

**Testimony of Martin D. Eakes  
Self-Help and Center for Responsible Lending**

**Before the U.S. Senate Committee on Banking, Housing and Urban Affairs**

***“Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program”***

**November 13, 2008**

Good morning Chairman Dodd, Ranking Member Shelby, and members of the Committee. Thank you for holding this hearing on the Emergency Economic Stabilization Act of 2008 and for inviting me to testify.

I serve as CEO of Self-Help ([www.self-help.org](http://www.self-help.org)), a nonprofit community development financial institution that consists of a credit union and a nonprofit loan fund. For close to thirty years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get home loans. In total, 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 America.<sup>1</sup>

I am also CEO of the Center for Responsible Lending (CRL) ([www.responsiblelending.org](http://www.responsiblelending.org)), a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

With the constant barrage of statistics and staggering dollar figures that have become commonplace during this financial crisis, it is easy to become numb to the depth and scope of the financial pain American families are experiencing today. However, the numbers paint a picture we cannot ignore. Using recent data from the Mortgage Bankers Association, we calculate that foreclosures on all types of mortgages are occurring at an annual rate of 2.3 million.<sup>2</sup> On subprime mortgages alone, the “spillover” costs are massive. At least 40 million homes—households where, for the most part, people have paid their mortgages on time every month—are suffering a decrease in their property values of \$352 billion. These losses, in turn, are infiltrating nearly every part of American life, from police and fire protection to community resources for education.

As we have become accustomed to hearing about the losses stemming from foreclosures,<sup>3</sup> we also hear on a regular basis that the foreclosure epidemic is being addressed through the voluntary efforts of servicers and lenders. Notwithstanding these efforts and results published by HOPE NOW,<sup>4</sup> the foreclosure problem is getting worse, not better. In fact, the voluntary efforts typically *raise* a distressed family’s mortgage payment instead of lowering it and result in a temporary fix with a high probability of failure.<sup>5</sup>

The major piece that has been missing from piecemeal efforts to stop the foreclosure crisis is a systematic, large-scale way to stop foreclosures that can be prevented. With wise implementation of the Emergency Economic Stabilization Act (EESA), we now have a chance of real success. Treasury should use the Troubled Asset Relief Program (TARP) to leverage *systematic* approaches to modifying mortgages to sustainable levels.

The most pressing need today is to help homeowners to stay in their homes and, by extension, support their neighbors' property values and the financial system as a whole, since financial institutions will not survive if their loan-related portfolios continue to fail. Yet as administered by Treasury, TARP has to date failed to deal with the root cause of losses by financial institutions, which are excessive foreclosures on owner occupants. Appropriate government action could prevent many of these foreclosures and help to reassure financial institutions that housing values are stabilizing.

We urge this Committee to gauge the effectiveness of EESA by how well it prevents foreclosures that will otherwise continue to batter the nation's economy. By taking meaningful action under the Act to stop the foreclosure epidemic, we can make sure that housing price declines don't overshoot market-stabilized levels, limit losses by financial institutions, and reduce debt burdens on consumers, whose spending power we need to pull us out of this downward economic cycle.

In my testimony today, I will focus on five key points.

- I. The injection of capital into banks has helped stabilize the market.
- II. Voluntary, loan-by-loan modification efforts are not effectively stemming the tide of foreclosures due to structural, legal, and financial obstacles.
- III. Streamlined, broad-based modification efforts are necessary to get ahead of the foreclosure curve, and can – and should – be accomplished through the existing TARP authority.
- IV. Several modest legislative initiatives could provide powerful additional tools to increase modifications.
- V. Judicial loan modifications can provide a crucial backstop in situations where servicers fail to modify a loan through the streamlined system though the family can afford a market-rate mortgage but is in dire straits under the current mortgage terms, and will provide a strong incentive for servicers and investors to make these programs work.

**I. Capital Injections into Banks has Helped Stabilize the Market.**

The original TARP proposal to use \$700 billion of government funds to purchase “toxic” subprime and distressed asset securities from financial institutions would not have been an effective intervention to stabilize financial institutions or to stem foreclosures. However, the use of some of those same funds to stabilize the balance sheets of financial institutions through equity

infusions is a potentially effective, lower risk method for stabilizing the markets and the economy. Ultimately, direct recapitalization of the banking sector has been at the heart of effective financial institution recoveries both in the U.S. and internationally. That said, Treasury should be requiring more from the financial institutions in return for this federal investment, including requiring the establishment of streamlined and affordable mortgage loan modification programs.

After Lehman Brother's bankruptcy, financial institutions were unwilling to lend to each other because they did not know which institution would fail next. This can be seen in various indexes of interbank lending, most notably overnight LIBOR, the rate at which international banks indicate they are willing to lend to each other for a single day. Historically, overnight LIBOR is priced about 1/10<sup>th</sup> of one percent above Fed Funds. This was true through the Bear Stearns bailout and the seizure of Fannie Mae and Freddie Mac during the first weekend in September. Sharp spikes in LIBOR rates occurred the day after Lehman Brothers was allowed to fail and inter-bank lending activity ground to a halt, followed by modest declines following the government's rescue of AIG. Continuing uncertainty in credit markets prevailed with relatively high LIBOR rates.

