ACCELERATING LOAN MODIFICATIONS, IMPROVING FORECLOSURE PREVENTION, AND ENHANCING ENFORCEMENT

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U.S. HOUSE OF REPRESENTATIVES

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CONTENTS

	Page
Hearing held on:	
December 6, 2007	1
Appendix:	
December 6, 2007	75

WITNESSES

THURSDAY, DECEMBER 6, 2007

Bair, Hon. Sheila C., Chairman, Federal Deposit Insurance Corporation	15
Calhoun, Michael D., President, Center for Responsible Lending	65
Deutsch, Tom, Deputy Executive Director, American Securitization Forum	40
Dugan, Hon. John C., Comptroller, Office of the Comptroller of the Currency	18
Green, Richard Kent, Oliver T. Carr, Jr. Chair of Real Estate Finance, George Washington School of Business, George Washington University	50
Hyland, Hon. Gigi, Board Member, National Credit Union Administration	20
Kroszner, Hon. Randall S., Governor, Board of Governors of the Federal Reserve System	17
Pearce, Mark, North Carolina Deputy Commissioner of Banks, on behalf of the Conference of State Bank Supervisors	24
Platt, Laurence, Partner, K&L Gates, on behalf of the Securities Industry and Financial Markets Association	63
Polakoff, Scott M., Senior Deputy Director and Chief Operating Officer, Office of Thrift Supervision	22
Schwartz, Faith, Executive Director, HOPE NOW Alliance	43
Shelton, Hilary O., Director, Washington Bureau, National Association for the Advancement of Colored People	46
Silver, Josh, Vice President for Policy, National Community Reinvestment Coalition	68
Silvers, Damon, Associate General Counsel, AFL–CIO	48

APPENDIX

Prepared statements:	
Kanjorski, Hon. Paul E.	76
Bair, Hon. Sheila C.	78
Calhoun, Michael D.	99
Dugan, Hon. John C.	110
Green, Richard Kent	124
Hyland, Hon. Gigi	130
Kroszner, Hon. Randall S.	148
Miller, George	160
Pearce, Mark	166
Platt, Laurence	178
Polakoff, Scott M.	181
Schwartz, Faith	191
Shelton, Hilary O.	205
Silvers, Damon	208

ACCELERATING LOAN MODIFICATIONS, IMPROVING FORECLOSURE PREVENTION, AND ENHANCING ENFORCEMENT

Thursday, November 10, 2005

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Sherman, Meeks, Clay, Baca, Miller of North Carolina, Scott, Green, Cleaver, Sires, Klein; Bachus, Baker, Pryce, Castle, Royce, Manzullo, Biggert, Miller of California, Capito, Hensarling, Garrett, Neugebauer, and McHenry.

The CHAIRMAN. The hearing will come to order. Can we get the doors closed, please? I apologize for the delay. This hearing was called prior to the recent announcement by the Secretary of the Treasury and the President about a restructuring but it does seem to me that it is very relevant. It has become even more relevant due to that.

Now we did call the hearing specifically to talk about further legislation regarding our bill on subprime, that is a complex and ongoing subject, and I will say that the Senate obviously is not going to act this year. We will have time to talk about further modifications that could be included in conference. It would be my intention to have this committee act on some of those before we do anything.

Our colleague from Delaware, Mr. Castle, had a very interesting bill that we thought about in conjunction with subprime and didn't have enough time. And on the other hand, many of us also believe that we need to do a little bit, maybe a moderate amount more in enforcement of the restrictions on inappropriate mortgages in general. There are—the pattern and practice is one possible view, but we are open, I believe, many of us, certainly my two colleagues in North Carolina and many others, to improving this.

I should also say that people had raised a question about some ambiguity in the language by which we seek to prevent people from being compensated for getting people into higher interest rate loans than they otherwise could have. And that was certainly our intention. People think there is some ambiguity. I always prefer redundancy to ambiguity. And in consultation with the gentleman from North Carolina, Mr. Miller, we have been working on it. If we get

to that, we will have language that will make it very clear that there was no such possibility.

I do then want to make two points today. One is a general point. What has been striking about the subprime crisis is not simply the subprime crisis, but the extent to which it has spread to be the most significant financial problem in the world, it seems, since the Asian financial crisis.

As I think about it, it does seem to me there is a problem intellectually and then ultimately politically that we and the Executive Branch and the Legislative Branch and in the private sector all working together have to solve, and that is, we need to find a substitute. It is a substitute for—the bank regulators are here, and I have always been told by bankers that the prime rule of banking was to know your borrower.

What has happened is we have created through a whole group of new methods a situation in which you not only don't know your borrower, but you have no idea who your borrower's borrowers were or are. That is, the nexus between the borrower and the lender, I believe, turns out to have been a more important safeguard than we thought.

We have been trying very hard, the private sector has, and some of us in the regulatory field, have been trying to find a substitute for the borrower-lender relationship. And we have been less successful than we thought. That's what risk management is. It's a substitute, it seems to me, for trying to know whether the person you lent the money to can pay you back. What we need to do is to figure out in not just the subprime, but in general, how we deal with that. That would be a subject of further hearings.

How do you keep the benefits of this increased liquidity and find some way to preserve, again, what had been the great safeguard of not lending money to people you don't think can pay you back? When you don't have to worry about whether they pay you back, and when the people who now own the loans don't know who in effect they lent it to ultimately, we have problems.

With regard to the proposal that the Administration has put forward, I welcome it. It is a recognition that the increase in the rates would cause serious problems and that some public sector concern with that is appropriate, that the market can't be left entirely to its own devices, although there is no violation of anybody's legal rights. But I did tell Secretary Paulson in a conversation this morning in fact that there are a couple of problems I have with it.

First of all, I think it is a grave error to say, as I understand the proposal does, that there's a cutoff at the 660 FICO score. Apparently, people have thought that a FICO score or credit rating was a good proxy for income. I don't think it is, and I think we would be making a great mistake, morally and also politically, if we tell two people who are otherwise similarly situated that the one who has been more careful about his or her credit is not going to get the benefit, and people who have been more or less careful will. I think the 660 FICO score is a great mistake. I understand there's a need for some kind of screen, but all of us I think, literally all of us, conservative, liberal, Democrat, Republican, etc., we have all been telling people, please, don't get into debt beyond what you can handle. Try and keep your credit score up. We have all been

telling people to keep their credit scores up. But to have a situation in which people who listened to us and got their credit scores up are now going to be worse off than other people who didn't keep their credit scores up, is a great mistake.

The other flaw, I think, from the standpoint of someone supportive of the general idea, and I welcome it, and I appreciate the initiative and I appreciate what Chairwoman Bair and others have done to urge its adoption, is the failure to do anything about a prepayment penalty. It seems to me that if you delay this for 5 years, that is a good thing, because the hope is that during that period, people can find some way to refinance and avoid the reset. But if they still face the prepayment penalty, as I understand it from Secretary Paulson, nothing in this proposal does anything about the prepay penalty except in effect to toll it, as the lawyers would say, just to push it down the road. But not having the prepayment penalty addressed, I think, is a flaw.

Finally, there is one where I do think there is a problem, but it is not the Administration's fallback. Now let me say here, I'm going to say this later, and—it is not comity. It goes against a lot of the norms, but I have to say that the increasing inability of the United States Senate to function is becoming a threat to governance. And that's not partisan. I know my Republican colleagues felt it when they were in the majority in the House and the Senate, and we feel it today. Senate norms, beyond partisanship, have evolved to that point.

I say that because one of the things that we would hope you would do with the time that is being bought by the 5 years is to help people get alternative financing. That means among other things, obviously not entirely, full use of the FHA for subprime borrowers, and full use of Fannie Mae and Freddie Mac.

This House passed, with a good deal of bipartisan support, differences about some aspects, but a good deal of bipartisan support on core principles for having the FHA and Fannie Mae and Freddie Mac more able to do this. They have been languishing in the Senate for a variety of reasons, and I hope that we will go forward with this. I believe it is a mistake to use that FICO score screen. I hope they will recognize that you need to do something about prepayment penalties, but I also hope that the Senate will act on the FHA and Fannie and Freddie, the GSE bill, so we can move forward.

The last point is just a question that my staff had raised with me, and I did not and I forgot to ask, and that is, does this allow for—or it does not allow for it, because people can still do what they want in the private sector—but does it contemplate negative amortization? If it does, that would be another grave error.

Putting off this reset and then having people get further into actual debt during that period would seem to be counterproductive, and we have not been able to determine whether that does or doesn't contemplate not doing negative amortization.

The gentleman from Alabama is now recognized.

Mr. BACHUS. Thank you, Mr. Chairman, and I thank you for convening what is really the latest of our hearings that the committee has held on the turmoil that continues to characterize the U.S. mortgage markets.

Since the committee's last hearing on this issue in October, the fundamentals in our Nation's housing markets have continued to deteriorate. Economic growth forecasts have been revised downward, and several of our Nation's largest financial institutions have written down billions of dollars worth of mortgage-backed securities.

What many had hoped would be a short-term market event that could be easily contained has instead become, in the words of Treasury Secretary Paulson, the largest single threat to the health of the U.S. economy.

Two years ago, I proposed a very unintrusive legislative solution to an emerging crisis in subprime lending, which was obvious to some of us. It included registration and licensing of all loan originators, both brokers and bankers, a mandate to regulators to adopt and enforce an ability to repay standard for subprime mortgages, and additional enforcement mechanisms to address unfair and deceptive, i.e., predatory lending practices.

At the time, we received some assurances, mainly from the industry, but also from regulators—and there were exceptions—that sufficient regulations were already in place and being enforced and that the market would, "take care of the abuses and excesses." Today we have reason to suspect those assurances. Undoubtedly, we know that the market is taking care of the excesses. Unfortunately, it is taking down the economy and lots more with it.

I'm still optimistic that a strong world economy will pull us through the current malaise, unless protectionist policies here in Congress gain the upper hand. With 100,000 new consumers entering the world economy every day, it's hard to believe that American companies won't benefit from that. And I think we're very fortunate that we have that backdrop to our current problems.

Although estimates vary, upward of 2 million subprime adjustable rate mortgages are expected to reset over the next 18 months. Very disturbingly, these are some of our poorest mortgages from an underwriting standpoint. They're even worse than the ones that have reset in the last year. If, as many predict, a significant number of these borrowers are unable to make their mortgage payments once their introductory rates expire, the result could be a wave of foreclosures that deepen the housing downturn and further damage our economy.

As we have heard in previous hearings, the consequences of foreclosure extend far beyond the individual parties to a residential mortgage contract, affecting entire communities and straining the resources of local governments forced to deal with blighted neighborhoods and declining tax revenues.

To avoid massive foreclosures, the Treasury Department, the FDIC, regulators, and some of the Nation's financial institutions have been actively engaged in efforts to identify and assist borrowers who are in danger of falling behind when their interest rates reset in the coming months.

The Administration, as the chairman said, is expected to announce today an initiative that would expedite the loan modification process by freezing the interest rates on hybrid adjustable rate mortgages where the borrower has demonstrated an ability to make payments at the lower introductory rate, but will be unable

to do so once the rate adjusts upward. While I intend to reserve judgment on the Administration's plan until all the details are known, I commend Secretary Paulson and Chairman Bair and others who have taken an activist role. They should be commended for encouraging innovative private sector solutions to a problem plaguing the mortgage market and American homeowners.

Congress has a role to play as well. The House has previously passed legislation to establish a nationwide registry of mortgage originators; to address abusive mortgage lending practices, which have led to today's problems; to modernize the FHA program so that it can assist a wider range of worthy subprime borrowers; to reform the GSEs and the oversight of the GSEs, which play such a critical role in providing liquidity in the mortgage market; and to provide tax relief to homeowners whose lenders have forgive portions of their mortgage debt. All of these measures await action in the Senate, and I would hope that the other body would find time on its calendar this year to move forward on some of these initiatives before events overtake us and market conditions deteriorate further.

There's a broad consensus now that something must be done to mitigate, if possible, an inevitable surge in foreclosures as loans reset. As we consider what positive steps should be taken, we must recognize that the best public policy is to address obvious destructive and predatory financial practices before the market and consumers fall victim, and before they become prevalent, so prevalent that a crisis mandates a legislative cure, which may have its own negative consequences.

Benjamin Franklin had it right when he said an ounce of prevention is worth a pound of cure. A word of caution is in order regarding proposals for wholesale corrective action. There is significant risk and concern in at least three areas: One, people who are able to pay and are not eligible for modification may feel unfairly treated. Questions of fairness, moral hazard, and equity are inevitable.

Two, litigation can be expected from several quarters. A change in the fundamental structure of our mortgage markets over the past 30 years has resulted in multiple parties to almost every mortgage contract, including sometimes tens of thousands of investors per contract.

Three, despite denials, we know that there will be costs. What are the costs, and who will bear them? There will be significant objections to having the public bear even a portion of the cost of these loan modifications.

In conclusion, Mr. Chairman, we also need to remember that there are already laws and regulations available to deal with predatory loans. Under the Truth in Lending Act, the Federal Reserve and other regulators already have the power to act to curtail unfair and deceptive acts and practices. Additionally, the FDIC and I think the OTS have asked for this authority. Indeed, the Federal Reserve is expected to issue proposed regulations later this month to address abusive mortgage lending practices pursuant to its authority under HOEPA. An energized and motivated regulatory community can address many of the worst cases without action by Congress going forward.

In closing, let me again commend the chairman for holding this hearing and the gentleman from Delaware, Mr. Castle, for his efforts on behalf of American homeowners. Thanks also to all our witnesses for being with us today. We look forward to your testimony.

The CHAIRMAN. I thank the gentleman. I would just add, if I could get unanimous consent, he referred to the OCC and the FDIC's interest in being able to promulgate unfair and deceptive. As members remember, the House unanimously passed a bill giving them that authority yesterday. So, one more we can add to our wish list over there, and we are well on the way to having that happen.

The gentleman from Pennsylvania.

Mr. KANJORSKI. Mr. Chairman, I commend you for convening this hearing on loan modifications. I share your concerns about the need to advance workable solutions to help borrowers who might lose their homes as a result of deceptive lending. We must also protect the stability of our financial institutions to protect against systemic risk and maintain the strength of the U.S. economy.

Predatory lending is a complex problem that requires a comprehensive national solution. I have long believed that a solution must consist of five main points: reforming underwriting standards; establishing registry systems for originators; bettering housing counseling; improving mortgage servicing; and enhancing appraisal independence.

As a result of the amendment that I offered on the Floor last month on escrow, appraisal, and mortgage servicing reform, the House-passed lending reform package addresses each of these issues. However, I am now convinced that a comprehensive solution now requires a sixth part because of the market uncertainty. We need to address the issue of homeownership preservation.

As a result, I and the other leaders on the Capital Markets and Financial Institutions Subcommittee sent a letter this week to the corporate executives in discussions with the Treasury Department about a private solution to this problem. While I look forward to the Treasury Secretary's announcement on these matters later today, we will likely need to move a bill on these matters, and I am putting together such legislation.

