50% to100% higher in a high unemployment area versus a low unemployment area.

The evidence is irrefutable. Negative equity is the most important predictor of default. When the borrower has negative equity, unemployment acts as one of many possible catalysts, increasing the probability of default.

HAMP modifications are, as you are aware, primarily a payment reduction plan. HAMP aims to lower the payment on the first mortgage plus taxes and insurance to 31% of a borrower's income.

HAMP has three fatal flaws. First the agent retained to make the modification was a mortgage servicer rather than an originator. This created a significant amount of ramp time as many servicers were not equipped to handle the many functions necessary to underwrite a modification. Second, HAMP only considers the first mortgage payment, taxes and insurance. It does not consider the borrower's total financial circumstances, including the second mortgage and other debt. Third, and most importantly, the program does not emphasize the re-equification of the borrower.

What makes us think that principal reduction would be a more effective modification tool than payment reductions? A few pieces of evidence point to this. First, the OCC/OTS reports that in Q2, 30.5% of mortgage loans in bank portfolios received a principal reduction as part of the modification. The corresponding number was zero for Fannie, Freddie, Government guaranteed and private mortgages. Thus, when the same party owns the first mortgage, the second mortgage, and the servicing, they look to maximize the net present value of the loan and often choose to do principal reduction. It is important to note that modifications on mortgage loans in bank portfolios have a much lower re-default rate than other types of loans.

What can/should be done? Here are some imperatives.

First, there is no one size fits all approach to modifications. There must be an explicit recognition that, in many cases, HAMP modifications as currently designed are not working. We believe that beating up on servicers to "do more" poorly designed modifications won't solve the problem. The program as implemented is addressing the wrong issue.

Second, moving principal reduction higher in the HAMP modification waterfall would be the most natural way to raise the success of the modification program. Would investors support this type of program? Absolutely! While a foreclosure is devastating to a borrower, it is also devastating to an investor—the recovery rate on a subprime loan is less than 30 cents on the dollar. It is approximately 50 cents on the dollar for a prime loan with a 200-400k loan size. The interests of the first lien investor and the borrower are totally aligned. It would be completely reasonable to further incentivize the investor to reduce loan balances through a government sponsored plan to liquefy properly de-risked loans. These would be loans in which the borrowers have performed as expected for some reasonable period of time after modification.

Third, any principal reduction program requires the Administration to address the second lien problem head on. The solution is clear-- the banks that own the second liens will have to write them down. The treasury may choose to pay an "extinguishment fee"; it may make sense to allow the banks to take the losses over time. But, for the sake of giving homeowners the best chance to stay in their home, the second lien will have to be extinguished. It should be noted that second liens have thus far, under HAMP, been treated with kid gloves. While the first lien modification program is fully operational, to the best of my knowledge the second lien program has not yet been implemented. Thus borrowers are paying the modified first lien amount and the full second lien amount, making the second lien, in effect, senior to the first lien. And even when the second lien program is implemented, it will merely make the second lien pari passu to the first lien.

Fourth, we endorse the revamped Hope for Homeowners Program, in which the borrower is refinanced into a government mortgage. This is a program that is apt to have far lower re-default rates than the HAMP modification efforts. The first version of this program was so cumbersome as to be non-operational. The recent revamp of this program addresses some of the issues. Two big issues that have not been addressed are: (1) the second lien issue and (2) misalignment of interests. We believe that were an institution to own the first mortgage, the second mortgage and the servicing, the institution may find this program to be a viable outlet, as the focus is on maximizing the NPV of all investments. We do not believe that this program will prove to be a viable outlet for loans backed by private label securitizations, as all interests are not aligned. The benefits of this program accrue mostly to the first lien investor, while the costs of this program fall on both the party that must fully document the modification (the servicer) but also the party that must write down the second lien (often the servicer).

Fifth, we need more transparency on the data. Releasing data on the number of completed modifications versus the number of modifications that were started in May, June, July etc would be a

helpful first step. Releasing data on the stage at which the modification attempt failed is critical. Data on the characteristics of permanent modifications and the performance of these permanent HAMP modifications is also very important. The only information we have on completed modifications comes from the Congressional Oversight Panel's October report on the first 1,700 completed modifications. The Panel found that the average payment was reduced by 34% and negative equity was actually increased from an average LTV of 134.1 to 136.6. That is, principal and interest advances were capitalized into the new balance, and there was relatively little principal forbearance. And principal forbearance is not very effective—the borrower still technically owes the money, so he has not been re-equified.

We do acknowledge that a poorly structured principal reduction plan could trigger additional strategic defaults. The proper plan will create significant frictions that would make a strategic default unattractive to borrowers who otherwise could afford to pay their mortgage. There is no single option here—shared appreciation features, requiring all reduced principal mortgages to be made with recourse, introducing an impact on credit scores and limiting future access to credit or ability to borrow against the property are among the ideas that must be considered.

We are concerned that if policies continue to kick the can down the road—working with a modification problem that does not address negative equity—delinquencies will continue to spiral with no end in sight.

My testimony has been focused exclusively on mortgage modifications. There are other measures that must also be taken if the capital markets are to function efficiently again. Amherst looks forward to working with this committee on the modification issue, as well as the broader set of capital markets issues.

Thank you very much for allowing me to testify today, it has been an honor.