Only when the Treasury Department indicated that a primary use of TARP funds would be to inject fresh capital into the banking sector did the money markets began to return to normalcy. On October 14, the morning after Treasury announced capital infusions into the nation's seven largest banks and committed \$250 billion total to bank preferred shares, overnight LIBOR tumbled to 2.18%. The following day, FDIC announced a guarantee on all non-interest bearing deposits and most senior unsecured bank debt. Within three days, overnight LIBOR had dropped to 1.67%, a mere 0.17% above Fed Funds. In the last ten days, overnight LIBOR has begun to trade below 1.00%. Other key indexes, such as the Fed Funds Effective rate, and one-month and three-month LIBOR, have moved toward their normal levels.

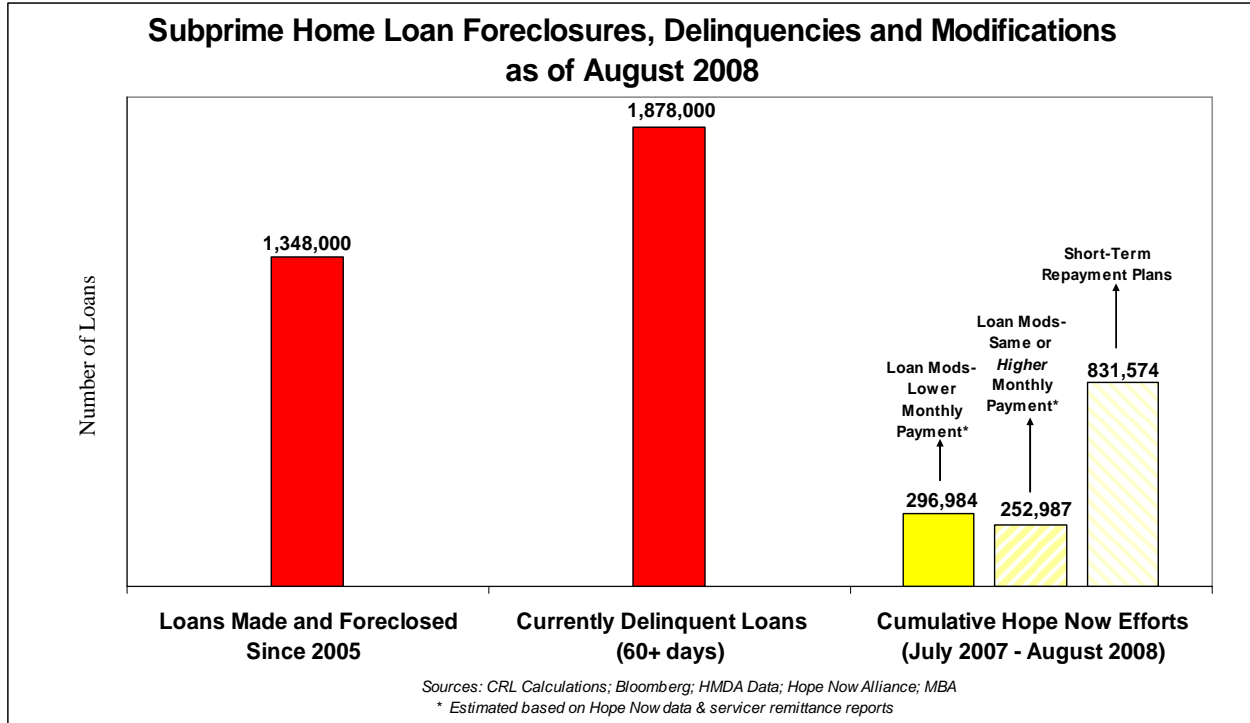
While a more stable LIBOR rate cannot solely be attributed to the bank equity injections and does not necessarily translate into lending by banks to businesses and individuals, it is a positive sign, and one that these actions had a large hand in bringing about.

## **II. Current modification efforts have failed to stem the tide of foreclosures.**

Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, the voluntary efforts undertaken thus far by lenders, servicers and investors have failed to stem the tide of foreclosures. Moreover, servicers still face significant obstacles in making modifications.

### ***A. The number of modifications is inadequate.***

Seriously delinquent loans are at a record high for both subprime and prime loans,<sup>6</sup> and all available data have consistently indicated that (1) continuing foreclosures far outpace total loss mitigation efforts, and (2) only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.<sup>7</sup>



In October, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008.<sup>8</sup> Similarly, the most recent report from the State Foreclosure Working Group of Attorneys General and Banking Commissioners (which covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans) confirms that progress in stopping foreclosures is “profoundly disappointing.”<sup>9</sup> Their data indicate that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report.<sup>10</sup> Even the homeowners who receive some kind of loss mitigation are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.<sup>11</sup>

What’s more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners and financial institutions in an even worse economic position than when they started. Data through September 2008 indicate that the large majority of HOPE NOW efforts rely on repayment plans,<sup>12</sup> which typically require financially burdened households to add previously unpaid debt to their current mortgage payments. Not surprisingly, we now see very high rates of re-default on loan modifications, primarily because most loan modifications or workouts do not fundamentally change the unsustainable terms of the mortgage to make the loan affordable to borrowers over the long term. According to Credit Suisse, when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.<sup>13</sup>

***B. Numerous legal and structural obstacles stand in the way of modifications.***

A recent Federal Reserve Staff Working Paper identifies a number of obstacles that limit the scale of modifications.<sup>14</sup> These obstacles help explain why voluntary loss mitigation cannot keep up with demand.