I have identified three principles that could help to guide our discussions for this task. First, we should refrain from using government resources to bail out those lenders who made bad loans or who relied on faulty underwriting standards.We should also limit the use of government resources to subsidize those homeowners who actively participated in schemes to purchase homes beyond their means, or who are here illegally.

Second, we should, to the maximum extent possible, apply market-based approaches that rely on minimal government involvement to address these problems. While the Treasury Department is making progress on this point with its plan, we need to do more. For example, my approved mortgage servicing proposal already mandates swifter response time by mortgage servicers to consumer inquiry. If enacted, this change ought to help ensure that homeowners will receive expedited assistance in the months ahead.

Third, we should identify those initiatives that have worked to address similar problems in the past and apply them around the country. Pennsylvania has already pioneered efforts to provide help to homeowners in danger of losing their home with a refinance to an affordable loan, the REAL program, and a homeowner's equity recovery opportunity, the HERO loan program. We might consider how to implement these initiatives in the national arena.

In conclusion, Mr. Chairman, identifying and putting in place policies to decrease foreclosures, preserve homeownership opportunities, and protect our economy is a complicated set of tasks. We need to approach this solution with an open mind and have flexibility to consider and advance the most pragmatic and practical policy solutions that can obtain bipartisan support. I am committed to achieving this consensus.

The CHAIRMAN. The gentlewoman from Illinois is recognized for 3 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. And I'd like to thank you today for holding today's hearing. It is one of a dozen that we have held to examine problems in the mortgage market, and I think we have made significant progress in examining and addressing the problem, but we have much more to do, and so I'd like to make just a few brief points.

First, that mortgage loans must be restructured. On this point, I'd like to commend all of the participants in the HOPE NOW initiative. Many people in the industry and the Administration have been working very hard to develop a solid mortgage restructuring plan that will help people keep their homes. I haven't seen the plan yet, but I hear that it might be released this afternoon, and I look forward to reviewing it.

As I have said before, I would be happy to offer my assistance in working out some commonsense legislative fixes to help borrowers in trouble. Additionally, I strongly support private sector market-based solutions. What I don't support is a taxpayer-funded bailout or special assistance to real estate flippers, illegal immigrants, or those engaged in fraudulent behavior.

In fact, just yesterday, as Congressman Kanjorski mentioned, he had Congresswoman Pryce and Congresswoman Maloney and me send letters to lenders offering our assistance and input on this very goal. And, Mr. Chairman, I'd like to submit those letters for the record as well.

Mr. KANJORSKI. [presiding] Without objection, it is so ordered.

Ms. BIGGERT. The second point I'd like to address should go without saying, and that's FHA reform. The FHA could be a viable alternative to predatory loans for many first-time homeowners, and a number of those currently facing foreclosure.

The House did its work, and the Senate sits on it again. This is a disappointing repeat performance from the last Congress, and we need to encourage the Senate to pass FHA reform now.

My third point is that housing counseling must be promoted. It is something many of us in this room have pushed for, for many years, so let's do it. Let's provide more funding for our HUD certified housing counselors. Too many people in mortgage trouble are afraid to contact their lender when they need help, and these coun-

selors are available to assist any homeowner who calls at 1–888–995–HOPE or 1–800–569–4287.

Finally, I'd like to say how encouraged I am to be looking at some new creative proposals here today. The first offered by Mr. Castle looks at incentives for the mortgage industry to restructure at-risk loans, and the second authored by Chairman Frank, Mr. Miller, and Mr. Watt is aimed at imposing civil monetary penalties on some bad actors in the mortgage lending industry.

I would like to thank these members for their leadership, and I look forward to hearing from today's witnesses about this legislation and any additional ideas that they may have.

With that, I look forward to today's discussion, and I yield back.

Mr. KANJORSKI. Thank you. Next we'll have Ms. Waters of California.

Ms. WATERS. Thank you very much, Mr. Chairman, and members. I'm very pleased that we're holding this hearing. It is absolutely one of the most pressing issues confronting this country today, foreclosures and the loss of homes.

Last week the Housing Subcommittee held a hearing in Los Angeles on foreclosure prevention and intervention. We were interested in looking at what servicers were doing to help families either in foreclosure or at risk of foreclosure. The news at that time certainly was not encouraging. We heard from homeowners grappling with foreclosure, or worse, bankruptcy, to contend with servicers who say they're willing to work with them but in reality, homeowners are complaining about calls that they're making to their banks and financial institutions, or, if they are lucky enough to find out who their servicers are, calls that are not being returned, and no answers.

I walked away from that hearing secure in the knowledge that servicers, securitizers, and even we here in Congress will have to do more if we are to stave off the foreclosure epidemic that is spreading through this country. California has been especially impacted by the wave of current and impending foreclosures. According to third quarter data, California has seven cities among the top nationally in foreclosures, although the Los Angeles area ranks 26th in terms of its foreclosure rate, with one foreclosure filing for every 113 households, it has the second highest number of foreclosure filings, with almost 30,000 filings on 19,000 properties.

At last week's field hearing, Los Angeles Mayor Antonio Villaraigosa testified as to the problems facing the City as a result of foreclosures. These problems include vacant and unkempt properties, evictions of renters, reduced property values, reduced gross metropolitan product, and reduced revenue to the government.

It is clear that this is a crisis that is affect homeowners, neighborhoods, communities, cities, and States. We need a solution now. It's absolutely clear that the threats of lawsuits and tranche warfare are contributing to the reluctance of securitizers to do right by our homeowners, our neighborhoods, and our economy. Indemnification seems like a reasonable solution to this concern. However, the absence of indemnification should not prevent servicers from doing the right thing—allowing our hardworking families to stay in their homes.

I'm very much interested in hearing the witnesses' views on this issue. But in closing, I must say that I remain unimpressed with the efforts of servicers, securitizers, and the Administration in dealing with this crisis. I am unimpressed with the efforts of the HOPE NOW Alliance. On Monday, Secretary Paulson outlined vague details of a plan to assist families with resetting ARMs who were at risk of foreclosure. Now it seems that plan is being more fleshed out, although we have yet to see the details. I have to say that I wish Secretary Paulson, who is not here today, would have started this process months ago, and I wish he would have started this process when Chairman Bair was advocating freezing these ARMs at the starter rate.

And I'm very, very disappointed that I woke up to the news this morning that Chairman Bair had moved away from her very good proposal to freeze the ARMs at the starter rate. We may never know how many borrowers could have kept their homes if the process would have been started sooner than later, and my initial review of the plan that the Administration is announcing is that is only going to help a very, very small number of people.

So I'm anxious to hear from our presenters here today so that we can hear what justifies this very limited proposal that is being put before us. I'd like to have some answers about why the majority of those who find themselves in trouble are not going to receive any assistance. With that, I yield back the balance of my time.

The CHAIRMAN. The gentleman from Delaware, Mr. Castle, for 5 minutes.

Mr. CASTLE. Mr. Chairman, thank you very much and thank you very much for calling this important hearing.

The housing situation confronting us is serious, complex, and far-reaching. No single or simple solution is going to fix the problems facing homeowners, lenders, loan servicers, markets, and investors. While I supported many of the reforms embodied in H.R. 3915, I believed then as I do now that those reforms are for the future, and intended to avoid some of the circumstances we find ourselves confronting today. It was clear when work on that bill ended, this committee would need to turn its attention to the present and address the facts unfolding before us. So I applaud you, Mr. Chairman, for bringing this committee together again and focusing our attention on the here and now.

During consideration of H.R. 3915, I offered and withdrew an amendment that would create a temporary, legal safe harbor for creditors, assignees, servicers, securitizers, or other holders of residential mortgage loans while loan modifications or workout plans were under way. I worried that lawsuits would stall or stop modifications. While this amendment was simple to describe, it is not without some complications in its application.

Therefore, after consultation with the chairman and ranking member, we decided the more prudent approach was to introduce this as a bill and fully vet these provisions at a hearing. I am interested in what our distinguished panelists have to say about H.R. 4178 and recommendations they may have for the language. However, I remain quite concerned that at any point some party could file suit and many or maybe all the efforts being made to modify

loans would come to an abrupt stop. That would be most unfortunate.

And, finally, how do we calculate the number of loans that may be at risk that bypass Federal regulators altogether when mortgage bankers took loans directly to Wall Street? There are a number of other statistics that need to be understood, but the point I am making is this: How are we to judge the progress of these modification efforts months from now?

Mr. Chairman, I believe that in foreclosure procedures, almost everybody is a loser: the individual homeowner; the neighborhood; the lenders; those who may hold the notes on it; or whatever it may be. The only winners may be lawyers handling the legal aspects of it. But other than that, there's nobody else. And I did not know the Executive Branch plan that we're seeing unfold now when all this was suggested and all this has to be obviously tried to fit in together. And let me just say, I'm open to suggestions. I don't necessarily believe that what I have written and submitted is necessarily the be all to end all. I just think we as a committee need to work hard on solutions, and whatever is the right way to go is where I'm willing to go.

With that, I yield back.

The CHAIRMAN. The gentlewoman from New York for 3 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, and I thank you for holding this hearing and I thank our witnesses for being here today for the ongoing series of hearings that this committee and the subcommittee have held about the subprime mortgage crisis and its effects on the overall economy.

By all accounts, we have not felt the worst of the housing slump. Millions of Americans are worried that they will not be able to afford to stay in their homes. In this committee and the House of Representatives, we have passed sweeping mortgage reform, anti-predatory lending legislation, as well as legislation to shore up the Federal Housing Authority and the GSEs. But tremendous uncertainty remains about how the subprime fallout and the housing slow-down and the credit crunch will affect the broader economy.

Financial markets continue to suffer by almost daily disclosures of wider subprime exposure for major banks and financial institutions. Apparently, some investors did not understand what they were buying when they held CDOs and CIBs. The markets need a better understanding of their exposure to risk. I applaud the agreement reached yesterday between the mortgage industry and the Administration to freeze interest rates on some mortgages. But today we are considering other steps we can take to encourage servicers to engage in work-outs with borrowers that will revise the mortgages so as to prevent default and foreclosure.

From the start of this crisis, it has been clear that servicers are perhaps the only participants in the complex, subprime mortgage market who have the ability to revise mortgages. And in recognition of this, this committee has taken steps to help them before, for example, by eliminating the unnecessary accounting complications from a misinterpretation of FAS 140 that could have prevented work-outs. This proposal goes further, and I compliment my colleague, Mr. Castle, in his work. But even it is just one small step, just one head of this complex and mini-headed hydra. There are

still a number of other steps such as final passage of our House FHA and GSE bills and reform of the Bankruptcy Code that must be considered priorities to help Americans keep their homes.

Chairwoman Sheila Bair and Secretary Paulson's initiative to spearhead a public/private effort, specifically to address foreclosure, is overdue, but very, very welcome. I look forward to your testimony today.

The CHAIRMAN. The gentleman from California for 3 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

We do not want to go down the road of having a government bailout to try to handle this problem. That would be hundreds of billions of dollars once we started that process. And so there is the possibility here of some voluntary workouts in the market, and the Treasury Secretary hasn't been involved in that. I think as we look at this problem, we have 95 percent of the American people right now able to make their mortgage payments on time.

But there is a huge problem coming in 2008, because 5 years ago, the interest rate was effectively one percent the discount rate and, as a consequence, that 5 years comes due for all of the individuals who took out those 5-year ARMs, principally in 2008. So that's when you're going to have this huge spike. There's going to be a question of whether the servicers can even handle the sheer numbers there.

Now, a lot of those individuals are going to lose their homes anyway—those involved in flipping, the speculators—a lot of them will lose their homes. But there's a significant percentage of people who would be able to continue to make their mortgage payments at the existing rate if they didn't have to go through the closing costs, the appraisal issues, and everything that goes with trying to get a loan at a higher interest rate.

And the consequences of that, of having people able to do that, will have a profound affect in terms of the spikes that we would otherwise see in foreclosures. What we worry about in these foreclosure spikes are not just the impact on the individual who loses his or her home, it is also the impact on the communities, on the neighborhoods. Because once that begins to compound, once those home values begin to decrease in those neighborhoods, we have a considerable problem.

Now there are certain incentives on the part of lenders and investors and borrowers, because they're the ones, besides the homeowners, that are also negatively impacted. They lose 30 to 50 percent of the value of that loan when a foreclosure occurs. So they have an incentive to be at the table right now, and the Treasury Department is trying to bring them to the table to work out an arrangement in which people can stay in their homes if they can continue to make those payments at the current interest rates they're paying.

That is what we are discussing today. If lenders and investors and servicers believe they can benefit from renegotiating a mortgage, they should do so, and we should not be an impediment to their efforts to do so. And so the current housing market turn-down frankly for us here seems to be the biggest impediment our economy faces. So we want to encourage the Treasury Secretary in his efforts here. In terms of pre-payment penalties, with work-outs,

with borrowers, these are being waived routinely now anyway. So I think we look forward to hearing the testimony, but I'd like to commend Secretary Paulson and all of the regulators for working with the private sector to come up with a potential solution that is not a government bail-out, but one that is based on a voluntary concept, that we don't want to see 30 to 50 percent costs go up in these foreclosures to the borrowers if it can be prevented.

I wish them well with that endeavor.

Thank you again, Mr. Chairman.

The CHAIRMAN. The gentleman from New York for 2 minutes, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman. And I want to thank the chairman for this most important hearing that we're here for today.

And I look forward to hearing the testimony from the individuals who are on the panel this morning, because to me we are at a crucial time, and I think that we need to do many things. And I would like to hear what you're saying, but I'll be quite honest. I'm focused, not on the speculators, not on the flippers, not on the people who were involved in real estate for business purposes, but for those average American citizens who simply wanted the American dream.

And they were able to purchase a house, and that house is their dream. Because what's at stake for them if they lose their house, if they go into foreclosure, is that they will never, ever be able to have that dream again. They will never, once you go into foreclosure, be able to buy a home again. They will never be able to provide for their families again. They will never be able to have the kind of appreciated asset that a home should bring so they can send their kids to school later on in life.

That's what's at stake here, the very essence of what America is all about. And that's why we need everybody to come together to try to figure out how we save not just a couple of people, but the mainstay of these individuals who basically just wanted to live the American dream, how we save them and keep them into their homes.

Now, ultimately, we have to stop and pass legislation that goes after the predator, that goes after the individual who is greedy and wants to rip people off. We have to make sure that we stop that. But I want to just say that the other thing that we need to do—I think this is a crying call that we institute in every private and public institution in American financial literacy—that we start teaching our young people at a very young age to look at it.

Because one of the things that someone who is predatory, the best way to eliminate anybody that wants to put a predatory loan is to give them an educated consumer. And until we're making series at every school and every child begins to receive financial literacy, then we are going to have some people who are going to slip through the cracks and become a victim of some kind of predatory loan.

