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"Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement"

Before the U.S. House Committee on Financial Services
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Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for holding this hearing to focus on constructive ways to reduce the epidemic of subprime foreclosures that we face today. I offer this testimony as the President of the Center for Responsible Lending (CRL) (www.responsiblelending.org). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. More information about CRL, and our affiliate, the Center for Community Self Help, is included in a brief appendix.

Last month we witnessed an important milestone when the full House passed an anti-predatory lending bill originated by this committee. This bill, H.R. 3915, is a significant step toward curbing many of the lending abuses that led to the subprime crisis today, and we appreciate all the commitment and hard work that led to the vote. However, weaknesses in key provisions of the bill severely limit how effective it will be at curbing the abusive lending practices that have led to today's foreclosure crisis, including one that is central to the topic of today's hearing: The proposed legislation fails to hold Wall Street accountable for supporting abusive lending by buying—or even worse, by soliciting—dangerous loans.

By its desire for more risky loans with higher interest rates, Wall Street has been a key driver in encouraging reckless lending. This is not only our opinion: the chairman of the Federal Reserve Board, Ben Bernanke, has stated recently that, "…the failure of investors to provide adequate oversight of originations and to ensure that orginators' incentives were properly aligned was a major cause of the problems that we see today in the subprime mortgage market."[1]

As part of today's hearing, the Committee specifically requested comments on two amendments introduced in the context of H.R. 3915. We believe that both of these amendments stem from attempts to help solve real and important problems, but neither of them solves the problem they are intended to address.

The amendment by Rep. Castle, now introduced in modified form as H.R. 4178, provides a "safe harbor" to mortgage holders and servicers engaged in restructuring loans. While we appreciate the impetus behind Rep Castle's effort, we believe that – particularly as written in H.R. 4178, which is worded differently than the original amendment language

– the immunity it provides is overbroad and would potentially preclude important claims unrelated to the problems with loan modifications.

The other amendment, a proposal from Reps. Frank, Miller and Watt, would authorize additional financial penalties for a “pattern and practice” of violations of the bill’s basic lending standards. While we are support the intent of the amendment, we believe there are much more effective ways to enforce the substantive standards set out in H.R. 3915.

My remarks today will focus on these points:

1. The disastrous and worsening scope of the subprime foreclosure crisis, including spillover effects to the economy, to families who don’t have subprime loans and to whole neighborhoods.

2. That Wall Street cannot continue to get a free pass for its role in driving the subprime mortgage crisis. The subprime situation escalated because Wall Street encouraged subprime lenders to abandon reasonable qualifying standards and ignore whether their customers could actually afford the loan, and any solution must address this fact.

3. The urgent need for <u>widespread</u> and <u>sustainable</u> loan modifications for homeowners struggling with abusive subprime loans.

4. The language of the Castle bill is overbroad and would potentially sweep in important claims unrelated to the problems of loan modification.

5. The Pattern and Practice amendment is not likely to solve the lack of effective remedies and enforcement in H.R. 3915.

6. A simple tweak to the bankruptcy code would help hundreds of thousands of homeowners. By giving judges the authority to modify harmful mortgages, similar to the authority judges already have to modify loans against vacation homes and investment properties, hundreds of thousands of homeowners could remain in their homes, and it would cost the U.S. Treasury nothing.

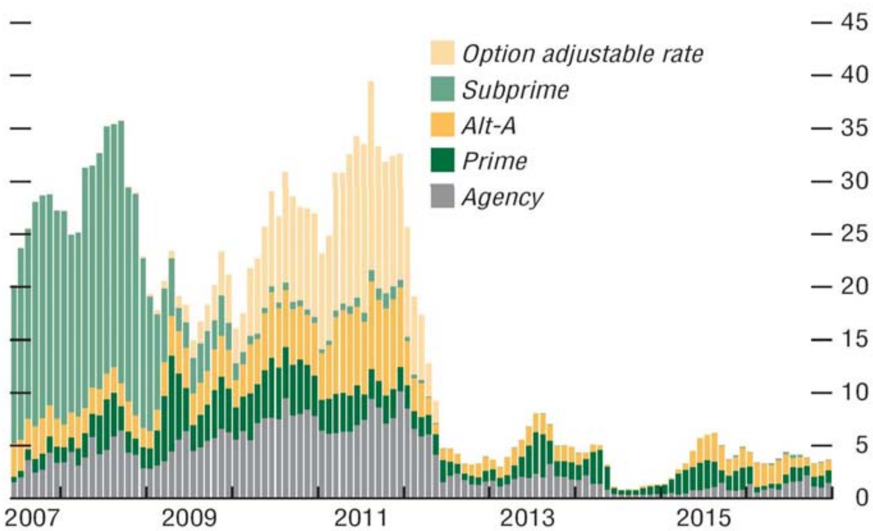
I. **The Scope of the Subprime Problem**

It is important to recognize that while the rate of subprime foreclosures is alarming today, the worst is still ahead.