- *Investor Concerns:* Servicers may shy away from modifications for fear of investor lawsuits.<sup>15</sup> While most Pooling and Servicing Agreements (PSAs) provide adequate authority to modify loans, these modifications may cause disproportionate harm to certain tranches of securities over other classes. Investors are also particularly concerned about re-default risk, where their short term losses from modifications will be compounded by future foreclosure costs, which will increase as housing prices continue to fall, if the borrower cannot sustain payments under the modified terms. In addition, when servicing securitized loans, some PSAs do limit what servicers can do by way of modification. For example, some limit the number or percentage of loans in a pool that can be modified.<sup>16</sup>
- *Second Liens:* Additional liens on a property pose a structural obstacle that is often impossible for servicers of the first lien to overcome. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,<sup>17</sup> and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, “it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications,” thereby dooming the effort.<sup>18</sup>
- *Servicer Incentives:* The way servicers are compensated by lenders creates a bias for moving forward with foreclosure rather than engaging in foreclosure prevention. Servicers are often not paid for modifications, but are reimbursed for foreclosure costs.<sup>19</sup> The Federal Reserve concludes, “Loan loss mitigation is labor intensive and thus raises servicing costs, which in turn make it more likely that a servicer would forego loss mitigation and pursue foreclosure even if the investor would be better off if foreclosure were avoided.”<sup>20</sup>
- *Limited Servicer Staff and Technology:* With few but welcome recent exceptions, servicers have continued to process loan modifications in a labor-intensive, case-by-case review. While they have added staff and enhanced systems, the lack of transparent, standardized formulas has limited the number of modifications that have been produced.<sup>21</sup>

**III. Treasury should use the Troubled Asset Relief Program (TARP) to leverage systematic modification approaches and larger numbers of sustainable modifications.**

As noted above, the most pressing need today is to help homeowners to stay in their homes and, by extension, support their neighbors' property values and the financial system as a

whole, since financial institutions will not survive if their loan-related portfolios continue to fail. Yet as administered by Treasury, TARP has to date failed to deal with excessive foreclosures. Appropriate government action could prevent many of these foreclosures and help to reassure financial institutions that housing values are stabilizing, thus encouraging increased lending.

Since taking over IndyMac Bank, the FDIC has developed a streamlined and systematic approach to loan modifications for IndyMac's loans. Similar approaches have now been adopted as part of a recent settlement between Bank of America and state Attorney Generals regarding unfair and deceptive lending practices by Countrywide, and most recently by JP Morgan Chase/Washington Mutual and Citigroup. While some aspects of these modification programs are potentially problematic,<sup>22</sup> and while these programs may not be able to reach sufficient numbers of loans held in private label securities where investors withhold their consent, these systematic approaches are a step in the right direction and can serve as a general model for the rest of the industry, with affordability enhancements that can be leveraged through the TARP program.

To facilitate as many loan modifications as possible, Treasury should adopt different strategies for three different categories of loans:

- **Loans in Private Label Securities:** Treasury should adopt FDIC's proposed loan modification guarantee program and provide guarantees to modifications from servicers with streamlined affordable modification protocols based on the FDIC/IndyMac model under the authority provided by Section 109 of EESA.
- **Loans Held By Fannie Mae and Freddie Mac:** As the conservator for the GSEs, the Federal Housing Finance Agency should direct them to facilitate modifications to the greatest extent possible. The recent November 11 announcement is a positive step for these loans.
- **Loans Held in Portfolio by Banks and Thrifts:** Treasury should require banks and thrifts that participate in Treasury's equity investment or asset purchase program to adopt these streamlined loan modification protocols.

*A. FDIC has proposed a loan modification guarantee program through TARP that would create an efficient subsidy for modifications of loans held in private-label securities.*

FDIC has pioneered a promising approach to streamlined modifications in its operations at IndyMac Bank, which it is applying to IndyMac loans held in portfolio and to those it services for private mortgage-backed securities investors, where possible. It has now proposed a Treasury program under TARP that could substantially expand this promising approach and effectively address the existing obstacles to modifications, particularly the obstacles posed by private securitization.

The FDIC/IndyMac model compares the net present value of modifying the loan to foreclosing and losing money reselling the house. As long the modification provides a greater

return than foreclosing, the loan can be modified. All loans are converted to fixed rate loans at the Freddie Mac Survey interest rate at the time of the modification, which is currently 6.2 percent. The model establishes a clear affordability target: a 38 percent debt-to-income ratio (DTI) for total housing payments for the IndyMac first mortgage (including mortgage principal, interest, taxes and insurance).

To reach the affordability target based on the income information they have (subject to income verification before being finalized), the model uses a three-step approach:

- Servicers first reduce interest rates for five years, potentially to as low as 3%, to meet the DTI target. Thereafter the rate rises by 1% per year until it reaches a market rate, which is defined as the Freddie Mac survey rate.
- If this rate reduction is not enough to reach the target DTI, the servicer would increase the loan term to a maximum of 40 years from date of origination.
- If the loan still isn't affordable, then a portion of principal would be deferred until the loan becomes due or pays off early, with no interest accruing. Monthly payments would be calculated on the lower balance, which would make the loan more affordable. Deferral, rather than forgiveness of principal, means that investors have the possibility of collecting on the full balance if housing prices recover.