So I'm anxious to listen to what you have to say today, but it's urgent that we do something, because I believe that the very essence of middle America, people who believe in America and America's dreams are at stake here.

I yield back.

The CHAIRMAN. We have 5 minutes left, 4 on this side, and 1½ on the other side.

The gentleman from New Jersey for 2 minutes.

Mr. GARRETT. Thank you, Mr. Chairman, for holding this important meeting. And I also want to compliment Mr. Castle for his efforts to at least begin trying to address the growing problems that are arising between investors, the lenders, and the borrowers, as they all attempt to refinance certain subprime loans that might be heading towards foreclosure.

As we all know, no one wins when a loan fails. The investors, lenders, and borrowers all experience some sort of loss when a loan goes bad. It is essential that a subprime market, the participants there, that we work with each one of them. And we look forward to hearing more details about the various plans today.

But with that said, I want to do all we can to help stem the current housing troubles being experienced. I do have concerns that too much government interference can have severe, long-term consequences in the future. I feel that a bail-out, as some on the other side of the aisle have suggested, would encourage riskier lending practices, further erode market discipline, and saddle taxpayers who did absolutely nothing wrong with the burden of paying for other people's mortgages.

I do want to applaud the Treasury Secretary for his efforts in bringing together all of the different participants in the mortgage loan process to try to work together and to facilitate a reported agreement that can keep more people in their homes, provide investors with a maximum return on investment, and prevent the current mortgage market problems from trickling into other parts of the economy. But, again, I look forward to reviewing the details of this agreement in more detail. I do have some initial concerns in its conceptual approach.

In a front-page article in The Washington Post today about this supposed agreement, they interviewed an average American, middle-class, a D.C. resident, in fact—someone who had been renting and had the opportunity to buy his 600 square foot apartment for $310,000 in late 2004. But he thought then that it was "absurdly overpriced." He went on in the article to explain his concerns with this reported agreement that we hear: "Now the government is rewarding people who made irresponsible decisions and bought homes beyond their means. There are those of us who purposely sat on the sidelines during the course of the last 3 years while this senseless frenzy was going on. And we presumed that the free market would be allowed to correct itself. The government is now meddling in the market and looking to prop-up lenders and borrowers alike and those of us who wisely bided our time got screwed."

Whenever the government overly interferes with the marketplace, there is the potential to create a so-called moral hazard that can affect future economic decisions and transactions. It is very plausible to suggest that the government effectively bails out everyone in this mess. We will continue to bail out bad actors in the future.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California, Mr. Baca, for 2 minutes, and then one more, Mr. Neugebauer.

Mr. Baca, then we'll go vote. Two minutes, quickly.

Mr. BACA. Thank you very much, Mr. Chairman, for convening this hearing. It's important.

California, more than any other State in the Nation, has been impacted by home foreclosures; 7 of the top 16 metropolitan areas with the highest rate of foreclosure in the Nation are in California, and especially in San Bernardino, number one in the Nation now in foreclosures in San Bernardino County, which is my area, where one in 33 homes in San Bernardino, Riverside County, are currently losing their homes.

And as the gentleman from back here indicated, Mr. Meeks, this is the dream of everyone, to own a home, the American dream. And many of these individuals have lost their homes. And when they lose their homes it's very difficult to replace them. They lose continuity within the community. They lose self-esteem. They lose confidence within themselves in terms of building hope for many of the individuals. And we're going to continue to lose more homes.

Our families are being torn apart by this crisis that's impacting them. It's impacting them going to school. Drop-out rates have increased in a lot of the areas because of the foreclosures. So it's also impacting there. Today the President is going to unveil a plan to freeze mortgage rates, but already the plan appears to fall short of what is needed, and too many families will be left out. We can't afford to leave these families behind. Foreclosure leads to, as I indicated, vacant lots, reduced property values, increased crime rates, and a depressed economy.

There are some lenders that have taken proactive stands to help these families stay in their homes. In California, Countrywide, GMC, and Litton Home & Equity who together serve more than 25 percent of the subprime mortgage loan issued nationwide, have agreed to a fast-track loan modification. But what about the rest of the industry? When are they going to step up to the plate? We need the other industries to also step up to the plate. This is a crisis. We need to address it. I appreciate our chairman taking the leadership on this. We must address it. We must continue to make sure that people have the American dream of owning their homes, retaining their homes, and staying in their homes. They waited too long. It's time that we addressed the problem.

Thank you very much, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas for 2 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

I think it's very clear here that this room is full of people with good intentions. And now the real challenge is to turn all these good intentions into good solutions. I would make just a few points. I appreciate the fact that the Administration has been having dialogue with industry through this process. I think that is important.

I think one of the slippery slopes here that we are moving down, we have to be very careful as we move through this process is government picking winners and losers, trying to distinguish between borrowers who have been doing the right things and are going to be penalized, because in fact they were doing the right thing, where we have borrowers who maybe weren't doing the right things and they are now somehow going to benefit from taking advantage of this.

The other thing is that we have to be very careful. We have very efficient markets. They're not always kind, but they are very efficient. And when they clean up a mess, they tend to be pretty swift. But the clean-up is generally a clean process. I think a lot of lessons have been learned and I think a lot of the legislation that we may be looking at, I don't think we have to worry about that behavior in the future, because there have been some very painful lessons.

But I think we have to be very careful here of how we influence market behavior in the future, because what we may in fact do is cause such uncertainty in the markets that the overall cost of mortgages go up. Because people looking at securities that are issued in the United States of America have some danger that the Federal Government might manipulate those contracts, and we've had that conversation in previous hearings.

I think the overall process here—I have been a mortgage lender and I have been a mortgage borrower, and no greater stakeholder interest exists other than between those two entities. And so I think it's very important that we let that process manifest itself. When we start putting third parties in there trying to negotiate what's in the best interest of one or the other, I think that's sometimes dangerous. I have sat across the table from borrowers in the past and sat down, and we worked out a solution that was in their best interest and the best interest of the institution that I represented, as well as I've sat down at a desk and worked out with my lender what might be in the best interest of myself and the lending institution that I borrowed that money from.

So let's be very careful as we move down that road that we let the market forces work the way they should. Let's let the business models that were instituted when these securities were put together work through that process. But let's be very careful not to let the Federal Government cause disruption in these markets in the future.

And thank you, Mr. Chairman.

The CHAIRMAN. We will now go and vote, and we will come back.

I apologize to the panel, but that's life.

[Recess]

The CHAIRMAN. We'll begin, thank you, with the Chairman of the Federal Deposit Insurance Corporation, Sheila Bair, who has in my mind played a very constructive role in our efforts to minimize the problems we face.

Madam Chairwoman?

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Chairman Frank, and members of the committee, thank you very much for the opportunity to testify today. As you know, the rising level of foreclosures across America is of great concern to everyone, and we're just getting into the thick of the problem.

Some 1.7 million subprime adjustable mortgages will reset by the end of 2009; 1.5 million of these borrowers are paying their mortgages on time, but hundreds of thousands could soon be forced into default because of unaffordable resets and insufficient equity to re-

finance. Wide-scale foreclosures will result in significant losses for investors and do great harm to communities and neighborhoods across America, especially those already hit hard by the housing downturn. What we need are commonsense solutions that are effective and long-term.

Last March, the FDIC hosted a series of meetings with regulators and industry to determine the authorities of servicers to modify loans expected to default. We determined that significant authorities to modify loans did exist. The regulators subsequently issued joint guidance emphasizing these authorities and encouraging servicers to use them. Yet, as we entered the third quarter of this year when re-sets began to go up, foreclosures kept rising, and loan modification levels remained low. So last September the FDIC made its own commonsense suggestions for systematic modifications.

Specifically, for owner-occupied homes where borrowers are making the payments on time but clearly can't afford the reset payments, we suggested fast-tracking them into long-term sustainable payments at the starter rate. Keeping borrowers at the starter rate minimizes the need for re-underwriting because the loan already has a performance history at that rate. Limiting the proposal to owner-occupied properties helps assure that borrowers being modified are motivated to hold onto their properties and keep paying. Because of the huge number of troubled loans, individually renegotiating each of them is costly and too time-consuming, so we suggested a systematic approach for this category to free up servicer resources to deal with the harder cases. I am delighted to say that our jaw-boning has been turned into action by industry working with government leaders.

Governor Schwarzenegger announced recently an agreement with four major subprime lenders to work with homeowners unable to afford escalating mortgage payments. His plan is in line with our proposal, and we support it. Later today, the White House and the Treasury Department are expected to unveil an industry-led plan for helping homeowners struggling with their mortgages, which also draws upon our suggestions.

To the critics who say such large-scale approaches are untested and unworkable, we say it's already being done successfully.

Those companies with active loan modification programs tell us they're saving time and money and they're keeping people in their homes. To those who say modifications are unfair, we say we have a difficult situation and there are no perfect solutions. The modifications are preferable to wide-scale foreclosures, which hurt not only borrowers, but neighborhoods, communities, and potentially the economy at large. Investors also benefit from loan modifications, because they maintain continued cash flows in today's market that will exceed the value of returns from foreclosing on a property. Just about anything beats foreclosure, which runs down neighborhoods and can cost up to half of the initial loan amount.

Mr. Chairman, the FDIC is committed to working with you to find solutions to the growing mortgage crisis, to mitigate damage to the economy from the housing market, and to give subprime borrowers who are willing and able to pay, a mortgage they can afford.

Thank you very much.

[The prepared statement of Chairman Bair can be found on page 78 of the appendix.]

Mr. KANJORSKI. [presiding] The Honorable Randall Kroszner, Governor, Board of Governors of the Federal Reserve System.

STATEMENT OF THE HONORABLE RANDALL S. KROSZNER, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KROSZNER. Thank you very much.

Chairman Frank, Ranking Member Bachus, and members of the committee, I appreciate the opportunity to appear before you today to discuss the recent problems in the subprime mortgage market and possible legislative solutions.

We continue to work to find and implement the best and most sustainable solutions to the current challenges in the market. First, we've worked to increase coordination among regulators in the enforcement of consumer protection laws and regulations. Earlier this year, for instance, we launched a cooperative pilot project with the Federal and State agencies to conduct reviews of certain non-depository lenders involved in the subprime market. And that pilot is proceeding.

Second, the Board along with the other Federal banking regulators has also worked to guide federally-supervised institutions and servicers as they deal with mortgage defaults and delinquencies. We support servicers' efforts to develop prudent work-out solutions, because foreclosure is a costly option for consumers, investors, and communities, and should be avoided when other viable options exist.

We also support servicers' collaborative efforts and creative efforts to scale up their activities to help borrowers on a more expedited basis, and in a cost effective way, without restricting capital availability in the market. However, loan modifications must be made prudently with proposed solutions that are sustainable in the long run.

Third, the Board continues to work towards more effective consumer protection rules. In the next 2 weeks, we will propose changes in the Truth-In-Lending Act, TILA rules, to require earlier disclosures by lenders and address concerns about misleading mortgage loan advertisements. At the same time, we will also request public comment on significant new rules under the Home Ownership Equity Protection Act, HOEPA, that would apply to subprime loans offered by all mortgage lenders to address unfair and deceptive mortgage practices.

The practices that we have been looking at include pre-payment penalties, failure to escrow for taxes and insurance, stated income and low-documentation lending, and failure to give adequate consideration to a borrower's ability to repay the loan.

Congress has also expressed understandable and appropriate concern about subprime lending and the challenges in the mortgage market more generally. The Mortgage Reform and Anti-Predatory Lending Act of 2007, which was passed by the House of Representatives, is designed to extend additional oversight and consumer protections in the market. We were asked to comment on

two issues not addressed in the current version of the Act that could be addressed through amendments or other actions.

One issue is the possible legal exposure of mortgage servicers who enter into loan modifications or work-out plans. There are many good reasons to be proactive and systematically reach out to borrowers. Servicers may often be able to offer alternatives that keep consumers in their homes in ways that are transparent, predictable, and in keeping with the general principles of safe and sound banking.

Borrowers who have worked hard to build their credit history over time, for instance, may see their options shrink if they get behind in payments and see their credit scores fall. Thus, it's important to reach out before stressed borrowers get behind.

We understand there are challenges with systematic approaches, including concerns about litigation. We encourage ongoing industry efforts to agree to standards for addressing these issues. We are hopeful that the industry can resolve these conflicts on a consensual basis, so they do not preclude servicers from taking actions that would otherwise be in the overall best interest of consumers and the industry. We encourage industry to work diligently to find sustainable solutions in the problems facing borrowers today.

A second issue that we were asked to comment on is the possible imposition of civil money penalties when the enforcement agencies find that there is a pattern or practice of violations. We would recommend that any such penalties be given a ceiling as well as a floor, because the market uncertainty that can be introduced by open-ended liability, and thereby potentially reduce the flow of funding to the sector.

We would also suggest that some discretion in the actual amount of the penalty, within a range, be given to the enforcing agencies. We would also encourage Congress to look at the resource needs of the agencies that are authorized to undertake the enforcement actions to ensure that sufficient resources are available for this important role. The Federal Reserve looks forward to continuing to work with Congress and others to craft sustainable solutions to these very difficult problems. Thank you very much.

[The prepared statement of Governor Kroszner can be found on page 148 of the appendix.]

Mr. KANJORSKI. The Honorable John C. Dugan, Comptroller, Office of the Comptroller of the Currency.

STATEMENT OF THE HONORABLE JOHN C. DUGAN, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Thank you Mr. Chairman, Ranking Member Bachus, and members of the committee. Today's hearing focuses on mortgage loan modifications, and explores two proposed amendments to the recently passed mortgage legislation. I want to focus my remarks today on the general issues involved with loan modifications.

Subprime adjustable rate mortgages typically provide for a lower starting rate that resets to a significantly higher rate over a 2- to 3-year period, the so-called 2/28's and 3/27's. The volume of such mortgages increased substantially over the last several years, into the first part of 2007. And as a result, with the passage of time,

the nation's mortgage markets now contend with a large volume of subprime ARMs that reset each month, a process that will continue through at least the end of 2008.

Because the monthly payment on these loans can increase substantially at reset, by 25 percent or more, borrowers almost always refinance into new mortgages at the time of reset, assuming that they are able to do so.

During the recent years, a significant house price appreciation in many parts of the country, the vast majority of subprime ARM holders were able to refinance at reset into new mortgages because of the increased value of their homes.

Conversely, with house prices becoming flat, or declining in many parts of the country during 2007, it has become increasingly difficult for many subprime ARM borrowers to refinance. While many such borrowers who remain current on their loans are still able to refinance at market rates or into FHA products, an increasing number have either fallen behind on their existing payments or face the prospect of falling behind when rates reset and they are unable to refinance.

There has been a vigorous and very healthy debate about how best to address widespread subprime resets, and the prospect of large numbers of defaults and foreclosures.

The outcome of this debate is obviously critically important to subprime borrowers in the first instance, and also to their creditors, typically, investors who hold interest in securities backed in whole, or in part by subprime ARMs.