The most immediate problems arise due to subprime mortgages, which in recent years have been dominated by hybrid adjustable-rate mortgages (ARMs). As rates on these exploding ARMs reset and as their monthly payments increase by 30-50%, homeowners will experience enormous payment shock. Given the slowdown in housing prices, these homeowners will not have the option to refinance or sell that they may have had in the past, increasing the likelihood of foreclosure. As the chart below shows, a large majority of these rate resets will occur later this year and throughout 2008, peaking in October 2008.[2]

Massive foreclosures also will arise from the large numbers of another product, the payment option ARMs, which are also facing significant payment resets.[3] Studies have shown that, particularly as originators who lacked experience in making these loans entered the fray in a significant way, many of these payment option ARMs were originated with lax underwriting standards – even though the majority of them are not subprime loans. The chart below shows a spike in payment option ARM resets between 2009 and 2011 just after the 2008 spike in subprime hybrid ARM resets.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Beyond the impact of foreclosures on the homeowners and their families, there is also a much broader societal impact. When a home goes into foreclosure, the negative economic and social effects extend to surrounding neighbors and the wider community. In our recent paper on the so-called "spillover effect,"[4] we have projected that, nationally, foreclosures on subprime home loans originated in 2005 and 2006 will have the following impact on the neighborhoods and communities in which they occur:

- 44.5 million neighboring homes will experience devaluation because of subprime foreclosures that take place nearby.
- The total decline in house values and tax base from nearby foreclosures will be $223 billion.
- Homeowners living near foreclosed properties will see their property values decrease $5,000 on average.

While we were not able to analyze the spillover impact of subprime foreclosures on African-American and Latino communities specifically, we know that communities of color will be hardest hit since these communities receive a disproportionate share of subprime home loans.

II. The Role of Wall Street

By investing in mortgages, Wall Street has been able to offer investors lucrative opportunities while also increasing funding to support the origination of more mortgages. In general, this symbiotic system has worked well. However, as the appetite for subprime mortgages has grown, so has the disconnect between the interests of Wall Street and the interests of homeowners and their communities.

Wall Street's pressure on lenders to increase the volume of loans at the expense of abandoning sound underwriting has been disastrous for Main Street. Not only are families losing their homes, but entire neighborhoods are losing billions of dollars in equity.[5] Any effort to prevent future lending-based abuses must hold Wall Street accountable.

Last May, at the request of this Committee, I presented testimony on "The Role of the Secondary Market in Subprime Mortgage Lending" that explained in detail how Wall Street drove the reckless lending that has caused so many subprime foreclosures.[6] The subprime situation escalated because Wall Street encouraged subprime lenders to abandon reasonable qualifying standards and ignore whether their customers could actually afford the loan.

The most obvious response to Wall Street's role in fostering the foreclosure crisis would be to hold the secondary market accountable, putting in place incentives for purchasers of subprime loans to discourage predatory lending practices and enforce expectations of sound underwriting. Under the legal doctrine of "assignee liability," purchasers of loans would essentially stand in the shoes of the original creditor. Assignee liability would give both loan purchasers and the homeowner a shared interest in ensuring that the loan is sustainable. Yet so far, no solution to the current subprime crisis has created the kind of accountability to prevent a similar situation from occurring again.

III. The Urgent Need for Widespread, Sustainable Loan Modifications

Loan modifications offer a crucial alternative for homeowners, taxpayers and the healthy functioning of mortgage markets in the future. They can provide long-term affordability to homeowners while avoiding much more expensive foreclosures for lenders.

One of the reasons loan modifications make sense is that they would put people into the position they would have been if they had not been sold a dangerous product. This week, the *Wall Street Journal* reported that more than half of the people who received subprime loans during 2005 had credit scores that would have qualified them for prime loans.[7] Even lending industry leaders have acknowledged that many homeowners who received subprime ARMs could have qualified for sustainable, 30-year fixed rate subprime mortgages, typically at a cost of only 50 to 80 basis points above the introductory rate on the unsustainable exploding ARM they were provided;[8] in some cases, the introductory teaser rate for these ARMs was higher than the rate for a 30-year fixed loan.

