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for the

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Standing Committee on Insurance

Hearing on Financial Guaranty Insurance and
Representations and Warranties in Securitized Debt Transactions
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Introduction

Honorable Chairman, Members of the Committee, Distinguished Colleagues: thank you for the opportunity to speak to you today on this important topic. My name is Jay Brown, and I am the Chief Executive Officer of MBIA Inc. This morning I will give you a brief overview of MBIA and the financial guarantee industry and discuss our involvement with securitizations of residential mortgages. I will also describe how the fraud, misrepresentations and failures of certain securitization sponsors to honor their representations and warranties on residential mortgage-backed securities that we insured have led to billions of dollars of claims on MBIA's policies.

These same actions have also undermined the ability of thousands of municipalities in New York and across the United States to buy our insurance, which, for over 35 years, has helped issuers access the credit markets and reduced their borrowing costs.

What's preventing municipalities from obtaining our insurance? Regrettably, it is the pointless litigation that's been filed against us. When I appeared before this Committee three years ago - at the height of the financial crisis - I noted that the structure of our business needed to change into one where our public finance, structured finance and asset management businesses each resided in separate legal entities. In February 2009, we restructured our company with the approval of the New York State Insurance Department to accomplish just that. We refer to this as our Transformation. Investors expressed a clear preference for a U.S. public finance-only financial guarantee insurance company - and our Transformation positioned us to provide much needed capacity to the municipal markets. But, two bank securitization sponsors joined a group of financial institutions and filed a lawsuit against the New York State Insurance Department and MBIA to challenge our Transformation. This litigation only compounds the damage they caused to our franchise by committing fraud and then failing to honor their representation and warranty obligations. Along the way, these same banks have attacked the Insurance Department and its approval of our Transformation, accusing them of bias, of conducting secret deals with MBIA, and of hiding the truth from the public - this after the Department conducted a thorough and independent investigation into our financial condition. While this litigation drags on, our U.S. public finance-only insurer – known as National Public Finance Guarantee Corporation – has been unable to serve municipal issuers and investors.

Background on MBIA and the Financial Guarantee Industry

I will provide more detail on the fraud, misrepresentation and contractual breaches committed by these financial institutions with regard to the mortgage loan securitizations we insured. But first, I would like to give you a brief overview of our industry and our company.

The financial guarantee industry has its roots in the public sector. Bond insurance has helped finance some of our country's great public works projects, including toll roads, bridges, ports, utilities and other essential infrastructure. AFGI, our industry's trade association, estimates that bond insurance has saved municipalities and their taxpayers more than $40 billion in interest costs since 1971. In the late 1980s and early 1990s, financial guarantee insurers began insuring structured finance transactions, which are securities backed by assets such as credit card receivables and mortgages.

From three companies providing bond insurance in the early days, the industry grew to as many as eight before the onset of the financial crisis. Few were able to withstand the test of time, however, and today effectively only two remain – Assured Guaranty and ourselves. While neither of us still carry the Triple-A ratings that were the hallmark of our industry for so long, our product continues to provide a substantial benefit to issuers and investors through its unconditional and irrevocable promise to pay principal and interest when due. We also provide portfolio surveillance and remediation services that have allowed us to work directly with issuers to head off defaults before they happen.

Turning to the MBIA group of companies specifically, we provide financial guarantee insurance, fixed-income asset management and other specialized financial services. The group has 400 employees in eight locations around the world, with the majority of them living in New York State and working in our Armonk, New York headquarters. We have been in the bond insurance business since 1974, and have insured financings in all 50 states. In New York State alone, we estimate that our guarantees have saved taxpayers $1.2 billion in interest expense over the years. Further, we have never failed to pay a claim when due.

Representations and Warranties

In our structured finance business, we believed that by doing business with large, well-capitalized and highly reputable loan originators, servicers and sponsors, we would limit our exposure to loss, let alone fraud. We believed that working with such reputable institutions would ensure that the reps and warranties written into the transactions were backed by an entity financially capable of meeting them. What we did not count on, and could not have foreseen, is that these institutions would willfully ignore both written underwriting guidelines and prudent lending practices on a massive scale and then subsequently refuse to honor the reps and warranties they made to us. As a result of their actions, we have paid out over $4.2 billion in claims through September, including $2.5 billion on Countrywide-sponsored transactions, $1.3 billion on transactions sponsored by what is now Ally Bank, $333 million on a Credit Suisse-sponsored transaction, and $76 million on a Morgan Stanley-sponsored transaction.

For context, I'd like to spend a few moments on how the reps and warranties that are the subject of today's hearing fit into the securitization and insurance processes. The process began when mortgage companies, also referred to as "originators," such as Countrywide, or Bank of America Home Mortgage as it's now known, approved mortgage loans according to a defined set of criteria, commonly referred to as underwriting guidelines, and either kept them on their books or sold them to an "aggregator" investment bank such as Credit Suisse or Morgan Stanley. Some financial institutions, like Ally's subsidiaries GMAC and RFC, both originated loans and bought them from other originators with the intention of securitizing them. Typically, an affiliate of the originator or aggregator, called the "sponsor" of a deal, would then pool a number of such loans, and transfer them to a special purpose trust which issued residential mortgage-backed securities, often using an affiliate as investment bank and generating millions in fees. Some of these securities were insured by us – and all were sold to investors.

Thus, these entities used the securitization process to transfer the risk of delinquency and default to investors or bond insurers. Financial guarantee insurance on these residential mortgage-backed securities was desirable because having the financial backing of a bond insurer led to higher ratings on the transactions. This not only increased the marketability of the securities, but also reduced the interest rate required by investors. As we have seen, investors were right to see the value in transactions with insurance versus those without. As I said before, we have paid every claim on the bonds we've insured.

When assessing whether to insure a transaction backed by a particular mortgage loan pool, bond insurers based their credit decision on the quality of the loan pool, the reputation and operational capabilities of the originators, servicers and sponsors, and their expectations for defaults and losses in the pool. All else being equal, a pool of prime loans can be expected to have far fewer defaults over its life than a pool of subprime loans.

The bond insurer addresses differences in loan pool quality by adjusting its requirements for the minimum rating attachment and the amount of overcollateralization and cash reserves available to absorb losses prior to claims on the insurer's policy. Again, all else being equal, a prime pool would generally require lower overcollateralization and cash reserves than a subprime pool, reflecting the differences in the underlying credit characteristics of the loans. In a typical transaction with a bond insurer, the sponsor of a transaction would make a series of representations and warranties in the governing documents to provide assurance that the loans in the pool met certain criteria – and recourse in case they did not. These reps and warranties were critical to us, as these criteria were a key determinant of the quality of loans eligible to be included in the loan pool - and consequently, how the pool could be expected to perform. Interestingly, during this same time period, we insured several billion dollars' worth of subprime mortgage securitizations. We required overcollateralization consistent with subprime loans because the pools were accurately represented to us, and we understood that they posed a higher risk than securitizations of prime loans. Ironically, these subprime transactions have performed with virtually no losses. Our losses have actually come from securitizations of what were represented to us as pools of prime loans – which, as a result, were structured with less overcollateralization. But because the quality of the loans was misrepresented, and they turned out to be anything but prime, the performance of the securitizations has been abysmal.

Thus, the sponsor of the securitization and the insurer each took on certain risks regarding the subject loans. For example:

- the originators or aggregators that actually evaluated (or were <u>supposed</u> to have evaluated) the loan applications at inception would accept responsibility for the reps and warranties regarding the loans and borrowers, and compliance with the guidelines;
- as a monoline insurer, MBIA accepted the risks that the collective pools of loans - having the characteristics represented and warranted by the sponsors – would not perform as anticipated and perhaps lead us to have to satisfy the trusts' obligations to its note holders. MBIA insured only the risks for which we bargained and for which insurance

> was solicited. Notably, we did not accept the risk of loss on loans that should never have been in the transaction in the first place. While the insurance coverage we provide bondholders is unconditional and irrevocable, we do have recourse, and have pursued it, against the originators when the pools have been misrepresented.

This allocation of risk was confirmed by the remedy provisions identified in the documents for breaches of the reps and warranties. When such a breach materially and adversely affects the insurer's rights in a loan – making that loan more risky, or worth less than it is supposed to be – the documents allow bond insurers to demand that sponsors cure, substitute, or repurchase the loans. This repurchase process is commonly referred to as the "put-back" process. If an insurer "puts back" an ineligible loan to the originator, the originator is obligated under the contracts to repurchase the loan - even if the originator had no knowledge of the defect at the time it sold the loan to the trust.

There is absolutely no requirement that a breach of the reps and warranties actually causes a default, despite what certain sponsors have been claiming. That would be like saying that you can't bring your car with faulty brakes back to the dealer until you actually crash. In reality, the reps and warranties address the risks that are presented to an insurer on Day One of the transaction. Quite simply, as in any insurance transaction, a misrepresentation of the fundamental characteristics of the insured risk allows the insurer to return that risk. Here, that means putting the ineligible loan back to the sponsor, whether or not the risk from that loan has resulted in a loss.

In the second half of 2007 we began to observe increased delinquency rates in some of our insured transactions. The delinquency rates were highly inconsistent with the purported quality of the loans, so we hired law firms and forensic diligence firms to investigate why this was happening. Their results were stunning. We learned that over 80% of the loans in the pools we insured were in fact **<u>not</u>** eligible to be included in the transactions, because they violated the guidelines and other terms of the contracts.

For example, sponsors repeatedly approved loans even though they had combined loan-to-value ratios that exceeded the limits set forth in the guidelines. In some cases they far exceeded guidelines, with ratios of over 100%. Loans were regularly approved even though the borrower's debt-to-income ratio – a crucial indicator of a borrower's ability to meet his or her debt obligations -- exceeded the maximums set forth in the guidelines. In many instances where loans were approved as "exception" loans, there were no compensating factors – none at all - that warranted departure from the underwriting guidelines – except for the originator's apparent interest in driving volume. Income verification on reduced documentation loans was often absent. Documentation violations were prolific. As it turns out, it was much harder to find loans that were actually eligible for inclusion in the pools, than it was to find loans with multiple breaches.

Consistent with the put-back protocol, we extensively detailed the specific defects in each and every loan and demanded that the various sponsors cure, substitute, or repurchase the ineligible loans. Despite our numerous requests, the transaction sponsors – after being presented with what they realized would be millions or billions of dollars in claims -- have breached their obligations and refused to repurchase the vast majority of the ineligible loans. In some cases, they refused the repurchase of even a single loan despite being presented with hundreds or thousands that were ineligible.

Further, as the situation developed, sponsors made other efforts to delay or resist their contractual obligations. Some tried to block or restrict our access to information, including loan origination files and underwriting guidelines. Most have delayed responding to the repurchase requests and engaged in a protracted and lengthy approval and appeal process. All but one, which commendably recognized its obligation and amicably resolved the issue, have demanded that the parties engage in "loan-by-loan combat". Ultimately, we had no alternative but to turn to the court system.

Since the fall of 2008, when we sued Countrywide and RFC, we have filed five lawsuits against sponsors and their servicers, alleging, among other claims, fraud and breach of contract. Our fraud claims generally allege that the deal sponsor intentionally misled us into providing insurance for these transactions by making false representations about their adherence to loan guidelines and the nature of the loans that would be included in the transactions. Certainly for Countrywide, there has been well-documented public evidence of intentional deviation from underwriting standards to increase loan origination volume. Our breach of contract claims focus on the specific breaches of the reps and warranties, as well as the fact that the put-back remedy has effectively been repudiated.

The cases have been proceeding, and we anticipate that the first one will go to trial in the Fall of 2011. We have enjoyed repeated victories along the way, defeating efforts to dismiss the complaints, to limit discovery against defendants, and to proceed on a loan-by-loan basis versus taking a sampling approach. We will continue to vigorously pursue these cases and we remain optimistic about our ultimate success. We have included a receivable in our financial statements of over $2.2 billion as of the end of the third quarter on the put-back recoveries. Our claims in these cases – on the contract claims alone – should help us recover most of the over $4.2 billion in payments we've made since 2008, as well as the likely $1 billion more we'll pay on future claims related to these loan pools.

The sponsors' failure to adhere to their own underwriting standards and their subsequent refusal to take responsibility for this has caused significant harm to MBIA and others in the industry. We have incurred billions of dollars in losses. The claims we have paid in connection with ineligible loans were a significant factor in the decisions by the ratings agencies to begin downgrading us in 2008. We have since effectively ceased writing new policies. As I mentioned earlier, we have been unable to provide much-needed insurance capacity to municipal issuers and investors at a time when their stressed budgets could benefit significantly from the reduced borrowing costs that our product provides.

<u>Conclusion</u>

I'd like to conclude with one final thought. Despite the substantial damage that has been done to our balance sheet, no holder of a bond we insured has failed to receive a single payment of interest and principal. We have met our obligations and honored every claim that has been presented to us, and we've done it without reliance on a single dollar of taxpayer-funded bailout money. That's a far cry from the conduct of those we are litigating against, most of whom received government assistance yet continue to deny their obligations. If nothing else, this has proven without a doubt the value that bond insurance provides.

Thank you for your time and interest. I'd be happy to answer any questions you might have.