But another critical stakeholder in the process is the mortgage servicers, one of whose jobs is to implement foreclosure when necessary, or in the alternative to make any loan modifications that may be appropriate to keep mortgage borrowers in their homes, while mitigating the substantial loses that would accrue to mortgage lenders from foreclosure.

National banks that service subprime loans have been working to balance the sometimes competing interests of borrowers and investors. Given the large number of resetting ARMs, and the potentially large number of borrowers who may be unable to afford the higher monthly payments at reset however, there is very good reason to explore new approaches to handling these issues on a broader scale.

Under these circumstances, it does make sense to try and identify a programmatic approach that would facilitate modifications of large numbers of mortgages quickly using a common set of criteria. Of course, and this is important, any programmatic approach should not prevent borrowers who do not qualify under the programmatic criteria, from qualifying for loan modifications based on a case-by-case evaluation of their ability to repay under modified terms.

Indeed, for many borrowers who are already delinquent, have already entered foreclosure proceedings, or will not qualify for this broader program, the loan-by-loan approach will continue to be the best hope for avoiding foreclosure.

That said, there will be a significant number of borrowers who are current on their payments at the initial rate, but will not be able to afford payments at the higher reset rate, or to refinance

into market or FHA mortgages. A programmatic approach to modification makes the most sense for these borrowers. Interested stakeholders in the lender servicer, and investor community, have been in intense discussions over the past weeks, to develop just such an approach. And it is our understanding, as has been announced today, that these stakeholders have indeed reached an agreement, and although we have not yet seen all the details, we very much support that approach in principle, thank you very much.

[The prepared statement of Comptroller Dugan can be found on page 110 of the appendix.]

The CHAIRMAN. Next, we have Gigi Hyland, who is a member of the board of the National Credit Union Administration.

STATEMENT OF THE HONORABLE GIGI HYLAND, BOARD MEMBER, NATIONAL CREDIT UNION ADMINISTRATION

Ms. HYLAND. Thank you Chairman Frank, Ranking Member Bachus, and members of the committee. I appreciate this opportunity to testify on behalf of the National Credit Union Administration, regarding proposals to help consumers reduce the risk of foreclosure.

I will address H.R. 4178, introduced by Representative Mike Castle, and an amendment to strengthen the regime for civil penalties against creditors who engage in unfair or unscrupulous lending practices.

In addition, I will briefly discuss the FDIC alternative to H.R. 4178 in the California agreement between the State and several large servicers. These subjects are timely and important given developments that dominate the daily headlines.

As background, I note that credit unions are a relatively small player in the home mortgage market, originating about 2 percent of total loans, and about 9 percent of those written by federally insured institutions. Most mortgage loans made by credit unions are fixed rate first mortgages. Only 2.1 percent of credit union real estate loans are of the non-traditional types, such as interest only and optional payment loans.

Regarding Congressman Castle's bill, prudent workout arrangements benefit both credit unions and their members. If Congress believes legislation is needed, we have some suggested changes to H.R. 4178. Specifically, the safe harbor outline in the bill will ease the process of modifying loans and developing workout plans on loans previously ineligible for changes. However, the 6-month window may be too short for consumers to act. It could also be difficult for credit unions to determine which are problem loans, given the multitude of factors to consider in a short timeframe.

In the alternative, NCUA suggests extending the period to at least 12 months. NCUA emphasizes the importance of clearly defined terms, including which loans fall into the safe harbor. We suggest using the same definition of reasonably foreseeable default used in the September 2007 interagency guidance level issued by NCUA and the other Federal financial regulators.

Regarding the definition of qualified mortgages, given the bill's inclusion of VA loans, and given the focus on loans at a higher risk of default, NCUA recommends including FHA loans as well.

The FDIC has offered alternative language to H.R. 4178. NCUA commends the FDIC for highlighting the importance of issues related to investors and securitized loan pools. We support good faith attempts to facilitate loan modifications. This is not only good for consumers, but it is a realistic approach that takes into account the importance of the secondary market. The FDIC proposal appears to reflect a recognition of servicer's duty to investors, and creates a rebuttable presumption that may encourage workout plans. This presumption does not terminate contract rights, but requires a burden of proof to be met by investors.

We also note, without comment, the absence of a distinction in the proposal between prime and subprime loans. Regarding the California proposal, NCUA commends Governor Schwarzenegger for working constructively with the largest servicers in that State to give borrowers financial breathing room when dealing with mortgage adjustments. We note that the agreement includes several concepts introduced in the interagency guidance I referenced earlier.

Those common concepts encourage servicers to: number one, work with borrowers; number two, review governing documents for loans transferred into securitization trusts to determine whether they can be restructured; and number three, to develop workout plans to be offered to at-risk borrowers.

The pro-active nature of the California agreement is laudable, particularly in that it tries to resolve issues before a default occurs. The California agreement also confirms that the States are well-positioned to promulgate these types of solutions.

Finally, I turn to the Frank-Miller-Watt amendment. The amendment imposes civil penalties on creditors who abuse borrowers by failing to abide by certain minimum standards such as determination of an ability to repay or determination of net tangible benefit to the borrower, in the case of a refinancing. The language calls for both administrative and civil money penalties to be imposed on regulated entities in contrast to non-federally regulated entities.

This is inconsistent with the provisions of H.R. 3915 which applied similar standards to all mortgage originators. Also, allowing for the submission of a complaint to any Federal banking agency, regardless of whether that agency has jurisdiction, may have the unintended consequence of slowing an investigation. Congress should consider language to encourage consumers to contact the appropriate regulator.

I will conclude with NCUA's assessment of the credit union experience with delinquencies and foreclosures. Even though delinquencies have increased, they remain low. In the interest only and optional payment end of the market, delinquencies are just .9 percent. Foreclosures have increased this year, but represent a small percentage, .1 percent, of credit union real estate loans. These numbers may be small, but NCUA is mindful of the broader market dislocation, and will continue to encourage credit unions to take extra care in non-traditional lending.

NCUA supports congressional scrutiny of the complex issues involved, as well as any responsible legislative effort that enhances

consumer protection while preserving the mortgage financing market's ability to attract and retain capital and liquidity.

We stand ready to work with Congress on these issues, and I would be pleased to answer any questions.

[The prepared statement of Ms. Hyland can be found on page 130 of the appendix.]

The CHAIRMAN. Next we have Scott Polakoff, who is the Senior Deputy Director and Chief Operating Officer of the Office of Thrift Supervision.

STATEMENT OF SCOTT M. POLAKOFF, SENIOR DEPUTY DIRECTOR AND CHIEF OPERATING OFFICER, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. Thank you for the opportunity to testify on behalf of OTS on loan modifications, foreclosure prevention, and efforts to curb future activities destabilizing to the mortgage markets.

Based on the recent data, total outstanding mortgage loans in the United States are approximately $10.4 trillion. Of this, total subprime loans account for $1.2 trillion, or 11½ percent of the U.S. mortgage market.

Subprime 2/28 and 3/27 mortgage loans account for a total of $496 billion, or roughly 4.8 percent of the aggregate U.S. mortgage market, and 41 percent of outstanding subprime mortgage debt.

Currently, about 2 million American families have subprime 2/28 or 3/27 mortgages that are scheduled to reset in 2008 or 2009. The initial starter rate for these loans typically range from 7 to 9 percent and a reset generally increases the interest rate by approximately 300 basis points.

Between 1980 and 2000, the national foreclosure rate was below .5 percent of aggregate mortgage loans. In fact, as recently as 2005, it stood at .38 percent. Since then, it has increased 55 percent, to almost .6 percent of outstanding mortgage loans. Far more troubling than that though, among subprime borrowers holding 2/28 and 3/27 loan products, foreclosures are projected to jump from about 6 percent currently, to about 10 percent by 2009. One of the most important considerations in structuring a viable loan modification program is reaching as many borrowers as possible, as quickly as possible. In our view, this translates into conducting an expeditious and systematic review of outstanding loans approaching reset or for which rate reset has already occurred in order to identify broad categories of borrowers eligible for loan modifications.

In structuring a viable loan modification program, three goals should be recognized and incorporated. First, and most fundamental, the program should preserve and sustain homeownership. Second, of course, the program should protect homeowners from avoidable foreclosures due to interest rate reset. Finally, it is important that our actions preserve the integrity of the broader mortgage markets, including capital market participation and the continued funding of the mortgage markets, as well as ensuring continued safety and soundness of depository institutions.

I would now like to take a moment to offer our views on H.R. 4178, and the Miller-Watt-Frank amendment offered to H.R. 3915.

H.R. 4178, the Emergency Mortgage Loan Modification Act, is offered as a safe harbor from liability for creditors, or signees, servicers, securitizers and other holders of residential mortgage loans in connection with loan modifications they conduct during the 6-month period after enactment of the legislation. We would like to thank Congressman Castle for introducing this bill, and helping to spur the debate forward. While we understand and appreciate the intent of this legislation, we have outlined a few items in our written testimony that may deserve committee consideration.

Specifically, we believe that servicers already have adequate flexibility to address issues covered by the bill. While we are most certainly supportive of actions that will help keep borrowers in their homes, and we are also respectful of contract law, and attentive to any immediate actions that could tarnish the interest of investors from reentering the housing market. The Miller-Watt-Frank amendment would oppose a civil penalty of $1 million, and not less than $25,000 per loan on a creditor, a signee, or securitizer for engaging in a pattern or practice of originating, assigning or securitizing residential mortgage loans that violate the duties of care established in H.R. 3915. These duties of care include ensuring the ability to repay requirement for certain mortgage loans in H.R. 3915, and the net tangible benefit requirements for certain mortgage loan refinancing under the bill. We certainly understand, and this amendment emphasizes the importance of H.R. 3915 to prospective homeowners in this country. I would like to point out though, that the Federal banking agencies already have authority which includes a significantly lower threshold than the pattern and practice standard to pursue civil monetary penalties against insured depository institutions, as well as their subsidiaries, holding company parents, affiliates, and service providers. A mandatory, monetary penalty removed Federal banking agency discretion. Such discretion is important to address programmatic lending violations and impose penalties and remedies tailored to the nature and extent of the violation.

In closing, Mr. Chairman, I would like to note on a tangential issue, that the House passed H.R. 3526, and that OTS looks forward to working with our colleagues in crafting a uniform regulation applicable to all insured financial institutions to address unfair or deceptive acts or practices, thank you.

[The prepared statement of Mr. Polakoff can be found on page 181 of the appendix.]

The CHAIRMAN. Let me just take 30 seconds, I very much appreciate you saying that, and I know that there have been some objections to OTS going forward. I think the great majority of this committee appreciates you going forward, we hoped you would go forward, and yes, having coordination with your colleagues would be very hopeful. I appreciate that, thank you.

Now, Mr. Mark Pearce, the deputy commissioner of banks for the State of North Carolina, on behalf of the Conference of State Bank Supervisors.

STATEMENT OF MARK PEARCE, NORTH CAROLINA DEPUTY COMMISSIONER OF BANKS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. PEARCE. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. I am Mark Pearce, deputy commissioner of banks for the State of North Carolina. I appear today as a member of the State Foreclosure Prevention Working Group, a joint effort of State attorneys general, State regulators, and the Conference of State Bank Supervisors.

Thank you for inviting us here this morning to discuss our ongoing efforts to prevent unnecessary foreclosures. For the past several months, State attorneys general and State regulators have worked with 20 of the largest subprime servicers to forge cooperative efforts to prevent unnecessary foreclosures. These servicers account for 93 percent of the subprime loans outstanding.

Through our meetings, we have seen great creativity and progress in enhancing servicers' ability to modify loans prior to foreclosure. However, many challenges remain.

In my testimony today, I want to make three points. First, mortgage servicers are being asked to fix problems created by poor origination practices in the subprime market. Many subprime loans that originated in the last couple of years have experienced severe delinquency before rates reset due to widespread failures of prudent underwriting and mortgage fraud. The addition of impending payment increases for over 1 million adjustable rate mortgages, will accelerate these delinquencies and further depress home values unless these loans are effectively addressed. At the same time, rate resets of subprime loans are only one aspect of the larger challenge of dealing with the reckless lending practices of recent years. Second, a significant disconnect remains between aspirations and results, as servicers struggle to meet the current and ongoing foreclosure crisis. Today's mortgage servicing system was not designed to deal with large numbers of loans facing payment shock, home priced appreciations, and a constriction in refinance options. Today's challenges require transition from the low-touch debt collection model, to a high tough foreclosure avoidance model, and that transition has been uneven at best. Despite positive statements from leaders of major servicers, we continue to hear too many complaints from homeowners and counselors about the challenges they face in protecting homes from foreclosure.

To get beyond anecdotal stories and statements of principles, the States have begun to gather data to monitor the progress of loss mitigation efforts. Last month, the State Foreclosure Prevention Working Group finalized a call report for servicers to collect the data needed to gain a clear picture of the outcomes of foreclosure prevention efforts.

Third, proposals to freeze rates for current homeowners who will default due to payment shock are an important step forward. The agreement announced in California last month and press reports of the HOPE NOW initiatives proposing rate freezes for certain borrowers may be the type of solution that will prevent significant numbers of unnecessary foreclosures.

In my written testimony, I detailed the elements of a rate freeze protocol the State Working Group believes will be critical to success

of any such program. A rate freeze is a sensible approach that maximizes returns to investors, enables current homeowners to keep their homes and protects neighborhoods and our economy from the spillover effects of unnecessary foreclosures.

This is far from a bail out, as taxpayer dollars are not rewarding investors or borrowers for imprudent behavior. Furthermore, when you consider that many homeowners could have and should have received better loan terms than the subprime loan they received, this rate freeze makes good sense.

While dealing with a slice of subprime loans is a significant step forward, we should not be lulled into thinking this proposal will solve the foreclosure crisis. Unfortunately, we are at the beginning of this road, not at the end of it.

My written testimony details a few challenges we still face, such as the need to improve systems, so that homeowners are able to access the right solution on the first phone call to the servicer, not the 5th, or the 6th, or the 12th. They must produce the paperwork necessary to modify a loan. We must find solutions for other categories of homeowners not affected by the rate freeze proposal. We must continue to expand our outreach efforts, especially utilizing the strength of nonprofit housing counselors, as many homeowners still do not understand that servicers can provide meaningful assistance. And finally, we must look ahead to payment option ARM products, as a second wave of resets will occur as these loans reach their negative amortization caps later this decade.

In conclusion, we appreciate Congress' efforts to address the foreclosure crisis, and look forward to working with you, the mortgage industry, and our Federal counterparts to minimize the impact of foreclosures in our communities across the Nation. Thank you for your time and attention.

[The prepared statement of Mr. Pearce can be found on page 166 of the appendix.]

The CHAIRMAN. Thank you. Let me begin the questioning with regard to the bill that our colleague from Delaware has offered, which we think is a very important point to have in the discussion.