For struggling homeowners**,** loan modifications provide the best opportunity to avoid the loss of their homes – ideally with long-term affordable mortgages. The best modifications, as recommended by the FDIC, will convert the existing adjustable rate mortgage to a long-term fixed rate mortgage at the original introductory interest rate for the life of the loan. Given that these initial rates were already risk-adjusted and substantially exceeded conventional rates, any alleged "risk" from modifying these loans into sustainable products is mitigated.

This type of adjustment should be sufficient to achieve affordability for homeowners in markets that have not yet experienced significant price declines. For homeowners in markets with steep price declines, deeper modifications may be necessary. For these homeowners, it still may be economically prudent for servicers to reduce the interest rate or the loan balance, rather than face the even higher costs of foreclosures.

For taxpayers, modifications minimize the negative consequences of foreclosures and prevent the need for large infusions of taxpayer subsidies to avoid them. Specifically, concentrated foreclosures serve to depress the prices of nearby homes, and to reduce the tax income to state and local governments. Concentrated foreclosures can also lead to higher municipal costs, as local governments step in to maintain the security and appearance of vacant homes in their communities.[9]

For mortgage markets**,** modifications refocus market incentives on sustainable loans, a healthy market and sustainable homeownership. Modifications will ensure that losses are borne by the lenders and investors who are responsible for making loans without adequately evaluating a customer's ability to repay them. This should lead lenders to make sustainable loans and servicers to properly service their portfolios. As long as any losses resulting from the loan modifications (relative to the original loan terms) are less than the losses that would result from a foreclosure, implementation of modifications is consistent with the servicers' requirements to maximize cash flows for the investors in securities as a whole.

For months, many large servicers have been trumpeting their efforts to contact homeowners facing resets early and to offer aggressive loan modifications. To date, however, the reality of results has not matched the rhetoric. According to a recent survey by Moody's, less than one percent of homeowners with subprime ARMs were receiving loan modifications at the time when their mortgage payments reset.[10] The housing counselors, community groups and consumer lawyers we hear from tell us that, in the vast majority of cases, modifications are not happening.[11] Additionally, the California Reinvestment Coalition recently surveyed 33 of the states' 80 housing counseling agencies and reported that few long-term affordable modifications were being offered.[12]

We also are hearing that even in the minority of cases where modifications are offered, they are limited to a one-year or even a six-month extension of the introductory interest rate, a modification that is too short-term to allow a family to engage in meaningful planning for their financing, housing and children's schooling. Any sustainable, meaningful loan modifications would ideally last for the life of the loan, but certainly no shorter than seven years.

A related and critical concern is that different homeowners will be treated differently (for example, those who cannot afford legal representation may be at a distinct disadvantage and may not be offered the same, or any, options). One need is to standardize the loan modification process to ensure fairness and efficiency.

There are a number of potential reasons to explain the failure to provide modifications despite their basic economic appeal. These include:

- <u>Misaligned financial incentives:</u> It appears that despite the larger economic savings from modifications, servicers may get paid more for a foreclosure than for doing a loan modification. A Deutsche Bank Securities official recently was quoted: "Servicers are generally dis-incented [*sic*] to do loan modifications because they don't get paid for them, but they do get paid for foreclosures." This official went on to indicate that it costs servicers between $750 and $1,000 to complete a loan modification.[13] This theory has been bolstered recently, as John Reich, head of OTS, has called for $500 payments to servicers for each loan modification.

- <u>Servicers are overwhelmed</u>. The magnitude of the crisis has simply been too much for many servicing operations to respond effectively at the individual level, even when managers support modifications. Hundreds of thousands of homeowners are asking for relief from organizations that have traditionally had a collections mentality, have been increasingly automated, and whose workers are simply not equipped to handle case-by-case negotiations.

- <u>Piggyback seconds</u>. The most intractable problem is the fact that one-third to one half of 2006 subprime homeowners took out piggyback second mortgages on their home at the same time as they took out their first mortgage.[14] In these cases, the holder of the first mortgage has no incentive to provide modifications that would free up homeowner resources to make payments on the second mortgage. At the same time, the holder of the second mortgage has no incentive to support an effective modification, which would likely cause it to face a 100% loss. The holder of the second is better off waiting to see if a homeowner can make a few payments before foreclosure. Beyond the inherent economic conflict, dealing with two servicers is a negotiating challenge that most homeowners cannot surmount.

