

TESTIMONY OF WILLIAM FRANCIS GALVIN

Secretary of the Commonwealth of Massachusetts

**Before the
United States House of Representatives
Committee on Oversight and Government Reform**

Hearing to Examine Mortgage CEO Severance Packages

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I am William F. Galvin, Secretary of State and chief securities regulator of The Commonwealth of Massachusetts. I want to commend Chairman Waxman and Representative Davis for calling today's hearing to examine the disparate impact on certain market participants of the subprime mortgage crisis and the related collapse of certain portions of the credit markets.

There has been a lot of public discussion of CDOs and collateralization of pools of mortgage loans and other assets. We have seen the bursting of a credit bubble and frozen credit and auction markets. I would like to testify as to my experience, as the head of the Massachusetts Securities Division, with some of the consequences of these events to individual investors, small businesses and local governments. I would also like to relate my experience as the overseer of many Massachusetts registries of deeds as to the plague of foreclosures we've recently seen resulting from the rampant and reckless mortgage lending that was fueled by the securitization process.

My testimony will begin by describing recent investigations and administrative actions by the Massachusetts Securities Division in connection with sales of highly complex and risky collateralized debt obligations to cities, towns and other investors in The Commonwealth of Massachusetts. CDOs are esoteric financial instruments that function as debt instruments collateralized by certain assets. Many CDOs are collateralized by pools of subprime and other mortgage loans. In certain CDOs the collateral consisted of pieces of other CDOs and other complex products known as "synthetic securities", which can magnify the risk exponentially. The business of packaging and issuing CDOs had been a highly lucrative one for investment banks until large parts of the CDO market froze and crashed in the summer of 2007.

I would now like to describe the sale of CDOs to the City of Springfield, Massachusetts. Springfield had struggled financially over the last decade. In 2004, it had a \$20 million operating deficit, but with an intensive restructuring it staged a miraculous recovery, resulting in a surplus at the end of the 2006 fiscal year. The City hired two agents of Merrill Lynch to invest its hard-earned surplus cash.

The City's goal was to invest in safe, liquid, short-term, cash-like investments. However, Merrill's representatives in charge of the account invested approximately \$14,000,000 of the City's money into three highly-risky CDOs, including CDOs collateralized by other CDOs. The Springfield CDOs were purchased from Merrill's own inventory. The largest position was \$12,600,000 invested in the Centre Square CDO, which had been underwritten by Merrill Lynch. Merrill received underwriting fees in connection with underwriting the CDO and remarketing fees in connection with selling pieces of it. We have alleged that at the time of the sale, the Merrill agents did not discuss the risks of owning CDOs with the City, even though those risks were well known. The basic fact that these instruments were CDOs was not disclosed to the City until months after the sales. At the time of the sales, disclosure documents for these CDOs were not provided to the City and no attempt was made to discuss the risks associated with owning them with City officials.

Within months after the sale of these CDOs to the City, and despite their triple-A rating, the auction market for them began to dry up and their market value began to plummet. For example, the estimated market value of one of the CDOs dropped, in a couple of months, to 5 percent of the purchase price. Other CDOs sold to the City by Merrill's brokers experienced similar extreme downward spirals. The City requested that these CDOs be sold, but City officials were informed that the auctions had failed and that there were no buyers. Merrill initially disclaimed responsibility for these investments. Subsequently, after these transactions began to receive scrutiny from my office and other regulators in Massachusetts, Merrill agreed to buy back the troubled CDOs. These allegations are all public record, as disclosed in our Administrative Complaint. Merrill will have the opportunity to address these allegations before an administrative hearing officer.

The Springfield case is not unique. In November, we filed an administrative complaint against Bear Stearns with respect to two failed hedge funds that had heavily invested in mortgage-related CDOs. The allegations involved improperly disclosed conflicts of interest. We are also looking into the sale to the State of Maine by a Massachusetts-based broker of approximately \$20 million of commercial paper issued by a Structured Investment Vehicle that used subprime mortgage-backed securities and other troubled assets as their collateral. This paper has also precipitously dropped in value.

These cases are troubling on a number of levels and have spawned a number of investigations by my office. We are, obviously, looking at other CDO sales to governmental entities in Massachusetts. In addition, we are looking at sales practices with respect to highly risky CDOs. We are also in the early stages of examining how some of the more speculative and high-risk CDOs managed to receive a triple A rating from the rating agencies, which enabled underwriters and broker-dealers to unload much of this highly-risky inventory. Another investigation by my office is examining the effect of the bond insurers' insuring of risky CDO transactions on the value of insured municipal bonds that tend to be held by risk-adverse investors. In addition, we are looking at the impact of downgrades to bond insurers—as well as frozen auction markets—on borrowing costs of issuers such as cities and towns and other governmental

authorities. As one example, the Massachusetts Turnpike Authority has reportedly stated that it might have to raise highway tolls to compensate for a predicted increase in interest expense due to the turmoil in the credit markets. This would affect consumers far removed from the originators of the CDOs and auction market securities that have caused this problem.