One concern I saw raised is whether this an unconstitutional interference with vested rights. But it did seem that maybe it was an analogy. The argument is that when someone bought a security, that purchaser had certain remedies against the securitizer, and we would be diminishing the remedies.

But it did seem to me that this Congress did something very similar when, over Bill Clinton's veto, we passed the Securities Litigation Reform Act, and I voted to override the veto. That was a situation where people had bought securities, and had certain rights at the time they bought them to bring certain kinds of lawsuits with certain kinds of evidentiary bars.

And we passed a law, which diminished the rights of existing shareholders. That law was not perspective, it didn't say that only people who are buying stock going forward are limited, it was a limit on shareholders.

It does seem to me that there is some kind of constitutional analogy here. In both cases, we are telling the purchasers of a financial instrument that you will have fewer remedies than you used to have.

Does anyone want to comment on whether there is a constitutional problem with Mr. Castle's approach, and whether or not the analogy I have given might alleviate some of those concerns? Yes, Mr. Dugan?

Mr. DUGAN. I think you are right, Mr. Chairman, that there are instances in which retroactive statutes that modified contract rights have been upheld constitutionally, but it can be a murky area. I think the point that we would say, is it is not free from doubt, and it would still create the potential for litigation if it really did expressly do it, but it is not 100 percent clear.

The CHAIRMAN. Ms. Bair?

Ms. BAIR. I think the concern was that the bill could perhaps be interpreted as being in conflict with the current contractual provisions of servicing agreements, and I think there would be a fairly easy fix to that if you wanted to pursue that, and we have provided some language to Congressman Castle.

We think that the current authorities are sufficient, and that if you do a net present value analysis where the loan modification value exceeds the foreclosure value, then the servicer has fulfilled its obligations to the pool as a whole.

I think legislation that would clarify what we believe is current law, and propose it as a clarification, would be something that could be done. I don't know if it is necessary though.

The CHAIRMAN. Well, I appreciate it. Let me make two points on that, and then I want to get to some other issues.

One, members of this committee did initiate a letter to the SEC, and the SEC Chairman was very responsive. And we do have the ruling from the Financial Accounting Standings Board which essentially says that if the servicer finds this to be in the real interest of the holder, they can do the modification.

But even though, and I would agree with you that yes, those say existing authorities there, but we have often been told by people in the business community that okay, what you say is true, but people are nervous, because you know, people aren't just worried about good lawsuits, they are worried about not so good lawsuits, lawsuits that are invalid.

So if in fact, what you say, and I think what you say is true, not if in fact, it seems to me that argues for the kind of approach the gentleman from Delaware is taking, that is, we are not diminishing any existing rights, but if you codify it, you give people some more insurance, the securitizers who were hoping to be active here, that they would be less likely to be sued, and we have been told in other contexts, that reassurance helps.

Let me ask about two of the issues that I raised now with regard to the President's plan. I am going to get into the question of the remedies, pattern, and practice for some of the other witnesses, but I am troubled by the cutoff of a 660 FICO score. And now I understand, I was talking to the Secretary, and he said, "Well, that is not absolute, it doesn't mean that if you are above it you can't get it."

But I think it would be very unwise for us, politically, to take people who would be similarly situated in every respect except the FICO. Say the person who had gotten herself into deeper debt, goes into this process with a little bit of an advantage over someone who

hadn't. I gather there were some who thought that the FICO score was a proxy for income, but I would ask all the regulators if you think using the FICO score as a cutoff this way is a good idea, even if it is not an absolute one. It seems to me counterproductive. We have been telling people watch your credit, get good credit. To penalize people who have better credit than people who have worse credit even as a start off seems to be a mistake. Ms. Bair?

Ms. BAIR. I have not seen the final documents. I do understand that this is an initial plan that will be undergoing further refinements. I think the advantage of using FICO is that it is quick and it is easy to determine. The disadvantage is exactly as you have articulated; it is really not a proxy for ability to pay. I know some servicers use just a strict ratio, a debt to income analysis, 40 percent I know is one, and perhaps that could be another screen that could be built in.

The CHAIRMAN. It doesn't seem to me to have more relevance than the FICO score.

Mr. KROSZNER. I think it is very important to look more generally beyond just FICO scores, but FICO scores can be useful in certain fast track situations. And so I do not think they should preclude working with other borrowers who are facing challenges. It seems to be a useful first step, but I do think it's important to think about the effects.

The CHAIRMAN. It's a first step and you really are saying—we can't just look at convenience and ease for that. But there's a kind—talk about moral hazard, do you really—I think almost everybody here—all sides, liberal and conservative, we've all told people, don't go too deeply into debt. And now people who have gone more deeply into debt are better off than people who weren't over and above the housing. I just do not know why we would want to do that.

Mr. Kroszner, do you want to respond?

Mr. KROSZNER. Well, I haven't seen the final details of the proposal but I'm not sure that it makes one group worse off or better off.

The CHAIRMAN. Well, it does. I talked to the Secretary and he affirmed it. If your FICO score is above 660, there is a heavier burden of proof on you to get into this modification than if there isn't.

Mr. KROSZNER. But it doesn't mean that there can't be other approaches to modification that can help those others.

The CHAIRMAN. That's true, but that doesn't move it away. You can't answer—the fact is that it is a factor. It is meant to be a screen. It can make it quicker and then not have any meaning. You can't have it both ways. And it is in fact meant to be—let's put it this way. Everything else being equal, you're worse off if you have a FICO score above 660 than below it. I just think that's a terrible idea for us to perpetuate.

Mr. Dugan?

Mr. DUGAN. I guess the way I understood it and I have not seen the detail of this particular one. Understanding that, I think there is a notion that at this part of the negotiations there had to be some kind of screen to indicate the people who could afford to refinance—

The CHAIRMAN. I agree.

Mr. DUGAN. You are just asking if FICO the right screen? Is that the question?

The CHAIRMAN. Yes.

Mr. DUGAN. And I haven't had enough time to look at it.

The CHAIRMAN. Okay. But there are two questions I'm asking. First of all, there is a question about whether it's a good screen. I don't think it is a good proxy for income. I think it's, you know, it's better than nothing maybe, but I think it isn't better than nothing because it goes counter to what we have been telling people—be careful about your debt.

We should not be counseling people that in some cases if they went deeper into debt and had a lower score, they would be better off.

Let me then switch, unless anybody else wanted to discuss that? Mr. Pearce?

Mr. PEARCE. Sure. I would agree with you. I think especially since you have many people who have subprime loans had prime quality credit when they got the loan. To penalize those homeowners who were steered into bad loans to begin with is a mistake. I think FICO scores especially if you look at trends, they may enable servicers to determine this borrower is in distress. Their credit is getting worse. And, as a result of decreasing FICO score, you could have—maybe that would be a proxy for having trouble making ability to repay. But I think ability to repay is something—

The CHAIRMAN. Well, I have run over my time and I apologize. I appreciate that because, you know, we never want to lose sight as we talk about this about the HMDA data. We'd show that if you're black or Hispanic everything else being equal you had a lot more chance of getting a subprime loan and you point to exactly that. That you could have people who were pushing the subprime loans because there's an element of racial and ethnic discrimination here. And they would be victimized by this.

My time has expired. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

Chairman Bair, I was looking at your testimony on page 5 in a footnote where we're talking about the servicers moving to protect the investors and loan modifications, in the footnote you talk about American Securitization Forum statement of principles.

One of their principles in these modifications is in a manner that is in the best interest of the borrower. How does that—I have asked the regulators how does that come into play? As you modify these, obviously the servicing agreement in most cases will give the servicer the right to protect the investor.

Ms. BAIR. Right.

Mr. BACHUS. But competing with that, you know, the type of modification, how is the borrower protected?

Ms. BAIR. As I understood it, these principles were developed subsequent to some securitization roundtables that we had hosted at the FDIC which I mentioned in my testimony. I believe that this was, and George Miller will be testifying later and can speak directly, but I think this was relating to the idea that the modified loan obligation should be sustainable, one that the borrower can afford. And that is in the best interest of investors, too. So I think it is almost a reflection that their interests coincide in that regard.

Mr. BACHUS. All right. On page 7, really what I am talking about here is the fairness issue. You talk about the small number of investors or small percentage who even after the escalation of the interest rate continued to pay.

Ms. BAIR. Right.

Mr. BACHUS. Those people will not get relief and I would ask all of you, how do we—there is going to be a natural response that this is not fair to those borrowers.

Ms. BAIR. Right.

Mr. BACHUS. How would you respond to that? I don't, I don't really think you can say that, you know, this may be beneficial to the community. It is obviously beneficial for those who are in foreclosure. It may be beneficial for the investor. I guess it is just not fair for the person who is current on his loan though, is it?

Ms. BAIR. Well, this is the case with any loan modification. And, again, there are no perfect options here. Especially in a declining housing market, it is in the best interest of investors who are rescinding the loans to modify as opposed to foreclose because the modification value is almost always going to exceed the foreclosure value. And it helps protect surrounding neighborhoods and communities because foreclosed homes can have a devastating impact on the surrounding property values.

And given the scale that we are dealing with I am very concerned about a steep spike in foreclosures having a fairly bad impact on our economy as well. So, yes, there is a fairness issue. And that is true with any loan modification.

I have a very conservative fixed rate mortgage. I am making regular payments. I am not going to get any help here. Probably most of us in the room have that situation, but we are between a rock and a hard place.

And if the alternative is foreclosure, I think clearly—and I think most would agree—we need to modify these loans and do so systematically so it is feasible to get to them all.

Mr. BACHUS. Thanks. Comptroller Dugan?

Mr. DUGAN. I would just add that, you know, in most cases it is not a matter of stepping up the interest rate and then paying the higher interest rate. The way these things were structured, they are really 2-year loans or 3-year loans. And when you got to the end, the crease was so much that you would refinance into a different loan. Now you are limited in that.

And I think the notion here is that there will be people, the people who can afford a higher rate are really hopefully the people who can afford to refinance hopefully into a prime loan. And that rate one would hope will be something that is comparable to whatever the starter rate reset. And in those circumstances it is not unfair I think.

Mr. BACHUS. I agree. In fact I think that is one, you know, some people have raised concern that 5 years you're kicking the can down the road, but in fact, you know, I do not think that is the case because in 5 years—

Ms. BAIR. That should hopefully give most a chance to refinance these very high cost loans even at the starter rate. Over half of the 2006 originations were above 8 percent. So there will be an incen-

tive to refinance out of them when they can and hopefully 5 years will give most borrowers an opportunity to do that.

Mr. BACHUS. I have one other question if I could.

There does seem to be a wide disparity between predictions, for instance, Chairman Bair, you talk about of the $1.7 million hybrid loans, you say in your testimony that as many as 1.4 million of those may be non-performing. That's a pretty high percentage. At least on page 7 and 8 of your testimony as I read it, you talk about 1.7 million hybrid loans. And then you talk about on page 8 as many as 1.4; there is an indication that as many as 1.4 may not perform.

Ms. BAIR. That's right. They cannot make the reset rate. And that is consistent with the past performance of these loans. As I also indicate in my written testimony, the 2003 originations of the 2/28s and 3/27s which have already gone the full reset, only 1 in 30 of those perform according to the original contract terms at that higher reset rate.

Mr. BACHUS. I know the OTS, Mr. Polakoff, you talk about maybe 6 percent of them don't perform. And, you know, we are talking about the vast majority or 6 percent. Of those type loans, what percentage of people, borrowers who took those loans are going to be able to—are those loans going to be able to perform after they reset? Is it 10 percent? Or is it 90 percent?

Mr. POLAKOFF. Thank you, Congressman. Part of it is a terminology issue. The 10 percent is actually foreclosure. So frequently borrowers don't perform, cure themselves, don't perform cure. So the 10 percent that I offered in my testimony was a projected foreclosure number for 2008 or 2009 absent some systematic way to address the reset.

Mr. BACHUS. But you agree with the Chairman Bair that a much, much higher percentage of that won't perform or cannot?

Mr. POLAKOFF. Absolutely. There is a large percent of the borrowers and it is getting worse because the—the late 2005 and the 2006 underwriting standards were atrocious in some cases. So that number is going to get worse. I agree with the Chairman.

Mr. BACHUS. So obviously, the vast majority of these loans—some people have said only a small percentage of it, but really a vast majority of this type loan can't perform at the reset.

Mr. POLAKOFF. Well, of the universe that remains before reset, there is still I would say a portion, maybe 25 percent or so, that would qualify for some sort of refinance opportunity.

Ms. BAIR. That's right. This is just the people who can't make the reset rate. Some subset of these will presumably be able to refinance even in today's housing market conditions.

The CHAIRMAN. I am going to have to go vote. Let me ask unanimous consent if I could just ask one other question that's relevant to this.

What troubles me here is the prepayment penalty. As I understand it says no waiver of prepayment. And that does seem to me in the current situation, you know, if they cannot afford the reset rate, can they afford a prepayment penalty? Because as I understand it, there is no waiver of prepayment. It is pushed further along to the reset but it is not waived. And that seems to me a serious defect here.

Ms. Bair?

Ms. BAIR. Yes. As I understand it and, again, I haven't seen the final details, but we testified last week in California at Mrs. Waters' hearing and I believe the ASF testified then that you are extending the starter rate but not the prepayment penalty. So under the contract, the prepayment penalty will expire when the—

The CHAIRMAN. That wasn't the impression—but if that is the case, I am happy—that I got from talking to the Secretary, you know, that is what happens when principals start talking substance without staff around.

I got the impression that it was in effect a tolling of prepayment.

Ms. BAIR. I don't think there is—

The CHAIRMAN. With what you tell me then I am much reassured.

Mr. KROSZNER. That is our understanding.

Mr. DUGAN. That is our understanding, as well.

Mr. KROSZNER. What Chairman Bair said.

The CHAIRMAN. That the prepayment penalty will be allowed to expire?

Mr. DUGAN. Because the investors want their money back. I mean if they get a pre—they are not going to want to—

The CHAIRMAN. I misunderstood. Then I still have the FICO thing, but that's a major resolution of a problem I had and I would hope that—we will ask that that be confirmed that there will be no—that the prepayment penalty will expire and at the end of the 5 years there won't be a prepayment penalty facing them in terms of refinancing. Thank you. Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

If anyone on the panel wants to grab the issue? Has there been any study as to the analogy of the factors here between the subprime lenders and credit card borrowers? Are they similar to people who are overstretched in their credit card situation?

What I am interested in is are we starting or going to find the methodology here to ultimately bail out credit card lenders from the 30 percent or 34 percent oppressive usurious interest rates that are out there? Should we look at that issue at the same time as we look at this issue? Does anybody want to grab that?

Mr. POLAKOFF. Congressman, I would offer that approximately half of the 2/28 and 3/27 subprime universe we are talking about actually was purchase money. And probably about half of that was first time purchase money for homeowners.

Of the remainder we have heard some anecdotal stories about individuals who refinanced and consolidated their credit card date to refinance 20, 24, or 30 months ago and now find themselves in a situation having difficulty making their mortgage payments and difficulty making their credit card payments.