- <u>Fear of investor lawsuits</u>. The servicer has obligations to the investors who have purchased the mortgage-backed securities through pooling and servicing contracts, but there are conflicting interests among the different levels of investors. Servicers are hesitant to modify the loans because they are concerned that it will impact different tranches of the security differently, and thereby raise the risk of investor lawsuits when one or more tranche inevitably loses income. This phenomenon is known as "tranche warfare." For example, a modification that defers loss will favor the residual holder if the excess yield account is released, but will hurt senior bondholders. Servicers see foreclosure as the safest course legally.

IV. The Castle Idea: Good Concept but Immunity Too Sweeping

As we noted earlier, concerns about investor lawsuits present a significant deterrent to servicers seeking to provide homeowners with loan modifications. We believe that Rep. Castle seeks to solve that problem. However, we believe that at least as drafted in H.R. 4178, the drafting is overbroad and could provide sweeping immunity to holders of loans that would prevent homeowners from making claims related to the improper origination of these loans.

We suggest that any effort to immunize holders and servicers from liability be very specific, and restricted to immunity from lawsuits brought by a securitization vehicle, a securitizer, and holders of securities backed by a pool of assets including residential mortgage loans.

Furthermore, in pursuing the idea of facilitating loan modifications by servicers, it is crucial that we not harm anyone who has a legitimate claim against a servicer. Right now, a wave of foreclosure-prevention scams is sweeping the nation, which offer homeowners the opportunity to "fix" their loan in some way. Any safe harbor for servicers needs to be carefully drawn to prevent the scammers from using it to protect themselves.

Another way to help servicers make widespread loan modifications would be to require servicers to engage in mandatory loss mitigation prior to initiating foreclosure proceedings. Right now, most of the efforts being discussed nationally are voluntary efforts, which does not chance the incentive structure for that servicers have. If the law required an effort to do loan modification, servicers would be in a much stronger position.

V. Pattern and Practice Amendment: Likely to Have Little Impact

Representatives Frank, Miller and Watt have proposed an amendment to the recent predatory lending legislation that has the laudable goal of imposing stiffer penalties for violating the anti-predatory lending law. Specifically, the amendment allows a regulatory agency to go after a "creditor, assignee or securitizer" that engages in a pattern and practice of "originating, assigning or securitizing" loans that violate the ability to pay or net tangible benefit standards. Violators would pay a penalty of a minimum of $25,000 for each loan involved, and a million dollar fine. Penalties would be paid into a Trust

Fund to be administered by the Secretary of the Treasury, although the text of the amendment appears to define eligibility for this fund in a way that, when combined with the other provisions of H.R. 3915, would mean few if any people were eligible.

We fully support strong penalties for violating the law. However, the performance of the subprime market in recent years illustrates that it is easier to prevent bad loan terms than to pursue bad actors, particularly through public enforcement. First, resources for enforcement are notoriously in short supply. Enforcement efforts on abusive subprime lending have been all too infrequent and totally inadequate to the large number of cases that should have been investigated.[15] Second, even when enforcement occurs, it can be extremely challenging to assemble the evidence needed to prove a pattern of abusive behavior, even when strong indications exist, and the pattern and practice requirement will slow down any relief for homeowners facing foreclosure and in need of immediate remedy.

Ultimately, we believe the most effective mechanism of enforcement will involve market processes, such as assignee liability. Our hope is that this amendment will not distract from other issues that we believe ultimately will be more important in promoting sustainable homeownership.

VI. Bankruptcy Reform is the Most Effective Solution

The best solution to the current mortgage crisis is a small tweak to the bankruptcy code. This tweak does not implicate the 2005 bankruptcy changes, but rather relates to an older provision of the law. Right now, wealthy investors and speculators may receive loan modifications in bankruptcy proceedings for the debt they owe on their vacation homes and investor properties. Yet current law bars middle-class homeowners from receiving a loan modification to save the roof over their heads. If bankruptcy law is like a life preserver, we're reserving it for the strongest swimmers while hundreds of thousands of families drown.

Changing the bankruptcy code to allow the courts to modify loans on primary residences could help as many as 600,000 families facing subprime exploding ARMs stay in their homes. The beauty of this remedy is that it will accomplish its objective without the necessity of requiring most of these families to actually file for bankruptcy. Changing the code will provide servicers the precedent and protection they need from lawsuits by tranches of investors who might otherwise object, and set standards to follow.

Making this small fix to the bankruptcy code will be a win-win for homeowners, lenders, neighbors, taxpayers and the economy as a whole. Homeowners can stay in their homes. Lenders will be guaranteed the fair market value of their house, which is more than they would receive at foreclosure sale, and without the lengthy delays and expenses associated with foreclosure. And loans can be modified quickly and effectively.