FDIC has also introduced some important procedural changes to try to increase response rates. Where they have income information, they establish a pre-approved modification offer which they send to the borrower via certified mail. To accept, the borrower can return the offer in an enclosed pre-paid envelope, with a signature, a lower payment and current income verification documentation. Where FDIC does not have borrower income information, they have used mail, phone calls and payments to counselors to try to contact borrowers.

Although it is still in its early stages, the FDIC /IndyMac model appears to be increasing modifications substantially and reducing foreclosures on its existing portfolio. So far, there has been a 75 percent response rate where FDIC has income information about the borrower and approximately 5,000 loans have been modified.<sup>23</sup> FDIC officials remain optimistic that this approach can also increase modifications for its securitized loans as well.

The FDIC/IndyMac model has already served as a model for other servicers as a way to expand and streamline loss mitigation efforts. Three other entities have adopted similar approaches: the Bank of America settlement of State Attorneys General lawsuits against Countrywide for unfair and deceptive lending practices, and more recently, voluntary efforts announced by JP Morgan Chase/Washington Mutual and by Citigroup. The Bank of America settlement establishes a lower affordability target of 34% of total housing debt to income.

To use this model to increase loan modifications for securitized loans, Treasury needs to implement a new loan modification guarantee program under TARP for loans meeting stronger affordability targets to share the loss risk from re-defaults between the government and investors.

**1. TARP loan modification guarantee program could guarantee 3,000,000 loans for \$50 billion.**

Treasury should implement the new loan modification guarantee program proposed by the FDIC and authorized under Section 109 of the EESA. This program would act as a strong financial incentive for servicers and investors to agree to modify loans to newly established affordability standards, modeled on the FDIC IndyMac modification program. Under such a program, servicers who modified loans to meet certain standards would share the losses that result from future re-defaults of these modified loans.

The appeal of the FDIC proposal is that it could be done on a widespread and streamlined basis and would substantially reduce foreclosures. It would result in sustainable and affordable home loans for families facing foreclosure, because it focuses on debt-to-income ratios and caps final interest rates at a pre-determined, prime rate (in contrast, some voluntary loan modification programs currently offer temporary modifications that subsequently lead borrowers to re-default). In addition, the FDIC model aligns incentives among investors and homeowners to the benefit of stabilizing home values: investors want to see modifications succeed because they share in future losses and the loan must perform for a minimum period before guarantee kicks in. Further, since the guarantee can cover the cost of a re-modification or disposition short of foreclosure, there are substantial incentives for servicers to forego foreclosure

*Affordability Standards:* Because federal resources would be insuring future performance risk, it would be important to establish strong affordability standards for the initial modifications. IndyMac is using a 38% housing DTI standard without any federal guarantee. However, with taxpayers funding guarantees, we believe that the initial affordability should be set at 31% of income for total housing costs. Experience with IndyMac and with other servicers demonstrates that a housing DTI at this level will be much more effective in reducing redefaults and therefore best protect taxpayer money.

Several additional standards should be required as well. First, the guarantee payments should not be available until the loan has a proven record of six months payments without delinquency after initial modification. Second, the guarantee should be limited to those loans where initial payments are reduced by at least ten percent to ensure that scarce federal guarantees are used only for loans that provide significant relief to borrowers and have a high likelihood of avoiding future re-defaults. Finally, the guarantees should remain in place for at least eight years, which covers the initial affordability period of five years plus the transition to the permanent rate.

*Efficient Use of Taxpayer Resources:* One of the most important aspects of this proposal is that the return on the government's investment would be substantial. \$50 billion would enable this program to assist up to three million borrowers at risk of foreclosures. Structured as a guarantee program, federal costs would only be incurred when modified loans default. These losses would be shared equally with the investors. To arrive at this estimate, FDIC postulates an effort where the government works with servicers to modify and guarantee three million loans with average balances of \$200,000. Assuming one-third of these loans re-defaulted and that total losses from these defaults represented 50 percent of the principal balance of the original \$200,000, the total loss would be \$100 billion in losses. Government would then bear only half



of this total, or \$50 billion. But the benefit would be keeping two million (hopefully more if the re-default assumptions are conservative) families in their homes and helping to stabilize the housing market. By using government funds as risk capital rather than liquidity, and leaving the loans within private securities, the government can leverage its funding 12 to 1 in loans modified (\$50 billion becomes \$600 billion of modified loans).

*Permitting Loan Modifications Even When a Second Lien Exists.* The best outcome for loans that have second liens – often with no value based on current market prices – is to have them paid off with very sharp discounts.<sup>24</sup> However, FDIC’s IndyMac and model allows modifications to go forward even with second liens attached in the event that FDIC is unable to negotiate with the holders of the second mortgage to give up its lien interest, and the new loan guarantee program should also take this approach. Leaving the second liens in place is not optimal, but may be a necessary evil since 50% of subprime and Alt A loans currently have piggyback seconds, and these borrowers should not face certain foreclosure just because their out-of-the-money second mortgage investors refuse to release their interests. Many second mortgages will not foreclose, because after the house is sold in foreclosure and foreclosure expenses are taken into account, there would be no funds left to pay the second.

*Incentive payments to servicers would increase number of loans modified.* As a counterweight to the reality that most servicing contracts compensate servicers more for foreclosure than modification, the FDIC also recommends that Treasury pay servicers approximately \$1,000 for each modification that meets the identified affordability standards. Just as Treasury pays investment advisors and other contractors under EESA to structure its equity investments or asset purchases, this program would pay the servicers who will do the work necessary to modify the mortgages under this program. This is an important component for the program.

## **2. The combination of modification guarantees and servicer incentives would address current obstacles to loan modifications for securitized loans.**

The combination of modification guarantees and paying servicers for affordable modifications would address many of the existing obstacles to broader scale modifications.

- *Investor Concerns:* A government guarantee to share the costs of future re-defaults has significant implications for the basic decision about whether a modification generates better returns for investors than foreclosing. Servicers would accept the government guarantee when the net present value to investors is greater to modify under the program than to foreclose, and the guarantee against re-default is likely to tip the scales strongly toward modifying. When the net present value comparison results in this clear positive outcome, the fears about investor lawsuits would be substantially alleviated.
- *Second Liens:* As described above, permitting modifications even if second liens existed will maximize the number of loans that can be modified in a streamlined fashion. When the ban on judicial modifications is legislatively lifted, as is discussed in Section V below, the ability to settle or write-off second liens will be significantly improved.

- *Servicer Incentives:* Paying servicers directly for delivering affordable and sustainable modifications would address the servicer incentive problem. A direct payment should mitigate current incentives for them to opt for foreclosures rather than modifications.
- *Servicer Staffing and Technology:* Adopting a systematic approach based on the FDIC model simplifies and streamlines the work of servicers, limiting staff time per case. The modification analysis can be performed by a simple model and requires much less staff time or expertise than the current labor-intensive process, which requires subjective scrutiny of family debts and budgets. FDIC was able to implement its new approach to modifications within weeks of taking over IndyMac Bank.

***B. Treasury and FHFA can prescribe more aggressive modifications for loans held or guaranteed by Fannie Mae and Freddie Mac.***

On Tuesday, the GSEs announced a program to provide streamlined modifications for loans they own or that have been placed in Fannie Mae or Freddie Mac mortgage-backed securities that they guarantee. While we need to learn more details about the program, this announcement is an important step forward for conforming loans, which represent over half of all mortgages in the country.<sup>25</sup> Since the GSEs represent just 20% of current foreclosures, however, our other recommendations are still important to address the remainder, particularly subprime and Alt A loans that are held in private label securities.

While private companies, Fannie and Freddie hesitated to purchase a loan that they guaranteed out of securities in order to modify the loan because accounting standards required the GSEs to mark the loan down to its current market value.<sup>26</sup> This caused accounting losses that weakened the firms' publicly presented capital position. While it is understandable that a private company under financial stress would hesitate in this manner, accounting-only losses should not drive substantive policy, particularly when modifying loans will result in lower final losses, which are now backed directly by U.S. taxpayers. We therefore commend FHFA and the GSE's for no longer making the distinction between loans on their portfolio and securitized loans for modifications, as evidenced by Tuesday's announcement.

However, the current Fannie Mae and Freddie Mac guideline that borrowers must be in default before loss mitigation activities may commence, which Tuesday's announcement does not change, has served as an obstacle to modification. Such stipulations have prevented many servicers from initiating timely and cost-effective modifications for borrowers who are likely to default in the future, and create the perverse incentive of having borrowers miss payments and enter default to qualify for modifications.

***C. TARP should require participating banks and thrifts to establish systematic loan modification programs for the loans held in their portfolios.***

The remaining at-risk loans are held directly by banks and thrifts in their portfolios. There are fewer obstacles from banks modifying these loans than if they were sold, but some obstacles remain from having these loans modified to avoid foreclosures. Most notably, banks may be

reluctant to modify such loans because such modifications will require marking down their balance sheets and weakening their capital positions, the same problem faced by Fannie and Freddie.

TARP's equity injection program provides a significant lever for requiring participating banks and thrifts to adopt a systematic loan modification program for their loans held in portfolio. Since the banks would just be recognizing losses they would soon bear anyway, and minimizing losses at that, Treasury should make receipt of equity from the TARP program contingent upon the adoption of a similar loan modification program. The fact that the government is providing equity that can absorb accounting losses should remove this objection. As noted above, JP Morgan Chase/Washington Mutual, Citigroup and Bank of America have announced programs along these lines, and their experience will be instructive.

***D. TARP asset purchase strategies should focus strategically on increasing loan modifications.***

The immediate priority for TARP to spur greater levels of loan modifications are the "three-bucket" framework I outlined above. There are supplemental approaches TARP might pursue should it proceed to implement a mortgage asset purchase strategy; if it does pursue such a course, it must maintain a clear focus on enhancing loan modifications. Several approaches could be carried out with existing authorities and several, as described below, would require legislative amendments to TARP:

**1. Buy servicing rights.**

Another way to break the modification logjam is for Treasury to purchase servicing rights where the PSAs provide the servicer with sufficient flexibility to modify. Servicing rights are very inexpensive, and should not cost more than about 1% of the outstanding balance; government funding could therefore be leveraged 100 to one to modify loans. Moreover, they are an eligible "troubled asset" under TARP. Once the government holds the servicing rights, it would be in a strong position—through a contract with a competent private subservicer—to aggressively modify loans within the limitations of the pooling and servicing agreements.

Having the government as servicer would provide a number of advantages over private servicers. First, given EESA's directive in Section 109 for the government to maximizing loan modifications, it would be highly motivated to modify loans when the net present value of modifying exceeds foreclosing. Second, it would be far more difficult for investors to challenge the federal government's use of the pooling and service agreement authority than if a private servicer did the modifications. Finally, government would have fewer financial constraints in paying for staff than highly strapped servicers to process modifications, if necessary.

One issue is that sometimes the net interest margin security (NIMS) insurer needs to agree to modifications beyond certain level, such as 5% of the loans. In these cases, the government might need to buy this insurance policy; while it would certainly be inexpensive, it would require taking on some limited liability for NIMS losses that would need to be calculated.

**2. Purchase second mortgages to gain control of them so that they can be consolidated with the first mortgages and restructured.**

As noted above, second mortgages are one of the greatest obstacles to modifications because a first mortgage holder will not generally voluntarily reduce interest or principal only to increase return for a second mortgage holder or cure its loan if the borrower is still in default on a second. Yet because most second liens are underwater, Treasury could purchase them very inexpensively, hopefully at not more than five cents on the dollar. If they could be purchased cheaply enough, this is an option worth investigating.

This program will be effective only in concert with a larger modification effort, however, so purchases should be concentrated on second mortgages where the owner of the first mortgage is known and a modification effort is already being made. In addition, it could establish a fund to purchase second mortgages that can then be accessed by servicers who run into the problem of a second mortgage when trying to modify a first mortgage whose owner is already known.

***E. Treasury should set specific goals for sustainable modifications with detailed reporting to increase transparency.***

I have pointed out a number of ways that servicers lack incentives to aggressively pursue meaningful loan modifications. Another disincentive is a lack of transparency and reporting requirements. Because loan servicers have no obligation to provide specific information on their servicing activities, it is difficult to monitor progress and assess servicing performance. For example, the data from HOPE NOW are aggregate data and not identified either by servicer or loan. This lack of data creates difficulty in ascertaining what is and is not working.

To improve analysis of modifications and to provide an incentive to servicers, Treasury should identify modification activity by individual servicer. Most helpful would be a database like that required by the Home Mortgage Disclosure Act (HMDA), with loan-level data made available to the public.

**IV. Additional legislative actions should be taken to incent and facilitate more loan modifications.**

***A. Change rules governing trusts so that the government can purchase whole loans out of securities.***

The biggest problem TARP faces with respect to loan modifications is that 80% of recent subprime and Alt-A loans were securitized, and if the government purchases securities, the government will own just a partial interest in the cash flow generated by loans, giving it no greater rights to modify loans than other owners scattered around the globe. If the government could buy whole loans, it would have the discretion to do modifications similar to what FDIC has done with IndyMac's portfolio or Fannie Mae and Freddie Mac just announced. However, trusts are designed to be passive entities and are not permitted to sell whole loans, even though they have some flexibility to modify the loans or accept a refinance for less than the principal balance.

Congress should pass legislation clarifying that participation in a government-sponsored whole loan purchase program would be permitted under Real Estate Mortgage Investment Conduit (REMIC) tax rules. Congress could further provide that continued REMIC status (and future tax benefits) is contingent on PSAs being modified to permit (but not require) participation in the loan sale process. Finally, Congress, the SEC or Financial Accounting Standards Board would need to ensure that accounting standards change to permit these sales. Clearly, having whole loans that servicers for whatever reason are unable to modify, that will cause needless foreclosures, and that Treasury cannot purchase even though it could restructure the loans to make them affordable to the borrowers and maximize the return to the government, is not socially optimal. There should be no objection to freeing servicers to modify or sell these assets at the direction of a Treasury program.<sup>27</sup>

Once Treasury purchased loans at a substantial discount and modified them to an affordable level, it could resecuritize the mortgages into pools guaranteed by the government. This guarantee would make the securities marketable and allow the government to revolve its funding into new purchases, increasing its impact.

***B. Amend TARP to provide for meaningful protection for servicers when they modify loans.***

One obstacle to servicers in modifying loans is that they fear lawsuits by investors harmed by their decision; any modification will favor some investors and disfavor others. TARP attempts to deal with this problem by making clear that servicers owe their duty to investors as a whole, not to any particular class of investors who may be harmed by a modification. However, TARP includes the exception “Except as established in any contract.” Congress should delete this phrase in order to provide servicers greater comfort.

Alternatively, Congress could enact a narrowly tailored indemnification provision for servicers who act reasonably in modifying or selling any loan under the Treasury program. Either change should increase servicers’ willingness to modify in the face of particular investor objections.

***C. Ensure income tax burdens do not undermine sustainability of loan modifications.***

Right now, when a servicer provides a homeowner with a loan modification containing a principal writedown (the type of writedown contemplated to occur under the new FHA Hope for Homeowners program) or, in certain circumstances, a significant interest rate reduction, the IRS considers the homeowner to have received taxable cancellation of indebtedness income unless the mortgage debt is “qualified” under the terms of the Mortgage Forgiveness Debt Relief Act of 2007 or the homeowner is insolvent. In many instances, especially where the difference between the original loan amount and the current value of the house is large, the prospect of tax liability could discourage homeowners from seeking a modification, or, if such a modification is obtained, the resulting tax liability could cause the homeowner to redefault on the loan. To prevent this perverse result, Congress should amend the Mortgage Forgiveness Debt Relief Act of 2007 in two ways: (1) lenders should not be required to file Form 1099 with the IRS when cancelling any

mortgage-related debt; and (2) the definition of “qualified mortgage debt” should be extended to include all mortgage debt, not just acquisition debt.

**V. Congress should lift the ban on judicial loan modifications, which would prevent hundreds of thousands of foreclosures without costing the taxpayer at all.**

It is important also to provide a backstop to protect those homeowners whose lenders cannot or will not agree to voluntarily modify their loans, either through the TARP initiative or otherwise. The best and only solution in these cases – where the homeowner could sustain a market rate mortgage – is to lift the ban on judicial modifications, and allow a bankruptcy court to implement an economically rational solution that otherwise would be lost. This move that can immediately help stem the tide of foreclosures *at zero cost to the U.S. taxpayer*.<sup>28</sup>

Judicial modification of loans in bankruptcy court is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century or investment banks like Lehman Bros., yet it is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are *not* permitted to modify in chapter 13 payment plans.

A small change to the bankruptcy code would provide judges the authority to modify mortgages and, we have estimated, help 600,000 homeowners – maybe more – keep their homes. Current proposals in Congress provide that modifications would narrowly target families who would otherwise lose their homes and exclude families who do not need assistance.<sup>29</sup> These proposals also limit the downside to lenders: interest rates must be set at commercially reasonable, market rates; the loan term may not exceed 40 years; and the principal balance may not be reduced below the value of the property.

This would also have the benefit of incentivizing servicers to participate in the TARP and other voluntary modification initiatives. To be clear, CRL does not want to see hundreds of thousands of homeowners actually file for bankruptcy. It is far preferable for most of these homeowners to receive a sustainable loan modification through a streamlined or individualized program. But if bankruptcy judges could make these modifications, it will help encourage additional voluntary modifications as everyone in the system would know the alternative.<sup>30</sup> Investors would have no reason to sue over a modification if the same or more costly modification could be made by a judge. Bankruptcy judges, who are extremely skilled at debt workouts, could help develop modification templates that could be used by servicers outside of the bankruptcy court context.<sup>31</sup> What’s more, as Lewis Ranieri, founder of Hyperion Equity Funds and “the father of the securitized mortgage market,” has recently noted, relief in bankruptcy court is the only effective way to break through the problem posed by second mortgages.<sup>32</sup>

**VI. Conclusion**

Today’s financial crisis is a monument to destructive lending practices—bad lending that never before has been practiced on such a large scale, and with so little oversight. Unfortunately, the entire country is paying the price. There is no single solution to the challenges facing us

today, but any effective policies must seek to maximize the number of families who stay in their homes. In particular, Treasury should ramp up its efforts to do FDIC-like streamlined modifications, Congress should explore additional tools to support modifications, and Congress should lift the ban on judicial restructuring of loans on primary residences.

---

<sup>1</sup> Self-Help's lending record includes our secondary market program, which encourages other lenders to make sustainable loans to borrowers with blemished credit. Self-Help buys these loans from banks, holds on to the credit risk, and resells them to Fannie Mae. Self-Help's loan losses have been under 1% per year—and increased these families' wealth.

<sup>2</sup> MBA National Delinquency Survey, 2<sup>nd</sup> quarter 2008. The 5.5 million reported by survey, divided by 0.85 to scale up to market size (accounting for underreporting), multiplied by 0.047, the 2Q 2008 foreclosure start rate, multiplied by 4 to annualize. Another 1.2 million were delinquent but not in foreclosure, and another 492,000 were sitting in foreclosure from previous quarters' foreclosure starts.

<sup>3</sup> On October 16, 2008, Eric Stein, senior vice president of the Center for Responsible Lending, testified before this committee regarding the causes of the crisis. While more details can be found in his testimony, it is clear that dangerous lending greatly inflated the housing bubble, and the resulting foreclosures of patently unsustainable mortgages are magnifying the damage of the bubble's collapse. <http://www.responsiblelending.org/pdfs/senate-testimony-10-16-08-hearing-stein-final.pdf>

<sup>4</sup> HOPE NOW is “an alliance between HUD approved counseling agents, servicers, investors and other mortgage market participants that provides free foreclosure prevention assistance.” See <http://www.hopenow.com>.

<sup>5</sup> “Subprime Loan Foreclosures & Delinquencies versus Lender Workouts,” Center for Responsible Lending (September 2008), at <http://www.responsiblelending.org/issues/mortgage/quick-references/subprime-loan-foreclosures-delinquencies-versus-lender-workouts.html>.