Mr. KANJORSKI. Well, if we go into the Paulson idea, is that going to be exacerbated now by a credit crunch problem?

Ms. BAIR. I think this will help to the extent you are not further distressed. Borrowers are stretched even at the starter rate. So if you try to squeeze some additional return and increase the starter rate, you are going to be impairing their ability to pay off other forms of debt. So I think to the extent this helps relieve borrower distress for the category of borrowers that have been identified ex-

tending the starter rate that presumably will leave households in a better position to continue servicing other forms of consumer debt.

Mr. KANJORSKI. But if we do that, then, are we going to encourage the holders of the credit cards to increase their interest rates to make up for the differential? I mean are we getting a coordinated effort here? Or can we freeze that, too?

Ms. BAIR. Well, I think the externalities involved with foreclosures have justified perhaps greater government leadership though again this is a private sector initiative. Credit card delinquencies are going up, but I don't see that we are anywhere near, and would not anticipate based on current data, the type of situation we are dealing with now.

And the externalities of credit card delinquencies and defaults are—I don't think you can compare those to foreclosures and homes which definitely have negative impacts on surrounding properties and economic health.

Mr. KANJORSKI. So, you are sort of describing something that we are not worried about the individual, we are worried about the community he lives in.

Ms. BAIR. Well, I am worried about borrowers, too. I do not want to suggest that. But I think we do have to also look at the external costs. The jump in external costs are also factors that weigh more heavily for greater government activity.

Mr. KANJORSKI. When you look across the country on foreclosure rates, various States seem to have greater amounts and lesser amounts. Particularly being from a very conservative State like Pennsylvania, I know the last thing in the world you want to do is get yourself into a foreclosure mode because of the judgement requirements. You do not really save anything, and all of your assets are at the disposal of the mortgage.

But is it time that we start looking at it? I keep hearing that one of the big problems is the California problem, which would not be exacerbated at this point if the sales price of real estate was not falling significantly at the same time the foreclosure rate was rising.

As I understand the California law, you can hand in the keys or possession of the property and that ends the obligation on the mortgage. If we are doing this in order to avoid destruction of communities in California, how is that going to happen?

Certainly if I were in one of these mortgages and I had maybe 2 or 3 percent equity in the property to begin with and then the market falls 20 percent, why do I want to even keep the property? I want to hand it in.

For a selfish decision, that is probably a smart decision. But, as it affects the neighbor or the neighborhood, it could be catastrophic. We will really be offering no relief here.

Ms. BAIR. I think that really goes to the question of consumer behavior. But the modification program is confined to owner-occupied properties who have been paying, making regular payments during that 2- to 3-year starter period.

As Scott pointed out, a good section of these mortgages are refinancing so these people—probably at least half if not more—have been in their home longer than that 2- or 3-year starter period.

I am not sure the research would show that consumers think in those terms. This is their home. They have been in their home for many years. And I think they are more focused on their monthly payment and their ability to service debt as opposed to looking at their home as a speculative investment. At least this category of borrowers.

I think in terms of the Alt-A market, especially the option ARM loans, these were investments—loans of choice for those who viewed properties as speculative investments and I think the dynamic you're talking about may be more in play there.

But the 2/28s and 3/27s are overwhelmingly owner-occupied. And, again, people have been in their homes, at least the category we're talking about for modification, at least 2 or 3 years and probably significantly longer because a lot of these are refinancings.

Mr. KANJORSKI. I look at the hair color of the panel, and I now recognize that I cannot call upon the historical knowledge of the S&L crisis.

If you remember in the S&L crisis, that was one of the problems. The price of real estate in subdivisions fell so significantly that people were surrendering the keys of their property to their mortgage holder for the purposes of acquiring the property across the street at half the price. And particularly, again, that happened in California.

I am just wondering if we thought—

Ms. BAIR. Well, I think the S&L crisis was heavily driven by commercial real estate lending. Residential was less of a factor I think. I don't deny that some of that took place. But I think here there are a number of reasons why. People again have been in their homes for many years. And that is the category that we are dealing with.

I would want to state that there would also be credit score consequences. There are possibly tax consequences for doing what you suggest. In addition, just having to find another place to live assuming the moving cost, you would really devastate your credit scores as Mr. Meeks, I believe, indicated earlier, really inhibiting your chance to ever get a mortgage again by doing that. So I think there are some disincentives to people doing what you suggest. I won't say it won't ever happen, but I think there are some significant disincentives.

Mr. KANJORSKI. All right. Thank you, Mr. Chairman, my time has expired.

The CHAIRMAN. The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman. I sense some degree of unanimity amongst all of you and up here that we really should try to address this problem if we can. And the question is how, how do we do it? That is a matter of some concern.

I am a sponsor of the H.R. 4178 which has been referred to on several occasions with respect to the safe harbor from legal liability, so I am somewhat concerned about that. And I noticed in your statement, Mr. Pearce, that you basically indicated that your office has been in contact with many loan officers who feel that they will be sued by the investors. And it is a question when, not if. That is a fairly definitive statement. Can you substantiate that?

Mr. PEARCE. We met with the top 20 subprime servicers and each one of them—we went around the room and a number of them brought up the fear of investor lawsuits. So, you know, we have focused with our work with servicers on the things they can do within the contracts they have right now. And we still think there is a lot of room for improvement in that.

There is this fear about lawsuits. And I think the two things specifically related to your amendment, the first is, if there is a constitutional issue or question whether this is going to impair contracts, you know, where is—does that create uncertainty that actually makes less modifications happen because people are unsure whether it's legally okay to do a modification or whether it is going to get challenged in court. I think other panelists have testified on that.

The second thing which is just a suggestion as you move forward with this is making sure that any kind of immunity is limited to investor claims. You know, this is about investors suing other investors.

One of the fears that I have having looked at abusive lending practices is in the modification, itself, as Chairman Frank pointed out earlier, you know, could prepayment penalties creep back in to some of these loans. Could modification fees be increased? There are things in the modification moment that I want to make sure that your amendment doesn't unintentionally permit additional abusive lending.

Mr. CASTLE. Thank you. Chairman Bair, you referenced in your oral testimony and it's in your written testimony that the investors also benefit by redoing these loans if you will. I think it's on page 12 of your written testimony. You went through some details on that.

I thought that was interesting because I came to this hearing not being certain how investors might benefit.

If I understand it correctly, it has been stated by several of you that these loans are not necessarily carried out to the next level so that that interest rate is not paid at that level, they go out and obtain another kind of loan or something, so they are probably better off if I understand it correctly going through the regular payment and not a foreclosure in terms of protecting their loans. Is that more or less correct? Or do you want to expand on that?

Ms. BAIR. That is exactly right. And I think there has been a good dialogue with the investor community and enhanced understanding of, again, it gets back to weak underwriting. Most of these, the vast majority of these borrowers were underwritten at the starter rate and stretched at the starter rate.

For most of them it takes over 40 percent of their gross income just to make the mortgage payment at the starter rate. So you are looking at people stretched at the starter rate with a 30 to 40 percent payment shock when the reset kicks in. It is going to be a fairly easy determination for many of them. They just, they just simply can't make it.

But this was, you know, I think this was a good dialogue with the investor community and I think the American Securitization Forum really deserves a lot of credit for working with their members and clarifying also that the servicer's obligation is to the pool

as a whole. So you need to look at the economic benefit to the pool as a whole. And I think the modification program that people are talking about is very consistent with that.

Mr. CASTLE. Thank you.

Mr. KROSZNER. On that point, given that industry estimates are that foreclosures typically involve a 40 to 50 percent loss, that gives a very a strong incentive to find some sort of alternative to foreclosure. And so the types of proposals that are being discussed by the American Securitization Forum are ways to try to address that and we can reduce the cost and get to people sooner before that circumstance occurs. That can be beneficial both to the borrower and to the investor.

Mr. CASTLE. Thank you. One of the reasons I wanted to have this hearing is so we could get ideas from you. And Ms. Hyland, you put forward several ideas for amendments we could make to my legislation from including FHA loans to extending the window to 12 months or whatever. Do you have any other ideas that you didn't touch on in your testimony you'd like to bring forward?

Ms. HYLAND. No, sir. Actually, we have included them in our comments and in our written testimony.

Mr. CASTLE. Okay. I appreciate that. I realize there are certain limitations and a number of you pointed out certain things that we need to pay attention to. Are there any fundamental underlying concerns about taking this approach at all that any of you may have?

Comptroller Dugan?

Mr. DUGAN. I do have a fundamental concern. And there is the litigation question and about whether you are getting rid of one form of litigation and getting another. And we already spoke about that. But I do think you have to weigh the possibility that by retroactively affecting a contract that you will discourage future investment in securities because people will believe that the contracts that they enter into can be modified at a later time. And I think you don't do that unless you really, really need to go down that path.

And I guess my question would be given the voluntary nature and the agreements that are coming out now and the good faith negotiations and the notion that servicers believe, seem to believe that they have a good bit of authority, I just would be asked the question at the current time whether the potential costs outweigh the potential benefits.

Mr. CASTLE. Well, let me ask your question. Based on what Chairman Bair said earlier about this may actually benefit to be able to redo these loans—

Mr. DUGAN. I think we all agree that modifications can benefit investors as well as borrowers if it is less costly than foreclosing. I think the question is if you were to do it in a way that cut some investors off from lawsuits you have a different set of concerns by investors.

There are some investors who will say this kind of modification does not benefit me and it violates the term of my bargain retroactively and it is not fair. And I am never putting my money in this kind of thing again. And I think you have to be careful about that.

Mr. CASTLE. Thank you. I yield back, Mr. Chairman.

Mr. KANJORSKI. The gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Kanjorski. I am interested in trying to get the best possible proposal to help people save their homes, and obviously, what I've heard about so far only happens to a very small number. And I'm interested in hearing from you how we can expand our efforts.

I referred to you, Ms. Bair, earlier when I gave my opening statement, because when I had my hearing, I heard that you had an idea about maintaining the teaser rate in perpetuity, I mean, till the end of—and I liked that a lot, and I thought it made a lot of sense. I can understand that there's pushback from, you know, various sources, but still, I don't think we should give up on the idea that we can do better than just have a 5-year period.

And so what I'd like to ask you is this. It appears that on some of these subprime loans, the teaser rates were even 3 to 4 points higher than the prime rate, so that if they had reset, they would be paying 11, 12, I don't know, 13 percent on the 2- or 3-year period of time. So, if in fact the teaser rates were very high and they got extended over a longer period of time, it seems to me that the investors will still be making money. They just wouldn't make as much money.

And so why can't we take that into consideration in one of these proposals, looking at what the teaser rate was to begin with? Ms. Bair.

Ms. BAIR. Well, yes, we did originally propose that these folks be converted into fixed-rate mortgages. Because as you say, the starter—I didn't even call them teaser rates, because they're so high—the starter rates are quite high. But Washington is about compromises. We got some people's attention with that proposal, but after further discussions, the 5-year benchmark seemed to be where we could get agreement, where there was greatest comfort among both investors and servicers.

I will tell you that I don't think it was a huge concession, because as a practical matter, these loans are high cost even at the starter rate, when borrowers can refinance out of them, they will. So I anticipate this 5-year term will give the vast majority of those who have been modified to refinance out into something lower cost, so that the overall duration of these loans probably will still be around 5 years. So, that is where the consensus was reached. But I do think it will give sufficient breathing room to folks to be able to refinance out.

Ms. WATERS. Well, I'm not going to give up on that, but I appreciate what you said about, you know, how you have to try and compromise.

The other thing I'd like to ask you is this. It seems that some of the considerations for whether or not the loan is going to be modified has to do with credit ratings and some other things. I am focused on the fact that many of these loans were given knowing there was weak credit. Many of these loans were no-doc loans.

Now why is it—and the modification of these loans all of a sudden, we're going to have such different standards than we had when we extended the loan in the first place? And if it was a no-doc loan, for example, okay, so you want to get some information

and find out who you lent this money to, that's okay. But why would that person be penalized because you now find out information about them that you should have been vetting before?

Ms. BAIR. Again, I have not seen the final details to be revealed by Treasury this afternoon. As I understand it, though, the FICO—well, let me say this. In guidance the FDIC and the CSBS issued some time ago with other agencies on loan modifications, we added a sentence suggesting a DTI analysis for determining ability to repay.

So I think DTI is another way, debt-to-income ratio is just another way to look at this that may more closely approximate ability to support the debt service. As I do understand it, though, the FICO is just an initial screen. If the FICO is below the 660 benchmark, I believe, no income verification is needed. But if you miss that, if it's over, you can still get a fast tracked loan, but the servicer is going to go in and redocument your income. So, I think there is still some flexibility and that the detailed income documentation is not required for the lower FICOs. As I understand it, that's the way it's supposed to work. Again, I have not seen the final plan.

Ms. WATERS. All right. Let me just ask quickly, Mr. Kroszner, who is a Governor, Board of Governors of the Federal Reserve, I'm told that the Federal Reserve was supposed to issue regs on mortgage underwriting standards, and it was never done. Why not?

Mr. KROSZNER. We have made a commitment, as the Chairman of Federal Reserve, Ben Bernanke, did in testimony in July, to issue these rules by the end of the year. I have said in my oral remarks here that within the next 2 weeks we will be issuing proposed rules on HOEPA, and so we will definitely being doing that and fulfilling our promise.

Ms. WATERS. What about loss mitigation? Who can talk to me about what the banks are doing with loss mitigation, whether or not they have departments. I'm told that many of them say they have loss mitigation departments but they have offshore companies they have contracted with, and people who are seeking some help cannot get returned telephone calls. They don't have any help on loss mitigation. Who knows anything about this? Not the regulators surely. That's something I shouldn't ask you guys.

Ms. HYLAND. Congresswoman—

The CHAIRMAN. Yes, sir?

Ms. HYLAND. Go ahead, please.

Mr. PEARCE. Ladies first.

Ms. HYLAND. Thank you. Congresswoman, from the credit union standpoint, we have information in the regulatory system that credit unions are reaching out to their members that may have these types of loans and offering financial literacy counseling and other types of efforts to try to put them in loans that are affordable.

Mr. PEARCE. Having—part of the reason why the State attorneys general and State regulators had these meetings with the top 20 subprime servicers was that there is this disconnect between the "We will do anything to prevent foreclosures," and the reality that homeowners are experiencing challenges in saving their homes. And some of that is just built into the system that servicers have.

Servicing is intended to be a debt collection practice. It collects payments and get it to investors as quickly as possible.

Ms. WATERS. So there is no loss mitigation activity?

Mr. PEARCE. So loss mitigation activities have developed in all sorts of institutions, but they've been relatively small and a last resort for loans that, you know, have some unusual problems. In fact, if you look at the evidence, there's been very few loan modifications in any of these somebody loans prior to the last 6 months. It just didn't happen.