As we are likely to see as these investigations progress, the events described above are only the tip of the iceberg. I fear that when all is said and done, the magnitude of investor loss will be breathtaking. And I fear that such losses will not be limited to wealthy, savvy risk-takers, but that small, risk-adverse investors and local governments have also been caught up in this widespread web of greed that certain investment banks have spun.

In addition, the effect of the rampant and reckless mortgage lending that enabled and was fed by the securitization of these mortgages is now being felt by homeowners across the country. My duties as Secretary of the Commonwealth include oversight of many of the Massachusetts registries of deeds. The staff of the registries gets a close view of the foreclosure crisis as plays out, because the legal paperwork for these foreclosures is filed with the registries. In January of this year, the Register of Deeds for Middlesex County North in Massachusetts prepared a Statistical Analysis of Foreclosures in Lowell, Massachusetts, which is another Massachusetts city with an economically diverse population that has struggled financially. The information and conclusions in this report are telling and tragic.

From 2000 through 2005, there were fewer than 50 foreclosures per year in Lowell—in some years the number was far lower. In 2006 there were 93 foreclosures in Lowell. In 2007, there were 283. These were loans made by national—not local--lenders. In 66% of these foreclosures, the property buyer borrowed the entire purchase price. Of these mortgages, the average foreclosure took place within two years of the purchase of the property.

The report anticipates that foreclosures in Lowell will continue to spike in 2008 as the interest rates of many adjustable mortgages begin to reset. Clearly, lending practices and lending standards in Lowell were not what they should have been. National mortgage lenders were consistently involved in helping purchasers buy homes they could not afford. Some of the common attributes of those mortgages included: no money down or low money down mortgages, interest-only mortgages, and mortgages with very low introductory “teaser” interest rates. Many of these borrowers were told that they could refinance their mortgages when the interest rate was due to reset, or that they would profit from these arrangements because of rising property values. However, in 2006 and 2007 many of these borrowers found they had no escape from these mortgages and they lost their homes.

The lending practices that were prevalent in Lowell were a foreseeable consequence of how many national lenders carried out their subprime lending business. The traditional relationship between lender and borrower with respect to a particular

piece of property has been severed. These national lenders made unsuitable loans to lower income borrowers knowing they would not have to live with those mortgage loans for their entire lifespan. Instead, those loans were sold, and many of those loans were bundled into mortgage-backed securities. These securities were sold to cities and towns, individual investors and pension plans. These low-quality loans ended up damaging both the borrowers and many of the ultimate holders of the loans. The middlemen profited in these transactions from a wide variety of fees, including mortgage origination fees, investment banking fees for underwriting the securities, and sales commissions for selling pieces of them.

Finally, the recent freezing of the auction markets appears to be yet another after-effect of the subprime lending excesses and the CDO auction market meltdown. Within the last couple of weeks, my office has received a flood of calls from people who thought that they were investing in safe, liquid investments only to find that they, in fact, have purchased auction market securities that are now frozen and cannot be liquidated. The frozen markets now are not limited to only mortgage-related securities or CDOs, but include wide range of other auction rate securities. As one example, we received a call from a young saver whose house down payment is now frozen in an auction rate security. We have heard from two siblings whose family trust is now frozen and cannot be distributed to other siblings. We have heard from a number of small business owners who find their businesses interrupted because money they thought was liquid is tied up in frozen auction markets. We have also heard from a 71-year-old retiree who sold a house in order to take the money and build his dream house. Like the others, he thought he was making a liquid and accessible investment but now cannot access his money.

My office will be investigating these cases in order to determine whether investors were informed that the money they were investing might become illiquid and inaccessible. In addition, we are looking into the role that the major investment banks that sold those securities had in the events—such as the CDO auction market crashing, the triple A rating proving to be all but meaningless, bond insurance becoming very tenuous and underwriters suddenly refusing to support the auction markets they created--that led to the freezing of these markets.

Many of these investment banks reaped enormous profits from the rampant mortgage lending and securitization described above, and their executives have been handsomely rewarded. We, however, are now left sorting out the ongoing damage that is rippling through our financial system.

What we are left with, when the dust settles, is mortgage originators, investment banks and their CEOs walking away with unworldly profits derived from subprime lending and securitization—and unwitting investors and would-be homeowners trying to repair the damage to their lives and communities.

I respectfully urge this committee to look into certain structural regulatory questions that necessarily arise in connection with this subprime crisis. What role did the repeal of the Glass-Steagall Act in late 1999—which had for over sixty years placed

certain barriers between commercial banks and investment banks--have in enabling the rampant lending and securitization of mortgage loans? Has the role of state banking regulators been preempted in such a way as to limit their ability to effectively address problems such as these? In addition, I respectfully urge this committee and federal and state regulators to work together to continue to uncover the details of the harm suffered by investors and mortgage borrowers and to hold the promoters of these exploitative financial arrangements responsible. In addition, I support legislative efforts to promote comprehensive disclosure of, and enhanced shareholder awareness of and influence with respect to, executive compensation.

Thank you for the opportunity to provide this testimony today.

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts