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

"Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets."

<u>April 10, 2008</u>

Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for holding this hearing on how we can stop the wave of coming foreclosures, break the cycle of spiraling losses in the housing and mortgage markets, and restore liquidity and stability to this crucial sector of the economy. We commend you for focusing on the problem and seeking positive solutions.

The U.S. economy faces significant challenges today, as 20,000 foreclosures on subprime mortgages are occurring every single week.[1] The negative spillover effects from these foreclosures are substantial: property values are dropping by billions of dollars, communities are losing precious resources, and millions of Americans who depend on a robust housing market are losing jobs and income. As foreclosures accelerate during the next two years, these economic effects will be felt even more strongly.

This crisis is not getting better on its own, and efforts to encourage lenders and servicers to modify unsustainable loans simply are not working. My major message today is that Congress has effective tools at its disposal to mitigate needless losses and avoid making an economic disaster even worse. It is too late to stop a severe downturn driven by reckless lending, but it is not too late to minimize the massive damage ahead. In these comments, I will discuss these issues:

- We face a severe foreclosure crisis with substantial negative effects on whole communities and the broader economy.

- Voluntary loan modifications cannot adequately address the problem. An effective government response is urgently needed to prevent the problem from growing worse.

- The Hope for Homeowners Act, proposed by Chairman Dodd, is an excellent proposal that can avert a significant proportion of unnecessary foreclosures that are otherwise inevitable. It provides a powerful tool to help stabilize the market and expedite economic recovery.

In particular, the Hope for Homeowners Act successfully meets the following policy criteria:

- It does not bail out lenders or investors whose actions led to the current crisis. By requiring mortgage holders to take a 13% "haircut" off the current value of the property, the bill ensures that lenders and investors shoulder a significant portion of the loss resulting from the lending and investing decisions that they made.

- It creates sustainable mortgages to preserve homeownership and family wealth. In contrast with recent subprime lending, FHA-backed loans are largely fixed-rate, amortizing mortgages, providing predictable expenses that many low-income households need rather than exploding interest rates two years after origination. They escrow for taxes and insurance, helping families budget for large certain expenses. They require documented income, making sure that the loans are affordable. And they require an assessment of the ability to repay the loan, helping ensure sustainable homeownership.

- It does not place taxpayers at undue risk. The Hope for Homeowners bill is well designed to ensure that the program is self-sustaining – as was the Depression-era Home Owners' Loan Corporation. Several mechanisms accomplish this: First, it permits refinancings for no more than 90% of the current value of the mortgaged property, which should reduce the incidence and severity of losses as compared with FHA's regular lending program, which allows for a ratio of 97% loan-to-value. Second, the 13% "haircut" includes 3% to be held in FHA insurance pool to cover losses. Third, borrowers will be required to pay an additional insurance premium of up to 1% annually to cover risk of loss. Fourth, FHA would recapture a share of the equity appreciation in home value when the house is sold. Finally, there will be interest earnings on the fund. The new FHA reserve fund should fully cover losses.

- It facilitates prompt action by relying on existing institutions. The Dodd proposal uses existing institutions: a modified loan product that is government-insured (FHA), a mechanism for private parties to provide the funding for the loans (through the secondary market entity Ginnie Mae), and a distribution mechanism (currently underemployed loan officers and motivated servicers with lending affiliates). Assuming servicers accept short refinances, it should not be difficult to make and fund the FHA loans.

Finally, even with the passage of the Hope for Homeowners Act, a significant proportion of troubled homeowners will be pushed into foreclosure because the loan servicer cannot or will not modify the loan or agree to a refinancing under the Act. The problem is particularly acute in the case of the large proportion of loans that were issued with "piggy back" second mortgages, which preclude relief absent the second lien-holder's consent. The Helping Families Save their Homes in Bankruptcy Act (S 2136) is the only solution that has been proposed that can address this problem, and for this reason remains an important companion to Chairman Dodd's excellent bill.

Self-Help and Center for Responsible Lending

I am Senior Policy Counsel at the Center For Responsible Lending (CRL), (www.responsiblelending.org), 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 Self-Help (www.self-help.org), which consists of a credit union and a non-profit loan fund.

For the past 28 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 other words, we work to provide fair and sensible loans to the people most frequently targeted for predatory and abusive subprime mortgages. 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. Our loan losses have been less than one percent per year.

In addition to making direct loans, Self-Help encourages sustainable loans to borrowers with blemished credit through a secondary market operation. We buy these loans from banks, hold on to the credit risk, and resell them to Fannie Mae. We have 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, CRL understands the importance of promoting sustainable homeownership and maintaining access to affordable home loans, and recognizes how responsible use of the secondary market can contribute to such a result.

I. We face a severe foreclosure crisis that will grow worse without adequate policy intervention.

A year ago, some mortgage lenders still insisted that the number of coming foreclosures would be too small to have a significant impact on the economy overall.[2] No one makes that claim today. Today, as foreclosures are at an all-time high and projected to grow higher,[3] the "worst case is not a recession but a housing depression."[4] Projections by Fitch Ratings indicate that 43% of recent subprime loans will be lost to foreclosure,[5] and at least two million American families are expected to lose their homes to foreclosures initiated over the next two years.[6]

As we show in our recent report on the "spillover" effect of subprime foreclosures, the negative effects are not confined to the families who lose their homes. Forty million of their neighbors will see their property values decline as a result by over $200 billion.[7] Federal Reserve Chairman Ben Bernanke recently noted, "At the level of the individual community, increases in foreclosed-upon and vacant properties tend to reduce house prices in the local area, affecting other homeowners and municipal tax bases. At the national level, the rise in expected foreclosures could add significantly to the inventory of vacant unsold homes—already at more than 2 million units at the end of 2007—putting further pressure on house prices and housing construction."[8]

Sadly, many of the borrowers who are losing their homes to foreclosure qualified for better loans that they would be sustaining today. A study for the Wall Street Journal found that of the subprime loans originated in 2006 that were packaged into securities and sold to investors, 61%% "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[9] And even those borrowers who did not qualify for prime loans could have received sustainable, thirty-year fixed-rate loans, for at most 50 to 80 basis points above the "teaser rate" on the unsustainable exploding ARM loans they were given.[10] Had these borrowers received the sustainable loans they qualified for, we would not be facing the foreclosure crisis we are in today.

Wall Street's appetite for risky loans incentivized mortgage brokers and lenders to aggressively market highly risky exploding ARM loans instead of the sustainable loans for which borrowers qualified. As Alan Greenspan told Newsweek, "The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime loan market would have been very significantly less than it is in size."[11]

Market participants readily admit that they were motivated by the increased profits offered by Wall Street in return for risky loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"[12] Even the chief economist of the Mortgage Bankers Association, when asked why lenders made so many loans that they knew were unsustainable, replied, "Because investors continued to buy the loans."[13]

For the sake of the economy as a whole, as well as individual families and their communities, it is essential that strong measures be implemented to avoid unnecessary foreclosures. This will entail addressing two problems – the reset of interest rates on subprime mortgages to unsustainable levels (a problem that has been at least temporarily ameliorated somewhat by reductions in short-term interest rates, but not eliminated), and the sharp increase in "under-water" mortgages – that is, mortgages that exceed the value of the mortgaged home.

Currently, 30% of families holding recent subprime mortgages now owe more on their mortgage than their home is worth.[14] These families are at an increased risk of foreclosure because "negative equity" precludes the homeowner from selling, refinancing or getting a home equity loan or other mechanism for weathering short-term financial difficulty.[15] Regulators and economists are increasingly cautioning that loan balances must be reduced to avoid unnecessary foreclosures that will further damage the economy.[16]

Federal Reserve Board Chairman Ben Bernanke recently observed, "[T]he current housing difficulties differ from those in the past, largely because of the pervasiveness of negative equity positions. With low or negative equity, as I have mentioned, a stressed borrower has less ability (because there is no home equity to tap) and less financial incentive to try to remain in the home. In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure."[17]

II. The current crisis calls for effective government action.

During the past six months, we have witnessed remarkable and highly disturbing events as the effects of unsustainable subprime mortgages spread through global markets and wreaked havoc on our national economy. Numerous companies have failed, and the government has found it necessary to intervene to keep Wall Street firms afloat.

Unfortunately, to date, Congress and the regulatory agencies have remained at least a step behind the problem, relying on the hope of voluntary measures by industry long after it became clear that meaningful modifications were not materializing to any significant degree. Already the government has recognized the need to intervene by facilitating substantial assistance for Bear Stearns and providing low-cost loans for investment banks through the Federal Reserve's discount window. However, to date Congress has not taken significant action to intervene on behalf of homeowners and prevent foreclosures.

Almost a year ago, in May 2007, Chairman Dodd convened a Homeownership Preservation Summit, which established a set of Homeownership Preservation Principles[18] that called upon lenders to modify loans to ensure long-term sustainability by reducing loan balances and switching to lower cost fixed-rate loans. Notwithstanding industry leaders' public endorsements of the principles, as well as widespread support for loan modification from President Bush[19] and all of the federal banking agencies and the Conference of State Banking Supervisors,[20] voluntary efforts by lenders, servicers and investors have been insufficient to address the massive number of foreclosures.

Looking at the first eight months of 2007, Moody's Investors Service found that lenders modified only 3.5% of subprime loans that reset to higher interest rates.[21] According to a recent report by the State Foreclosure Prevention Working Group, a collection of state Attorneys General and Bank Commissioners, only 24% of seriously delinquent borrowers were working with professionals in any type of loss mitigation activity that could lead to preventing a foreclosure.[22] Efforts of the Hope Now Alliance also fall short. As recently acknowledged by the vice chair of Washington Mutual, who helps run the program, many of the homeowners who have sought Hope Now assistance "will not receive long-term relief and could ultimately face higher total costs."[23] Chairman Bernanke noted that loan modifications involving "reductions of principal balance have been quite rare."[24]

While the government has encouraged private companies to do loan modifications and constructive refinances, the fact is that the private sector faces significant obstacles and disincentives because of the large number of players resulting from securitization.

Refinancing, for its part, has too often been unavailable because of the current lack of liquidity in the market generally, and because borrowers facing foreclosure do not qualify for refinancing due to their delinquency on current loans or the lack of sufficient equity in the home. Loan servicing companies fear lawsuits by affected groups of investors, face financial incentives to foreclose rather than modify or accept short refinances, and face the problem of loans made with "piggyback" second mortgages. These factors have tied the hands of servicers and made it impossible to modify or refinance the loan, even where doing so is clearly in the best interest of the investors as a whole.[25]

There is an emerging consensus that half-measures in the private sector are not working. FDIC Chairman Sheila Bair recently said that the current economic situation calls for a stronger government response, since voluntary loan modifications are not sufficient.[26] The necessity of government action also is gaining recognition among Wall Street leaders. Just this week, a senior economic advisor at UBS Investment Bank stated that, "when markets fail, lenders and borrowers need some sort of regulatory and legislative framework within which to manage problems, rather than be forced to act in the chaos of the moment."[27] Moreover, as former Federal Reserve Board Vice Chairman Alan Blinder recently noted, the fact that most of the mortgages at issue have been securitized and sold to investors across the globe "bolsters the case for government intervention rather than undermining it. After all, how do you renegotiate terms of a mortgage when the borrower and the lender don't even know each other's names?"[28]

III. The Hope for Homeowners Act will prevent foreclosures.

To further stabilize the economy and speed recovery, Congress must go beyond encouraging loan servicers and investors to do the right thing. Today strong, decisive action is necessary—not only for homeowners, but for the entire nation.

<u>A. The Home Owners' Loan Corporation offers a useful model.</u>
In crafting solutions to the worst housing crisis since the Great Depression, Congress can find useful guidance in a highly successful solution that was implemented at that time. The Home Owners' Loan Corporation (HOLC) was established in 1933 to help distressed families avoid foreclosure by buying mortgages at a discount from the banks that held them, and restructuring them into loans that borrowers could afford and sustain.[29]

HOLC purchased and restructured more than a million mortgages, 20% of all mortgages in the country, and over the life of the program, extended $3.5 billion in loans (the corresponding figures in today's economy would be 2.5 million loans worth $750 billion).[30] During the 1930s, nearly 20% of HOLC borrowers defaulted, and HOLC acquired 200,000 homes, most of which were sold by 1944. The average HOLC borrower was two years delinquent on their mortgage, and HOLC turned down 46% of applicants. It closed its books in 1951 having turned a small profit.[31] Very quickly, the government intervened in a massive way, and had an extraordinary impact ameliorating a housing crisis in which almost half of all mortgages were in default.[32]

From this experience, the Federal Housing Administration, Fannie Mae and then Freddie Mac, developed to facilitate widespread provision of the type of long-term, fixed-rate loans that HOLC provided.

B. Hope for Homeowners offers an excellent approach.

The Hope for Homeowners Act of 2008 creates a new program within the Federal Housing Administration (FHA) to help refinance mortgages that otherwise are highly likely to go into foreclosure. Under the Act, FHA-approved lenders will be encouraged to refinance abusive loans at a significant discount for homeowners who are trapped in abusive mortgages and face difficulty paying their mortgages.

The Act has a number of provisions to ensure that the loans are targeted to homeowners in real need, and that the new loans will be sustainable. New loans will be based on a family's ability to repay the loan, and no investors or investor properties will qualify for participation in the program, only owner-occupants. All loans eligible for the program must be 30-year mortgages with fixed interest rates. Finally, the FHA will not insure more than 90% of the current value of the home.

By providing loans with a 90% loan-to-value ratio, the program will create equity for the homeowners who qualify. However, the Act specifies that the homeowner must share this equity and future appreciation in the property's value with the FHA.

The Act would create the modern equivalent of the HOLC, although the structure of the modern mortgage market today requires a variation in approach. While HOLC purchased distressed mortgages from lenders who held them, today the vast majority of loans are securitized, which means they are owned by investors in different tranches often scattered around the world. Current accounting standards for off-balance sheet securitization transactions (specifically Financial Accounting Standard 140) make it impossible for servicers to sell securitized loans at a discount, making the original HOLC idea unworkable for most loans.

The Act recognizes this limitation, and rather than having the government buy mortgages directly, asks servicers to agree to forgive a certain amount of the balance of a loan on a mortgage headed for foreclosure in exchange for getting the loan off their books through being refinanced by a new government-guaranteed mortgage. Current accounting, tax and contractual standards do indeed permit loan servicers of securitized loans to voluntarily modify mortgages, including by reducing principal balances, in this way if these conditions are met: (1) a loan is in default or it is reasonably foreseeable that the loan will default; and (2) investors will recover more financially through a loan modification than if the loan goes through foreclosure.

The Hope for Homeowners Act offers an effective way to address the two key drivers of foreclosure today: unsustainably high mortgage rates and negative equity in the home. By incentivizing servicers to pursue refinancing in preference to foreclosing, the Dodd proposal will significantly reduce the number of coming foreclosures. The proposal encourages servicers to take an up-front write-down of principal by accepting a refinance of a troubled loan, thereby offering servicers and investors a way to exit the loan and cut off further losses. Just as with foreclosure, the servicer would not be responsible for any subsequent borrower redefaults.

Given current and projected declines in home values,[33] we would expect that the refinancing terms will provide mortgage holders with better returns – and in many cases significantly better returns – than could be obtained at a foreclosure sale.[34] As a senior economic advisor at UBS Investment Bank noted, enabling the government to restructure loans at a discount by requiring lenders to accept a significant "haircut" as an alternative to "owning defaulted, non-earning assets" could provide an effective means to "lessen or draw out foreclosures and have a positive effect on the valuation of [mortgage] securities that now do not trade or do so at enormous discounts."[35]

Breaking the gridlock of families who cannot get a voluntary modification but can pay a reasonable FHA loan with a balance less than the value of the home through a new FHA loan would be a tremendous advance for borrowers and neighborhoods. Allowing the loan to be paid off by an FHA loan for less than the principal balance – a so-called "short refinance" – provides a new sustainable mortgage to the borrower and offers loan servicers a readily available mechanism for refinancing. Thus, the Hope for Homeowners Act holds great promise for foreclosure prevention on a much larger scale than anything that has been done to date.

IV. The Hope for Homeowners Act meets key policy goals.

We believe any action policymakers contemplate should be assessed against key policy goals. Specifically, any proposed policy solution should meet these criteria:

- Does not bail out the lenders and investors whose actions led to the current crisis;
- Creates sustainable mortgages to preserve homeownership and family wealth;
- Does not place taxpayers at undue risk; and
- Facilitates prompt action, therefore relies on existing institutions as much as possible so that solutions can be implemented in time to have significant impact.

A. No bailout of lenders or investors.

The Act is structured to avoid bailing out lenders or investors or rewarding the irresponsible lending that helped create the current crisis. It accomplishes this objective by limiting allowable refinancing to 87% of the current (not original) value of the mortgaged property. By requiring mortgage holders to take a 13% "haircut" off the current value of the property, the bill ensures that lenders and investors shoulder a significant portion of the loss resulting from the lending and investing decisions that they made. In the case of under-water mortgages, the 13% discount off the property's current value will reflect a larger discount off the outstanding balance of the mortgage loan. While the Dodd bill will put a floor under their losses in order to avoid further damage to the economy, it keeps a sufficient portion of the responsibility where it belongs, thereby ameliorating moral hazard.

This is an essential component of the bill, which should not be waivable under any circumstances. For this reason, we recommend that section 257(e)(6) of the bill be modified to remove any possibility that this requirement could be waived.

B. Sustainable loans.

For several generations now, FHA has provided sustainable homeownership opportunities for families who might not be able to get conventional mortgages. In contrast with recent subprime lending, FHA-backed loans are largely fixed-rate, amortizing mortgages, providing predictable expenses that many low-income households need rather than exploding interest rates two years after origination. They escrow for taxes and insurance, helping families budget for large certain expenses. They require documented income, making sure that the loans are affordable. The debt ratios of 33% mortgage debt to income and 41% total debt to income have proven prescient, as the 50% and 55% subprime total debt ratios have gone into default in alarming numbers.

Further, the loan balances on the loans will be written down to 90% of the current market value of the house, and interest rates reduced to conventional rates. The fact that both interest rates and principal balance will likely be lower than the families faced previously will significantly increase their chances of success.

C. No undue risk to taxpayers.

Just as the HOLC proved self-sustaining and even modestly profitable, the Hope for Homeowners bill is well designed to ensure that the program can sustain itself too. It has a number of mechanisms to accomplish this. First, it permits refinancings for no more than 90% of the current value of the mortgaged property and will use underwriting standards for borrowers that, while more flexible than current standards, are targeted at borrowers who can afford the new loans. By requiring a 90% loan-to-value ratio, the program should reduce the incidence and severity of losses as compared with FHA's regular lending program, which allows for a ratio of 97% loan-to-value. Second, the 13% "haircut" includes 3% to be held in FHA insurance pool to cover losses. Third, borrowers will be required to pay an additional insurance premium of up to 1% annually to cover risk of loss. Fourth, FHA would recapture a share of the equity appreciation in home value when the house is sold. Fifth, the summary materials state that there will be a $20 billion appropriation into the fund. Finally, there will be interest earnings on the fund. These factors are likely to ensure the soundness of the program and to prevent against the risk of taxpayer losses.

Adding together the 3% equity from the initial refinance; four years of 0.75% annual insurance payments by the borrower, totaling 3%; and 3% from equity appreciation recapture provides a total reserve pool of 9% of the amount of lending accomplished. (Nine percent could be accumulated in other ways too, of course, by adjusting each factor up or down.)

According to the 2006 FHA actuarial review, the average lifetime default rate for 30-year fixed rate FHA loans is 10.97%.[36] Even if the default rate for loans under the Hope for Homeowners proposal were twice the FHA's normal default rate, which would roughly correspond to the 20% default rate experienced during the 1930's by HOLC,[37] the program would have sufficient reserves to cover these losses. Assume loss severity were 45%,[38] meaning that each loan recovered 55 cents on the dollar and lost 45 cents. In this conservative case, total losses for the program would equal loss incidence (20%) times loss severity (45%), or 9%, which would be covered by the reserve pool.

While there is risk in any lending program, particularly one that targets borrowers in severe financial difficulty, there are substantially greater risks if the government does not step forward and substantially address the problem. Massive further foreclosures begetting boarded up damaged homes begetting further house price declines by neighbors begetting further foreclosures is an all too likely scenario absent implementation of the Dodd proposal.[39] The current harm to our national economy is severe enough, and worse is sure to come.

D. Speed of implementation; uses existing institutions.
The scale of the foreclosure crisis requires a quick and a major response. In practice, these two factors are often in tension with each other. In order to get help to families that need it, there should be a policy bias toward using existing institutions as much as possible, to avoid the delays of designing and staffing new ones. The Dodd proposal accomplishes this goal by using existing institutions: a modified loan product that is government-insured (FHA), a mechanism for private parties to provide the funding for the loans (through the secondary market entity Ginnie Mae), and a distribution mechanism (currently underemployed loan officers and motivated servicers with lending affiliates). Assuming servicers accept short refinances, it should not be difficult to make and fund the FHA loans.

As discussed below, this is still a large, new program, and will take time to implement.

V. Suggested adjustments to the bill.

We agree with Chairman Dodd that there is no need for an eligibility screen for borrowers that would require that the borrower currently have a 40% current debt-to-income (DTI) ratio, as Chairman Frank's excellent proposal states. Such an eligibility requirement will exclude many deserving homeowners who, although they have a less than 40% DTI, cannot pay their current mortgage because they have other debts that they need to pay or unique expenditure circumstances. A 40% DTI is especially burdensome for lower income homeowners, as it leaves little residual income for other necessities. In addition, it is not necessary to impose an existing mortgage debt-to-income payment, as other factors already screen potential borrowers.[40] Given that many borrowers will not be helped by any program that is purely voluntary for servicers and lenders, as described in Section VI, the program should not be further restricted with a DTI requirement.

However, we do have a small number of suggestions to improve the measure. First, Chairman Dodd's idea of recapturing equity from borrowers helped by the program when they later sell their house is fair, and will help keep the program solvent and prevent taxpayers from having to cover those losses. We also agree that the amount of recapture should reduce on a sliding scale over a five-year period. However, Representative Frank's formulation of cutting off the appreciation recapture at 5 years for sale or refinance, except for a flat 3%, rather than sharing appreciation half and half in perpetuity, strikes us as preferable. Chairman Dodd's proposal will need to permit households to retain appreciation due to capital improvements; calculating costs of such improvements beyond a five-year period would be administratively difficult. Further, cutting the amount of recapture after five years to a flat 3% would be fairer to the families involved.

Second, the bill appears, at section 2(e)(6), to permit the next Administration to waive any of the protections in the bill. That authorization is dangerous, because it would permit a full lender bailout. For a bill with such a short time horizon, the bill should not permit such broad powers to waive the important protections. Third, the section on encouraging Fannie Mae and Freddie Mac to similarly refinance distressed loans is worthy, but may not be workable; in any case, the GSEs' housing goals should not be waived. Fourth, it is not clear how the auction process would work. For such a process, it is important that Sen. Dodd retains all the protections against investor bailout, such as the 13% haircut requirement.

Finally, the administrators of the program will need to issue rules to protect against mortgage broker abuses in originating loans under the program. Compensation to brokers or retail originators that increases when the interest rate charged borrowers rises, through yield spread premiums or overages, should not be permitted. Further, FHA should police the terms of these loans in the market to make sure that lenders are not charging excessive fees or interest rates, since the loans are fully government guaranteed.

VI. Court-supervised modifications are necessary complement to bill.

Even with the passage of the Hope for Homeowners Act, a significant proportion of troubled homeowners, who could afford to sustain a mortgage on economically rational terms, will be forced into foreclosure because the loan servicer cannot or will not agree to modify the loan or refinance under the Act. Often this result will be to the clear detriment of investors as a whole. It is critical in such cases, as a last alternative to foreclosure, to permit a court to adjust the mortgage if the borrower can afford a market rate loan. Currently, bankruptcy courts can modify any type of loan, including yachts and vacation homes, with the exception of one type: primary residences. Removing this exclusion would help homeowners (not speculators) who are committed to staying in their homes, without bailing out investors and without costing taxpayers anything. The Helping Families Save their Homes in Bankruptcy Act (S2136) provides a narrow, time-limited mechanism for breaking the deadlock that is forcing into foreclosure families who can afford a market rate loan.[41]

We believe that the court-supervised loan modifications bill is a necessary complement to the FHA refinance program for three reasons. First, it provides important incentives to get lenders to voluntarily agree to the short refinances. Second, it's an important backstop for families who fall between the cracks and can't get the FHA refinance. There are a number of reasons that voluntary modifications are not occurring in sufficient numbers, including overwhelmed servicers and fear of investor lawsuits (Chairman Dodd's proposal to provide a safe harbor against lawsuits for servicers participating in this plan is a positive step, but won't stop all lawsuits or prevent all fears of them). The most vexing obstacle, however, is when there is a piggyback second mortgage holder who won't agree; a third to a half of 2006 subprime borrowers took out piggyback second mortgages on their home at the same time as they took out their first mortgage.[42] The presence of these loans often makes it impossible for servicers to modify either mortgage because the second mortgage holder has no incentive to cooperate.[43]

Finally, it could take as much as a year to get a large, new program of this scale up and going, while the bankruptcy change can be implemented immediately. Thus, to address the current subprime default crisis, we'd need the court supervised modification program. The FHA refinance proposal would still provide important help for many subprime borrowers and, unfortunately, it will also be needed for the second wave of foreclosures, namely poorly underwritten option ARM and Alt-A mortgages that are scheduled for payment increases loans in 2009 and beyond.

Together, the Hope for Homeowners Act and the Helping Families Save their Homes in Bankruptcy Act, would prove highly effective at stemming the tide of coming foreclosures, and providing urgently needed relief to struggling homeowners, the communities they live in, and the economy as a whole.

Conclusion

Effective government action is urgently needed to avoid a flood of needless foreclosures that will devastate families, destroy communities, and do further damage to the economy as a whole. We believe that the Hope for Homeowners Act is a strong proposal that will provide an effective tool for stabilizing the economy and speeding recovery. We applaud the Committee for focusing on the need to find a prompt and effective mechanism for breaking the cycle of spiraling losses in the housing and mortgage markets.

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[1] *See* Written Testimony of Mark Zandi, Moody's Economy.com before House Subcommittee on Commercial and Administrative Law (January 28, 2008), available at: http://judiciary.house.gov/media/pdfs/Zandi080129.pdf; *See also* Center for Responsible Lending , Subprime Spillover, (Rev. Jan. 18, 2008), http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[2] *See, e.g.*, Statement of John M. Robbins, CMB, Chairman, Mortgage Bankers Association at the National Press Club's Newsmakers Lunch – Washington, DC (May 22, 2007) (Speaking of predicted foreclosures, Mr. Robbins stated: "As we can clearly see, this is not a macro-economic event. No seismic financial occurrence is about to overwhelm the U.S. economy."); Julia A. Seymour, "Subprime Reporting , Networks blame lenders, not borrowers for foreclosure 'epidemic,'" Business & Media Institute (Mar. 28, 2007) ("[T]here are experts who say the subprime 'meltdown' is not the catastrophe reporters and legislators are making it out to be. 'We don't believe it will spill over into the prime market or the U.S.

economy,' said [Laura] Armstrong [Vice President, Public Affairs] of the Mortgage Bankers Association.").

[3] Renae Merle, Home Foreclosures Hit Record High, Washington Post, March 6, 2008.

[4] David M. Herszenhorn and Vikas Bajaj, "Tricky Task of Offering Aid to Homeowners," The New York Times (Apr. 6, 2008) (quoting Susan M. Wachter, a real estate finance professor at the Wharton School of the University of Pennsylvania. According to Professor Wachter, "In the market that we have in front of us, prices decline and supply increases, driving prices down further.").

[5] Fitch Ratings estimates total losses of 25.8% of original balance in Q4 2006 loans placed in MBS they rated, and that loss severity will be at 60%, which means that 43% of the loans are projected to be lost to foreclosure (25.8/60); lack of home price appreciation said to increase defaults. Glenn Costello, Update on U.S. RMBS: Performance, Expectations, Criteria, Fitch Ratings, p. 17-18 (not dated, distributed week of February 25, 2008). According to Michael Bykhovsky, president of Applied Analytics, an estimated 40% of outstanding subprime mortgage loans could go into default over the next three years; the dire outlook due to declining home values (press briefing at the Mortgage Bankers Association's National Mortgage Servicing Conference, February 27, 2008).

[6] *See* Written Testimony of Mark Zandi, Moody's Economy.com before House Subcommittee on Commercial and Administrative Law (January 28, 2008), available at: http://judiciary.house.gov/media/pdfs/Zandi080129.pdf; *See also* Center for Responsible Lending , Subprime Spillover, (Rev. Jan. 18, 2008), http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[7] *See* Center for Responsible Lending, Subprime Spillover, (Rev. Jan. 18, 2008), http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[8] Statement of Federal Reserve Chairman Ben Bernanke on March 4, 2008, reprinted by Bloomberg.com and available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apeU.0IaETdM ("Bernanke statement")

[9] Rick Brooks and Ruth Simon, Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market, The Wall Street Journal at A1 (Dec. 3, 2007).

[10] January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.

[11] "The Oracle Reveals All," *Newsweek* (Sept. 24, 2007) pp. 32, 33.

[12] Vikas Bajaj and Christine Haughney, Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages," The New York Times (Fri. Jan. 26, 2007) C1, C4.

[13] "Subprime Loans Defaulting Even Before Resets," CNNMoney.com, February 20, 2008.

[14] Edmund Andrews, Relief for Homeowners is Given to a Relative Few, New York Times (March 4, 2008) (loans originated in 2005 and 2006).

[15] Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures, Federal Reserve Bank of Boston Working Papers, No 07-15 (Dec. 3, 2007) at 3-4 (this otherwise good article misses the fact that certain loans themselves can create the cash flow shortfall that cause underwater loans to fail, when they are structured with initial low

payments that are scheduled to rise, such as subprime 2/28 hybrid ARMs, and that certain loan terms have been statistically demonstrated to increase foreclosures, such as prepayment penalties).

[16] Federal Reserve Chairman Ben Bernanke recently said, "When the mortgage is 'underwater,' a reduction in [loan] principal may increase the expected payoff by reducing the risk of default and foreclosure." "Preventable foreclosures" could be reduced, he said, by enabling loan servicers to "accept a principal writedown by an amount at least sufficient to allow the borrower to refinance into a new loan from another source." This would "remove the downside risk to investors of additional writedowns or a re-default." See Bernanke statement.; see also, Edmund L. Andrews, Fed Chief Urges Breaks for Some Home Borrowers, The New York Times (Mar. 4, 2008); John Brinsley, Bernanke Call for Mortgage Forgiveness Puts Pressure on Paulson, Bloomberg.com (Mar. 5, 2008).; Phil Izzo, Housing Market Has Further to Fall, The Wall Street Journal (Mar. 13, 2008) ("Last week, Federal Reserve Chairman Ben Bernanke suggested that lenders could aid struggling homeowners by reducing their principal — the sum of money they borrowed — to lessen the likelihood of foreclosure. Some 71% of respondents [i.e., economists surveyed by the NYT] agreed with the suggestion.")

[17] Bernanke Statement, note 8.

[18] Homeownership Preservation Summit Statement of Principles (May 2, 2007), http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Chairman Dodd, and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae).

[19] White House press release, August 31, 2007. See also the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (Encouraging lenders to address subprime hybrid ARM resets by pursuing "appropriate loss mitigation strategies designed to preserve homeownership. . . . Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal.")

[20] Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages http://www.federalreserve.gov/boarddocs/srletters/2007/SR0716.htm.

[21] Aashish Marfatia, US Subprime Market Update November 2007, Moody's Investors Service (Dec. 17, 2007) at 2.

[22] Analysis of Subprime Servicing Performance, Data Report No. 1, February 2008.

[23] David Cho and Renae Merle, Merits of New Mortgage Aid Are Debate – Critics Say Treasury Plan Won't Bring Long-Term Relief, The Washington Post (Mar. 4, 2008) (citing remarks of Bill Longbrake, senior policy adviser for the Financial Services Roundtable and vice chair of Washington Mutual).

[24] Bernanke statement.

[25] http://www.responsiblelending.org/pdfs/court-supervised-modifications-would-make-large-scale-foreclosure-prevention-possible.pdf, p. 2.

[26] FDIC Chairwoman Sheila Bair (stating ""We've got a real problem. And I do think we need to have more activist approaches. And I think it will be something we need to be honest with the American public about. We do need more intervention. It probably will cost some money."), Real Time Economics, The Wall St. Journal (April 7, 2008) available at: http://blogs.wsj.com/economics/2008/04/07/fdic-chairwoman-calls-for-activism/?mod=google_newsThe

[27] George Magnus, "Large-scale action is needed to tackle the credit crisis," Financial Times (Apr. 8, 2008).

[28] Alan S. Blinder, "From the New Deal, a Way Out of a Mess," The New York Times (Feb. 24, 2008).

[29] See C. Lowell Harris, History and Policies of the Home Owners' Loan Corporation (National Bureau of Economic Research) 1951; Alex J. Pollock, American Enterprise Institute for Public Policy Research, Crisis Intervention in Housing Finance: The Home Owners' Loan Corporation, December 2007; Andrew Jakabovics, Throwing Homeowners a Lifeline: A Proposal for Direct Lending to Qualified Troubled Borrowers, Center for American Progress, December 2007, available at: http://www.americanprogress.org/issues/2007/12/pdf/holc_paper.pdf.

[30] Alan S. Blinder, "From the New Deal, a Way out of a Mess," The New York Times (Feb. 24, 2008).

[31] Alan S. Blinder, "From the New Deal, a Way out of a Mess," The New York Times (Feb. 24, 2008); see also, David M. Herszenhorn and Vikas Bajaj, "Tricky Task of Offering Aid to Homeowners," The New York Times (Apr. 6, 2008) ("During the 1930s, when the government set up the Home Owners Loan Corporation to buy and modify defaulted loans, the agency ended up foreclosing on 20 percent of its borrowers, said Alex J. Pollock, a fellow at the American Enterprise Institute. He said any new plan should be set up to withstand losses on a sizable number of loans.")

[32] Pollock, p. 2.

[33] Home prices have fallen by 5% to 10% nationwide, and market experts predict that prices will decline by an additional 20%. See Lawrence Summers, Prevent US Foreclosures, Financial Times (Feb. 24, 2008).

[34] See Bernanke Statement ("A recent estimate based on subprime mortgages foreclosed in the fourth quarter of 2007 indicated that total losses exceeded 50 percent of the principal balance, with legal, sales, and maintenance expenses alone amounting to more than 10 percent of principal. With the time period between the last mortgage payment and REO liquidation lengthening in recent months, this loss rate will likely grow even larger. Moreover, as the time to liquidation increases, the uncertainty about the losses increases as well. The low prices offered for subprime-related securities in secondary markets support the impression that the potential for recovery through foreclosure is limited. The magnitude of, and uncertainty about, expected losses in a foreclosure suggest considerable scope for negotiating a mutually beneficial outcome if the borrower wants to stay in the home.")

[35] George Magnus, "Large-scale action is needed to tackle the credit crisis," Financial Times (Apr. 8, 2008) (Speaking favorably of the likelihood that Congress "will almost certainly pass a first round of legislation before August, using the government's balance sheet to purchase eligible mortgages at a discount and restructure them, and requiring lenders "to accept a 'haircut' of up to 25 percent.").

[36] This projected default rate includes FHA loans with seller-financed down payment loans, which have been included in a third of recent loans and have caused substantially greater defaults than loans without these programs. These should not be allowed in the FHA refinance program, which should reduce losses. See Rachel L. Swarns, Looming Deficit Impedes Federal Housing Agency, New York Times (April 9, 2008). The 10.97% figure represents a combination of actual claim rates and projections of future losses for their 1977-2007 years of originations. An Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund for Fiscal Year 2007, Prepared for HUD by Integrated Financial Engineering, Inc., October 12, 2007, Available at http://www.hud.gov/offices/hsg/comp/rpts/actr/2007actr.cfm, Econometric Results Appendix, worksheet F30_Orig_CumC.

[37] Pollock at 2, 5.

[38] The average loss severity for 2006 FHA loans was 39.05%. On the one hand, 85% of FHA loans were originated at over 90% LTV for the period 2000 - 2007, so we would expect severities under this program to be lower than 39%. On the other hand, property values continue to decline. Thus, we conservatively assume average severities of 45%.
2007 Actuarial Review.

[39] See, e.g., Eugene A. Ludwig, "Viewpoint: Economic Sense in Foreclosure Plan," p. 11 American Banker (April 4, 2008); (former Comptroller of the Currency stating that the Dodd proposal is needed to stop the devastating fiscal and social effects of foreclosures and affirming that "bold legislative intervention is not just the right thing to do now but also sound economics. Government has an ethical responsibility to help citizens in trouble, many of whom were victimized by the unregulated and unscrupulous.")

[40] Because of the obligations of the servicer under the pooling and servicing agreement between servicer and the trust holding the loans, accounting (FAS 140) and tax (REMIC) rules, the servicer cannot accept a short payoff without having done an individualized determination that the borrower is likely to be foreclosed on and recovery from foreclosure is likely to be less. The consequences for the servicer to <u>not</u> make these determinations is sufficiently severe – they face lawsuits from investors under the pooling and servicing agreement, the off-balance sheet structure must be dismantled and brought back on-balance sheet to the original lenders, and the trust loses its pass-through tax status – that Congress should be able to rely on them to screen eligible borrowers.

[41] CRL Issue Brief, Solution to Housing Crisis Requires Adjusting Loans to Fair Market Value through Court-Supervised Modifications (Apr. 1, 2008), available at http://www.responsiblelending.org/pdfs/senate-bankruptcy-support-brief-feb27.pdf; see also http://www.responsiblelending.org/pdfs/senate-bankruptcy-support-brief-feb27.pdf.

[42] Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5; see also Bernanke Statement ("data collected under the Home Mortgage Disclosure Act suggest that nearly 40 percent of higher-priced home-purchase loans in 2006 involved a second mortgage (or 'piggyback') loan.").

[43] William Launder, Second Liens Proving Hurdle on More Refis, American Banker (Mar. 6, 2008) ("In better times, getting approval for subordination was considered a formality that at worst might set the borrower back a few hundred dollars in fees. But in today's tanking housing market, lenders are finding that a second mortgage is virtually unsecured, and they are doing what they can to protect their interests — even if that means making it harder for the borrower to get out of an onerous first mortgage."); Kenneth R. Harney, Actions Don't Match Words of Help, The Washington Post (Mar. 1, 2008) ("Bottom line: If you've got a second mortgage and need to refinance, there could be a big pothole in the road. The second-mortgage holder might stand in the way."); William Launder, Servicers Have Full Plate In Dealing with Seconds, American Banker (Feb. 20, 2008); Vikas Bajaj, "Equity Loans as Next Round in Credit Crisis", New York Times (March 27, 2008), available at: http://www.nytimes.com/2008/03/27/business/27loan.html?_r=1&hp=&adxnnl=1&oref=slogin&adxnnlx=1206626472-UGVenBqi0sm7/UXhhFpe9Q