And so, you know, servicers that we've met with I think are making energetic efforts to add staff and do things to make loan modifications easier. However, it's still at the bottom of the waterfall. It needs to be sort of at the top so that people can get that option quickly for those that need it.

Ms. WATERS. And quickly, I understand that the servicers are charging fees for loan modifications?

Mr. POLAKOFF. Congresswoman, I don't believe that's accurate. It's actually part of the pooling and servicing agreement that requires the servicers to modify the loans when the net present value is beneficial to the trust. That's part of the fee that they generate as being a servicer. So, at this point I'm not aware of any servicers that are collecting an additional fee.

Ms. WATERS. Thank you very much.

Mr. KANJORSKI. We're down to the last 5 minutes. We have a bit of a problem. Ms. Bair, you have been promised that you'll be allowed to leave by 1:15? All of you have that commitment?

Ms. BAIR. The Treasury announcement is at one, so—

Mr. KANJORSKI. Okay. There's a general revolt.

Mrs. MALONEY. I'll miss the votes if I can ask a question.

Mr. KANJORSKI. Okay. Well, will you surrender to take the chair, then?

Mrs. MALONEY. Sure.

Mr. KANJORSKI. Okay. Mel, did you want to continue while we're voting?

Mr. WATT. I don't want to continue while we're voting, but I do think this is perhaps the most important panel on this issue, because we get some really good inside information. And I do have some important questions to ask about Mr. Castle's bill. So maybe I can propound those questions in writing. I don't want to hold people here for that purpose, and I don't want to miss a vote, either. So I'll just play it by ear and see where we are.

Mr. KANJORSKI. We're down to the last 5 minutes.

Mrs. MALONEY. [presiding] Okay. Thank you. Today the Mortgage Bankers Association released statistics showing that the rate of foreclosure statistics and the percentage of loans in the process of foreclosure are the highest ever. And so we are really not at a time for half-measures.

I want to congratulate Chairwoman Bair for her leadership in coming forward with really many good ideas during this crisis, and really giving government and regulators guidance in it. But as my colleagues have pointed out, you originally had a proposal that would have included more homeowners in the loan modifications, and what changed you or persuaded you to go along with the narrower proposal? The statistics from the mortgage bankers today

shows that it is the highest ever, and we really need to cover more people.

Ms. BAIR. Well, I haven't seen the details of the final plan. And as I understand it, what will be revealed this afternoon will undergo some further refinements. So, I do think, as I understand it, though, it pretty much tracks what we had suggested, which was fast tracking those 2/28s and 3/27s that are current, owner-occupied, can't make the reset and can't refinance, they will get an extension of their starter rate for 5 years. And the 5 years was a bit of a compromise, but, again, I think that will give borrowers plenty of time.

So I think it is, it's a very positive step forward. And this is a collaborative consensus-building process, and I really am greatly appreciative of Secretary Paulson for taking the lead the way he did, and working with the industry to get this agreement.

Mrs. MALONEY. Also, Chairwoman Bair, the Administration is not proposing any liability safe harbor for the servicers who modify loans. And without that, do you think servicers will risk getting sued for loan modification?

Ms. BAIR. Well, I think there has been a lot of talk about that, but, again, I think with the attention drawn to this, the universal call for systematic modifications and the work of the American Securitization Forum to develop best practices and systematic modifications will help that process.

So I think that is really one of the things, one of these reasons we're doing this is to establish consensus that this needs to be done. It is in investors' best interest to do it, and some best practices on how to do it will help protect servicers as they modify these loans in scale.

Mrs. MALONEY. Do you think that we need legislation like the Castle bill to help solve this problem?

Ms. BAIR. I really don't. I think the current legal authorities are sufficient. Again, if you do, I think it would be important to craft it so that it's clearly just a clarification of current law and not any suggestion of abrogating current contractual provisions. We offered some technical language to Congressman Castle for his consideration, but I do think the legal authority is already there, and the legislation really is not necessary.

Mrs. MALONEY. And I'd like to ask Governor Kroszner, in my view, the prepayment penalties, especially in the subprime mortgages, have been really unfair and abusive. And as you know, the House bill would ban prepayment penalties in subprime loans an amendment that I added on the Floor would limit them and ban them in prime mortgages as well.

But I understand the Fed could regulate prepayment penalties by rule, and do you anticipate doing that in your upcoming rules?

Mr. KROSZNER. This is precisely one of the areas that we have been looking at. When I held the HOEPA hearing in the summer, we focused on this issue, and that is one of the areas that we will be addressing in our rules that we'll be coming out within 2 weeks.

Mrs. MALONEY. Within 2 weeks? That's great. And also, we went through a period where we had a great activity in lending, our economy was very liquid, and now loans have just—and lending has dried up. And I would just like to hear any ideas from the

panel of how to get liquidity back into the marketplace and to get lending moving and to get our economy churning again. Just any ideas today or in writing. That's one of the things that we confront. And I thank everyone for your testimony. Any ideas in that respect?

Ms. BAIR. Well, I would just say I think in times like these, deposit insurance plays a very important role, because it helps support the ability of banks to access deposit funding to make loans, to make credit available. So I think that is part of it. And in fact—deposits are providing an important source, an increasingly important source of funding for credit extension.

Mrs. MALONEY. Okay. I have to run and vote. Put your ideas in writing. The Chair notes that some members may have additional questions, and they may wish to put them in writing.

We will now be in recess until the end of this series of floor votes, and at that time, we will convene with the second panel.

I want to thank all of you for your hard work and your excellent testimony today. We stand in adjournment.

[Recess]

Mr. KANJORSKI. [presiding] The committee will come to order. The next panel consists of: Tom Deutsch, deputy executive director, American Securitization Forum; Faith Schwartz, executive director, HOPE NOW Alliance; Hilary Shelton, director, National Association for the Advancement of Colored People; Damon Silvers, associate general counsel, AFL–CIO; and Richard Kent Green, Oliver T. Carr, Jr. Chair of Real Estate Finance at the George Washington School of Business, George Washington University.

Mr. Deutsch.

STATEMENT OF TOM DEUTSCH, DEPUTY EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM

Mr. DEUTSCH. Good morning, and thank you for the opportunity to testify here today. I'm honored to be here representing the American Securitization Forum on actions that mortgage market participants can undertake to help prevent mortgage foreclosures and mitigate losses.

As a side note, the American Securitization Forum is a broad-based, not-for-profit professional forum that advocates on behalf of the interests of not only all institutional investors, but also servicers, issuers, financial intermediaries, trustees, rating agencies, financial guarantors, legal and accounting firms, mortgage insurers, data analytics vendors and other firms, all in the securitization marketplace. So please note that my remarks are not only on behalf of servicers but also of investors as well, who have both come to agree on a number of pieces of a framework that will be announced shortly this afternoon.

As a general matter, no securitization market constituency—including lenders, servicers, or investors—benefit from subprime mortgage loan defaults and/or foreclosures. Foreclosures are nearly always the most costly means of resolving a loan default. As a result, it is typically the least preferred alternative for addressing a defaulted loan, whether or not the loan is held in a securitization trust. The ASF therefore strongly supports the policy goal of avoid-

ing foreclosures wherever possible and reasonable alternatives exist.

A basic principle underlying the servicing of subprime mortgages or subprime loans in securitization transactions is that for those who are unable is that—it's according—their service according to their contractual terms and to maximize recoveries and minimize losses on those loans. This principle is embodied in the contractual servicing standards and other provisions that set forth the specific duties and responsibilities of servicers in securitizations.

In turn, these contractual provisions are relied upon by investors in mortgage-backed securities, who depend primarily on the cashflows from the pooled mortgage loans for their return on their investment. This is a critical point that I'll address later in the testimony.

The servicing of subprime mortgage residential loans included in securitization are generally governed by a pooling and servicing agreement, essentially, a PSA. This is the contract associated with securitizations. And servicers are bound by these contracts to follow accepted servicing practices and procedures as they would employ in their good faith business judgment, and that are normal and usual in their general mortgage servicing activities.

Most subprime securitization transactions authorize the servicer to modify loans that are in default or for which default is imminently or reasonably foreseeable. This is an important point, as it is associated with both REMIC tax law as well as FAS 140 considerations. Contractual loan modification provisions ion securitizations typically also require that the modifications be in the best interest of the security holders.

Servicers of mortgage loans in the current environment, given market conditions, evolving market conditions, and many of the changes that we've seen, have redoubled their efforts to both help borrowers to avoid foreclosure, and to minimize losses to securitization investors. Most servicers have developed and are implementing procedures to reach out to hybrid ARM borrowers well in advance of their interest rate reset in an effort to identify and prevent potential payment problems before they occur.

Let me talk a little bit about what's currently going on in the industry and many of the discussions that we've had as of late, and what will be announced shortly this afternoon. The application of loan modifications and other loss mitigation techniques to distressed or potentially distressed subprime loans has received intensive focus from servicers in the broader securitization market as well as policymakers and regulators.

Working with a broad range of industry members—again, including servicers, investors, issuers, financial intermediaries, and others—the ASF has taken concrete steps to facilitate wider and more effective use of loan modifications in appropriate circumstances.

Last June we published recommended industry guidance designed to establish a common framework related to the structure, interpretation and application of loan modification provisions in securitization transactions. This document concludes that loan modifications for subprime mortgage loans that are in default or for which default is reasonably foreseeable, are an important servicing

tool that can often help borrowers avoid foreclosure as well as minimize losses to securitization investors.

ASF also released guidance supporting the view that borrower counseling expenses may be viewed as servicing advances, and where consistent with operative securitization documents, can be reimbursed from securitization trust cashflows, effectively creating additional funds for counselors working with borrowers to help resolve troubled loans. ASF's statement should be very important in addressing some of the funding needs of many counseling organizations.

Maybe let's skip down to in response to the challenges and the many suggestions about the industry's efforts, that the ASF is releasing later on this afternoon a framework of looking at securitized loans, of segmenting borrowers into different groups, and of addressing both the needs of servicers in most efficiently effectuating loan modifications, as well as the needs of borrowers in being able to stay in their homes and avoid foreclosure.

We have developed a criteria by which servicers can systematically evaluate the subprime ARM portfolios for the purpose of efficiently segmenting loans and borrowers to identify various potential loan disposition options. We will also announce development of two analytic tools and methods that servicers can apply on a more systematic and streamlined basis to evaluate loan affordability, borrower capacity and willingness to repay, and other factors that are relevant to decisionmaking regarding refinancing opportunities.

I should note in particular one of the suggestions earlier by Chairman Frank was related to prepayment penalties. This framework will address prepayment penalties specifically. Any time a loan modification is done, and in particular where it's done for 5 years, nearly all prepayment penalties expire at the reset, which in a 2/28 or 3/27 is after the first 2 or 3 years. If you modify a loan beyond the existing payment, beyond the existing rate, those prepayment penalties expire as that rate resets. Hence, there is no prepayment penalty. They don't effectively stick around until the modification ends.

Also, in terms of refinancing opportunities, the refinancing, as we suggest in our guidance, will be done or should be done as close or as near as possible to the reset time, again, avoiding any prepayment penalties and making borrowers easier to afford their loans.

The purpose of all of this effort has been to assist servicers in their efforts to streamline their loan evaluation procedures and to expedite their decisionmaking process. While this effort is designed to streamline these decisionmaking processes, it preserves the essential requirement that loan affordability and maximization of recovery to investors must be determined on an individual loan-by-loan basis, including through which the systematic application of reasonable, presumptive criteria in appropriate circumstances really make it work faster, quicker, more efficiently for servicers.

Again, loan-by-loan analysis is still done, but with more simplified and creative metrics.

Finally, let me address the Emergency Mortgage Loan Modification Act of 2007 that would create a safe harbor from liability for servicers or others who modify certain types of residential mortgage loans.

As a general matter, we have significant concerns with any legislation that would abrogate or interfere with the previously established private contractual obligations. Changing this standard would alter the commercial expectations of investors and could undermine the confidence of investors in the sanctity of agreements which are central to the process of securitization.

Therefore, we would like to continue to work with Representative Castle and this committee to determine if additional steps may be necessary or helpful to address any legal, regulatory, accounting, or other obstacles to the delivery of loan modifications and other loss mitigation relief to borrowers, pursuant to industry-developed frameworks, including the streamline approach that will be outlined in more greater detail later today.

Chairman Frank and distinguished members, I thank you very much for the opportunity to participate in today's hearing. We believe that the interests of the secondary mortgage market and those participants continue to be aligned with borrowers, community and policymakers to prevent foreclosures. To that end, ASF stands ready to assist and commend your leadership on these important matters.

Thank you very much.

[The prepared statement of the American Securitization Forum can be found on page 160 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Deutsch. And now we'll have Faith Schwartz, executive director, HOPE NOW Alliance. Ms. Schwartz.

STATEMENT OF FAITH SCHWARTZ, EXECUTIVE DIRECTOR, HOPE NOW ALLIANCE

Ms. SCHWARTZ. Thank you, Congressman Kanjorski. Mr. Chairman, Ranking Member Bachus, and committee members, thank you for having me and HOPE NOW come and testify today. My name is Faith Schwartz. I am the executive director of the HOPE NOW Alliance, and I am here to talk to a liability about the unprecedented joint industry and nonprofit national initiative to reach out to at-risk borrowers and find solutions to prevent foreclosure.

In this role, I work to coordinate the efforts of all of our industry and nonprofit partners. HOPE NOW has been in existence since October 10th, a little less than 2 months, formed at the encouragement of the Department of Treasury and HUD, and built on the efforts that you and other Members of Congress have encouraged us to undertake, HOPE NOW has established a coordinated national approach among servicers, investors, and counselors to enhance our ability to communicate with borrowers and to offer them workable options to avoid foreclosure.

On November 13th, loan servicers who are in HOPE NOW, their members agreed to a statement of principles to help distressed homeowners stay in their home. These principles are to reach out to all 2/28 and 3/27 borrowers at a minimum of 120 days prior to ARM reset to educate them about the product in ARM and potential interest rate they may be resetting to.

An important announcement was also made that they agreed to establish a single port of entry for all third-party credit counselors

who are working with their borrowers to come into the company so they have a single port of entry through a 1–800 number. In addition, they agreed to have faxes and e-mails available for a single port of entry so they won't get lost in the system in the servicing companies, and we think this is a great step forward. We are currently proactively implementing those principles as we speak.

As of November 19th through November 30th, the HOPE NOW servicers also agreed to mail out to the most at-risk customers a letter to their borrowers on HOPE NOW letterhead, to encourage them with a 1–800 number to call their servicers. As you probably know, one out of two people who go to foreclosure never talk to their servicers. So this is an attempt to reach the most at-risk segment.

Three hundred thousand letters were sent out, and we'll soon know how that worked. In December, we'll have a repeat mailing with additional borrowers, and in there we will add the 1–888–995–HOPE hotline number, which will offer them another solution and come through a third-party credit counseling agency, monitored and operated by the Homeownership Preservation Foundation. That group directly connects the homeowners with a HUD certified nonprofit counseling agency whose counselors will have direct access to lenders and servicers through a single port of entry.