<sup>6</sup> See HOPE NOW Data for all periods, available at <http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf>.

<sup>7</sup> See, e.g., “Subprime Loan Foreclosures & Delinquencies versus Lender Workouts,” at note 4; also, HOPE NOW Data, July 2008, available at <http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf> (reporting 197,000 foreclosure starts and 192,000 repayment plans initiated and modifications completed, combined in July 2008).

<sup>8</sup> Credit Suisse Fixed Income Research, *Subprime Loan Modifications Update*, October 1, 2008, p.2, available at <http://www.credit-suisse.com/researchandanalytics>.

<sup>9</sup> State Foreclosure Prevention Working Group, *Analysis of Subprime Servicing Performance*, Sept. 2008, at 2, available at [http://www.mass.gov/Cago/docs/press/2008\\_09\\_29\\_foreclosure\\_report\\_attachmentI.pdf](http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachmentI.pdf).

<sup>10</sup> Id. at 6 .

<sup>11</sup> Id at 7-9.

<sup>12</sup> *HOPE NOW Loss Mitigation National Data July 07 to September 08*, p. 9 HOPE NOW Alliance (October 2008) available at <http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20September%2008.pdf>

<sup>13</sup> Credit Suisse, *Subprime Loan Modifications Update*, p.1.

---

<sup>14</sup> The Incentives of Mortgage Servicers: Myths and Realities, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf, Federal Reserve Staff Working Paper, Finance and Economics Discussion Series, 2008-46.

<sup>15</sup> See Bajaj, Vikas and Meier, Barry, *Some Hedge Funds Argue Against Proposals to Modify Mortgages*, New York Times, October 23, 2008.

<sup>16</sup> See Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Apr. 5, 2007 (noting specific examples of PSAs with various modification restrictions, including 5% by balance, 5% by loan count, limits on frequency, and limits on interest rate).

<sup>17</sup> Credit Suisse, *Mortgage Liquidity du Jour: Underestimated No More*, March 12, 2007 at 5.

<sup>18</sup> Credit Suisse, *Subprime Loan Modifications Update*, Oct. 1, 2008, at p. 8.

<sup>19</sup> See Testimony of Eric Stein Center for Responsible Lending, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, October 16, 2008, at fn 30, available at: <http://www.responsiblelending.org/pdfs/senate-testimony-10-16-08-hearing-stein-final.pdf>.

<sup>20</sup> The Incentives of Mortgage Servicers: Myths and Realities, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf, Federal Reserve Staff Working Paper, Finance and Economics Discussion Series, 2008-46, at p. 15.

<sup>21</sup> Id. at pp. 3, 9, 23.

<sup>22</sup> The preferred outcome for loans where property values have fallen and the house is worth less than the principal balance outstanding on the loan is to reduce principal to the current appraised value of the property, which provides the homeowner with the ability to accumulate equity through appreciation and the flexibility to sell their house and move if necessary. The FDIC and streamlined bank approaches defer rather than reduce principal.

<sup>23</sup> Christopher Palmieri, *IndyMac's Fast Track Mortgage Modification Program*, Business Week, October 8, 2008

<sup>24</sup> The FHA's new Hope for Homeowners program takes this approach, although it is too early to tell whether it is feasible on a large scale.

<sup>25</sup> For example, it's unclear how the "borrower hardship" requirement will be implemented, or what level interest rates will be permitted to rise to if they have been reduced for five years.

<sup>26</sup> AICPA Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer (SOP 03-3).

<sup>27</sup> See Center For American Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages, April 2008, available at [http://www.americanprogress.org/issues/2008/04/reimc\\_brief.html](http://www.americanprogress.org/issues/2008/04/reimc_brief.html).

<sup>28</sup> For a detailed discussion of judicial loan modifications, see Statement of Eric Stein, Center for Responsible Lending, U.S. Senate Judiciary Committee, Dec. 5, 2007, available at <http://www.responsiblelending.org/pdfs/stein-statement-to-senate-judiciary-looming-foreclosure-crisis.pdf>.

<sup>29</sup> Under current proposals, loan modifications would be available only where the homeowner's income is insufficient, after deducting for modest IRS-approved living expenses, to cover the mortgage payments. In addition, there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through existing hurdles.

<sup>30</sup> The same phenomenon occurred when Chapter 12 was passed to modify loans on family farms in the late 1980s.



---

<sup>31</sup> See statement by J. Rich Leonard, US Bankruptcy Judge, Eastern District of North Carolina, at <http://www.responsiblelending.org/pdfs/leonard-letter.pdf>

<sup>32</sup> *Lewis Ranieri to deliver Dunlop Lecture on Oct. 1, Harvard University Gazette, Sept. 25, 2008*, available at <http://www.news.harvard.edu/gazette/2008/09.25/06-dunlop.html>; Ranieri, “Revolution in Mortgage Finance,” the 9th annual John T. Dunlop Lecture at Harvard Graduate School of Design, Oct. 1, 2008, *available at*: [http://www.jchs.harvard.edu/events/dunlop\\_lecture\\_ranieri\\_2008.mov](http://www.jchs.harvard.edu/events/dunlop_lecture_ranieri_2008.mov) (last visited Oct. 13, 2008).