Conclusion

While there are many ideas for helping some of the homeowners who are facing financial ruin due to predatory lending, the fact is, there is no good solution for those who have already lost their homes and those in the most vulnerable positions. As Congress considers how to help these families, it is crucial that any solution also prevent such abuses from happening again. While H.R. 3915 is a good start, unless and until Wall Street is held accountable, many of the protections that this Committee has worked very hard to institute will be meaningless.

To restore the world's confidence in our markets and recover a reasonable expectation of integrity to our mortgage financing system, we need decisive policy actions to realign the interests of people who buy homes and institutions that provide the loans and the entities that invest in those mortgages. As long as subprime lenders have little or no incentive to make a loan successful, we will continue to push families back financially, and rather than building our nation's prosperity through homeownership, we will continue to lose economic ground.

APPENDIX

The Center for Responsible Lending and Self-Help

Michael Calhoun serves as the President of the Center for Responsible Lending (CRL) (www.responsiblelending.org). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

CRL is an affiliate of the Center for Community Self Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families, those often targeted for subprime loans. Self Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country. Self Help loan losses have been less than one percent per year.

Before assuming his current position with CRL, Mr. Calhoun oversaw Self-Help's secondary market operations, where the organization purchased home loans that were often made to homeowners with blemished credit. Self Help bought these loans from banks, held on to the credit risk, and resold the mortgages to Fannie Mae. The organization has used the secondary market to provide $4.5 billion of financing to 50,000 families across the country, loans that have performed well and significantly increased these families' wealth. Through this lending experience, Mr. Calhoun understands the importance of promoting sustainable homeownership and maintaining access to affordable home loans, and has an appreciation of how responsible use of the secondary market can contribute to such a result.

END NOTES

[1] Ben Bernanke, Chairman of the Federal Reserve, "Housing, Housing Finance, and Monetary Policy," remarks made on August 31, 2007.

[2] Credit Suisse, Fixed Income Research, October 23, 2006.

[3] These loans provide homeowners with at least three payment options each month: a fully amortizing payment, an interest only payment, and a minimum payment, which is less than the full amount of interest. The difference between the minimum payment and the full amount of interest due is added into the principal balance of the loan, so that the balance of the loan grows. This is called "negative amortization." When the principal balance reaches a certain threshold, usually 115% - 125% of the original, the loan recasts and requires the homeowner to make a fully amortizing payment on the larger loan balance.

[4] *Id.* at note *5.*

[5] *Subprime Spillover*. Center for Responsible Lending, November 2007. *Available at* *http://responsiblelending.org/issues/mortgage/research/subprime-spillover.html*.

[6] Michael D. Calhoun, "The Role of the Secondary Market in Subprime Mortgage Lending," testimony before the U.S. House Committee on Financial Services-Subcommittee on Financial Institutions and Consumer Credit (May 8, 2007), available at www.responsiblelending.org.

[7] Insert WSJ article, 12-3-07.

[8] See January 25, 2007 letter from the Coalition for Fair & Affordable Lending (CFAL), an industry association, to the heads of the federal banking regulators, urging the regulators not to apply the October 4, 2006 Interagency Guidance on Nontraditional Mortgage Product Risks to subprime 2-28 ARM loans.

[9] Erik Eckholm, "Foreclosures force suburbs to flight blight," *The New York Times*. March 23, 2007.

[10] Jeanne Sahadi, CNN Money. "Subprime: Big talk, little help." September 26, 2007. http://money.cnn.com/2007/09/26/real_estate/few_loan_modifications/.

11 See, e.g., Carolyn Said, "Modified mortgages: Lenders talking, then balking," San Francisco Chronicle, September 13, 2007, http://sfgate.com/cgi-bin/article.cgi?f=/c/a/2007/09/13/MNJ8S1FKC.DTL.

[12] *The Chasm Between Words and Deeds: Lenders Not Modifying Loans as They Say To Avoid Foreclosures.* California Reinvestment Coalition, October 2007.

[13] Quote from Karen Weaver, managing director and global head of securitization research at Deutsche Bank Securities. "Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods," *Inside B&C Lending*, November 16, 2007 p. 3.

14 Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5.

[15] The National Community Reinvestment Coalition reports that the Department of Justice has only brought seven enforcement actions related to lending discrimination, and only five related to mortgages. Similarly, the Federal Reserve Board has made hundreds of referrals for pricing disparity problems to the various banking regulatory agencies, yet zero enforcement actions have ensued. See NCRC testimony.