Very quickly, the homeowners HOPE hotline, 1–888–995–HOPE, has already been quite a success. Since 2003, it has received over 300,000 calls and counseled over 130,000 homeowners. Calls are increasing dramatically to this hotline. In October there were 22,000 calls to the hotline and it produced over 10,000 counseling sessions. As of November 30th, the HOPE hotline had received almost 150,000 calls in 2007. And these calls have led to 67,000 counseling sessions.

As you also know, NeighborWorks America's national network of more than 240 community-based organizations in 50 States, which is part of the HOPE NOW Alliance, and it's actively providing in-person counseling services to consumers today, as are many other counseling groups. Tomorrow, NeighborWorks and other HOPE NOW Alliance members will meet with HUD and other counseling intermediaries to review ways to include the grassroots counseling groups as well into our effort.

You've asked us to come here today to talk a little bit about accelerated loan modifications. Loan modifications are a solution for borrowers who have the ability to repay a loan and a desire to do so and keep their home but may need some help in doing so. Loan modifications are not the only solution, and in many cases, refinancing, forbearance, repayment plans provide borrowers a more appropriate option.

HOPE NOW members have been working very closely with American Securitization Forum. Many of the same members are in both groups, and their investor members, to identify categories of subprime ARM borrowers who can benefit from a workout solution.

We are working to develop a triage system in advance of a reset solution for borrowers who would qualify for refinancing, loan modifications and other workout options. The key is to allow the servicers to have a system to offer options to borrowers in a manner that does not violate the pooling and servicing agreements with

investors. Servicers need to be confident that the investors will accept and support more far-reaching loan modifications and other workout solutions and will not engage in a series of lawsuits that can only slow down the effort to assist targeted borrowers.

It's important the markets recognize that this approach is needed to avoid unnecessary foreclosures that could exacerbate the housing market downturn, further erode the value of existing mortgage securities, but most importantly, keep people in their home.

The three areas being looked at are to look first at the refinancing. There are a large amount of current 2/28 and 3/27 loans that will be eligible for agency refinancing, FHA, or FHA secure type of financing. It's important to note that in 2007 alone, 500,000 of these loans have refinanced.

For the loan modification, the second category, the segment of borrowers includes those with good payment records but who will not quite qualify for the refinancing. They're candidates for streamlined loan modifications in this category, and if they can't refinance, borrowers will be offered a modification, and the details of that will soon be announced. I am not completely familiar with all of the details of that at this time, but I will be at some point later today.

And then loss mitigation was something other discussed, so we talked about the current set of circumstances with borrowers who are current, pre-reset and can't afford the reset. And then there are borrowers who are already delinquent, and there would need to be some options for that category.

Mr. Chairman, it's important to note that a streamlined, scalable solution for current borrowers facing a reset will allow for more detailed attention to the at-risk, hard-to-reach and delinquent borrowers, the borrowers that we're reaching out to through letters to try to get us in the door to the servicing shops.

We are committed to an aggressive system of finding solutions for borrowers. As part of that system, HOPE NOW will track and measure outcomes. We will develop measures of trends in delinquencies, resolution outcomes, reinstatement workouts, repayment plans, modifications, short sales, and foreclosure. The intent is to develop consistent and informative data reports based on a common definition and to develop information that provides insights into the nature and the extent of the current mortgage crisis and helps in the development of workable solutions that avoids foreclosure wherever possible.

I would just like to note that we have some testimony on H.R. 4178 that I'd urge you to look at, and we appreciate the goal in Congressman Castle's legislation and feel it brought us all talking about the issue, and that was an important step forward.

So thank you for inviting us to participate.

[The prepared statement of Ms. Schwartz can be found on page 191 of the appendix.]

Mr. KANJORSKI. Thank you, Ms. Schwartz.

We will now hear from Hilary O. Shelton, director, Washington Bureau, National Association for the Advancement of Colored People. Mr. Shelton?

STATEMENT OF HILARY O. SHELTON, DIRECTOR, WASHINGTON BUREAU, NATIONAL ASSOCIATION FOR THE ADVANCEMENT OF COLORED PEOPLE

Mr. SHELTON. Thank you, Congressman Kanjorski. And I want to thank Chairman Frank for once again inviting me here today to talk about predatory lending and some of the initiatives your committee is undertaking to help alleviate the problems associated with predatory lending and to ensure that we are never faced again with a foreclosure crisis similar to what we are looking at today.

I would like to also take this opportunity to once again thank the chairman, as well as Congressman Miller, Congressman Watt, and the other members of the committee who have worked so hard and for so long to address this problem. Your drive, your initiative, and your commitment are deeply appreciated.

As many of you know, my name is Hilary Shelton and I am director of the NAACP's Washington bureau. We are the public policy and advocacy arm of the nation's oldest, largest, and most widely recognized grassroots-based civil rights organization.

And I have said it before: Predatory lending is unequivocally a major civil rights issue. As study after study has conclusively demonstrated, predatory lenders target African Americans, Latinos, Asians and Pacific Islanders, Native Americans, and the elderly and women at such a disproportionate rate that the effect is devastating to not only individuals and families but entire communities as well.

Predatory lending stymies families' attempts to build wealth, ruins people's lives, and given the disproportionate number of minority homeowners who are targeted by predatory lenders decimates entire communities.

Because predatory lending is so important to the NAACP and our members in the communities we serve, we have been actively involved in the predatory lending debate here on Capitol Hill and throughout our country. As such, we worked closely with you, Chairman Frank and Congressman Miller and Congressman Watt, among others, for the development of H.R. 3915, the Mortgage Reform and Anti-Predatory Lending Act of 2007. And while we supported the bill with amendment throughout the process, we were, like most people, disappointed with the final product that passed the full House.

Specifically, we had hoped that the bill would have been improved through the amendment process to provide stronger penalties for lenders who break the law and remedies for the victims of predatory lending. We also need to ensure that any final Federal product is the minimum standard, allowing States to continue to be even more aggressive in eliminating predatory lending and protecting homeowners.

Thus, we strongly supported amendments offered during the floor consideration that would have increased the penalties on individuals or businesses which practice predatory lending. We also opposed amendments that would have weakened key provisions, including the very important anti-steering provisions, the renters protections, the prohibition of prepayment penalties in the subprime market, and the prohibition on the use of yield spread premiums in the subprime market.

We also ardently opposed and shall continue to work against any Federal preemption of State law which limits an individual State's ability to respond to local or regional anomalies which may adversely affect their residents, as well as new predatory practices which may threaten legitimate homeownership after enactment of this Federal law.

We were dismayed to see that many of the amendments we supported were defeated, and hope to work with the Senate to ensure that if and when strong anti-predatory lending legislation becomes law, that breaking the law does not become simply the cost of doing business.

Which brings us to the pattern and practices amendment. As Chairman Frank stated on the House Floor during the consideration of H.R. 3915, the amendment that was offered was developed in a hurry and needed much more consideration. We applaud the chairman for his efforts to bring more accountability to the securitizers, and we also appreciate his foresight in withdrawing the amendment and holding the subsequent hearing to look more thoroughly into this issue.

While we support the goals and the premise of the amendment, we do have some concerns about the implementation of any resulting law.

First of all, and perhaps most importantly, we do not support allowing this pattern and practices provision to be preempted. We believe that every individual should be able to bring a private right of action against anyone and everyone involved in predatory lending.

Secondly, the NAACP has expressed concerns over the last few years about the inaction of several Federal agencies when it comes to to launching investigative or prosecutory efforts involving civil rights violations. Our concern about the tough pattern and practices provision would be that it must be followed up with action by the regulators or it is really of little use.

Finally, Mr. Chairman and members of the committee, the NAACP has some concerns about the amounts prescribed in the amendment for fining companies found to be in violation of a pattern and practice of predatory lending. To the NAACP as well as most Americans, I believe that $1 million plus $25,000 for each bad loan would be enough to stop us from even considering breaking the law.

Yet we all know one of the biggest subprime lenders paid $425 million in a settlement and didn't blink. Thus, we must ask how much this will make the industry sit up and take notice? We don't know the answer to the question, but I suspect it is larger than any of us can fathom.

So I want to thank you again, Chairman Frank, Congressman Miller, Congressman Watt, and the other members of the committee for your aggressive response to the predatory lending problem facing our Nation and for your continued diligence on this issue. I look forward to continuing to work with you to ensure that more homes are not lost to foreclosure either in the near future or in years to come.

The attack by subprime lenders on communities of color across the Nation is not only a moral disgrace and ethical shame, it

should be clearly illegal. With your help, we will ensure that it is. Thank you, and I welcome your questions at this time.

[The prepared statement of Mr. Shelton can be found on page 205 of the appendix.]

The CHAIRMAN. Next, Damon Silvers, the associate general counsel of the AFL–CIO.

STATEMENT OF DAMON SILVERS, ASSOCIATE GENERAL COUNSEL, AFL–CIO

Mr. SILVERS. Good afternoon, Chairman Frank. Thank you very much for the opportunity to appear today. My name is Damon Silvers, and I am an associate general counsel for the AFL–CIO. I am here on behalf of our newly elected executive vice president, Arlene Holt Baker, who could not be here due to the death of her mother.

Everywhere that Arlene has been in her new position in the last several months, union members and union local leadership have expressed the view that the subprime crisis is becoming the single most significant economic problem facing our country. The labor movement believes our country faces an urgent financial crisis that is threatening to spread into a full-blown recession, threatening not only housing, but the stability and health of the broader capital markets and jobs of working Americans.

In the last week we have heard from hundreds of AFL–CIO members who are living in fear of losing their homes. One example is Kimberly Somsel of Westland, Michigan, an unemployed single mother facing foreclosure due to a ballooning 2/28 loan payment. She is selling the family car and her furniture just to get by. And most telling, in relation to what this committee is looking into, five houses on her block are threatened with foreclosure. She is literally one in millions. And this crisis is happening now in our communities.

The AFL–CIO believes that policy, public policy, must be oriented here toward achieving four things immediately.

The first is a moratorium on foreclosures on subprime loans until a viable loan restructuring program for the vast majority of the holders of these reset mortgages is not only in place but has been given a chance to work, and what will necessarily be in many cases individualized solutions are given the time to be worked through. We believe such a moratorium would be something in the range of 6 months to a year.

Secondly, there must be a long-term loan restructuring program. We agree with the original FDIC position that 30 years at the teaser rates is the appropriate solution.

Third, we must reward restructurings and not foreclosures. Therefore, servicers must be encouraged or, if necessary, compelled to step away from servicing agreements that reward foreclosing rather than restructuring loans.

Fourth, transparency: Mortgage servicers must commit to publicly reporting, company by company—and that is the key point—how many subprime loans they are servicing, how many have been reset, how many have been restructured, and how many foreclosures are occurring and where.

And fifth, outreach: With all respect to the efforts of the HOPE NOW group, we believe that many of the borrowers here suffer

from significant mistrust of the lending community, and that outreach would best be done at least in collaboration with Federal Government agencies so that it is clear that the people who are doing the outreaching are not trying in some fashion to again take people's homes.

These recommendations flow directly from the AFL–CIO's recent successful experience with the mortgage crisis associated with Hurricanes Rita and Katrina in the Gulf. Immediately following those storms, the mortgage industry offered hurricane victims 90 days of forbearance. At the end of the 90 days, the AFL–CIO helped bring together bank regulators, led by the FDIC, community advocates in the Gulf and nationally, and the entire community of mortgage lenders and secondary market participants.

In those meetings, the community advocates and the labor movement asked for a one-year forbearance on mortgages in the Gulf and a moratorium on foreclosures. And although there was no formal understanding beyond, again, another short-term moratorium, there were a series of informal understandings and working relationships that came out of those meetings that led to an effective one-year foreclosure moratorium in the Gulf.

And although there have been foreclosures in the Gulf since that time and since the hurricanes, the wave of mass foreclosures widely feared at the end of 2005 never occurred. The credit for that fact goes to all the participants in the dialogue, but the key point was that the demand to have an explicit moratorium was made, and we believe tacitly accepted by the industry.

Now, in putting forth this agenda for immediate action, the AFL–CIO recognizes that much good work has been done to protect homeowners in the housing market going forward. The AFL–CIO supports this committee's work to give homeowners more protections through H.R. 3915. However, we strongly urge Congress to ensure that on final passage, that bill provides for meaningful multiple avenues for enforcing consumer protection standards, including, at a minimum, the right for a State attorney general to enforce its standards.

The AFL–CIO also strongly urges Congress moving forward to quickly pass this committee's bills, strengthening the FHA and creating a low income housing trust fund, and improving the regulations of the GSEs, as well as moving forward on Senator Durbin's bill that gives bankruptcy judges the authority to restructure home mortgage loans in personal bankruptcy and its House companion, H.R. 3609. We also favor tax relief for mortgage holders who get concessions from their lenders.

Now, the Administration's reported deal this afternoon with the mortgage industry appears to go part of the way toward a loan restructuring program, although it appears to apply to far too few borrowers—according to today's New York Times, perhaps only 12 percent of those facing resets.

However, for this program to work properly, it needs to be paired with the foreclosure moratorium we are urging, firm-by-firm reporting, and government outreach to borrowers. Otherwise, we fear that the Administration's program will turn into one more piece of lip service to the notion of restructuring loans, where the reality

is that a variety of financial incentives drive firms toward the worst possible solution, which is foreclosure.

Some say, let working people suffer. Markets left alone will get it right in the end. Yet somehow there is always help in these situations for the well-connected. Cheap money for the banks, severance packages for their failed executives, billions in bonuses for the investment bankers who structured the mortgage deals, while workers, single women who are heads of household, people of color, and the retired are treated as just so much collateral damage. But this time the reality is that we as a Nation must act to help the people who really need the help because the alternative is not just injustice, it is a genuine economic crisis.

The AFL–CIO hopes that as you have led so far, Chairman Frank, you will continue to bring business and regulators together to make real the program we have outlined. In particular, I would note that the four points of our program should be at the center of any kind of trade around litigation issues. We stand ready to work with you to ensure the American dream of homeownership and an economy that works for all. Thank you.

[The prepared statement of Mr. Silvers can be found on page 208 of the appendix.]

The CHAIRMAN. Now, Dr. Richard Kent Green, the Oliver T. Carr, Jr. Chair of real estate finance at the George Washington School of Business.

STATEMENT OF RICHARD KENT GREEN, OLIVER T. CARR, JR. CHAIR OF REAL ESTATE FINANCE, GEORGE WASHINGTON SCHOOL OF BUSINESS, GEORGE WASHINGTON UNIVERSITY

Mr. GREEN. Chairman Frank, and members of the committee, thank you for inviting me to testify today. My name is Richard Green, and I am the Carr Professor of real estate and finance at George Washington University.

Let me begin by saying that my thoughts on the subprime crisis have evolved considerably over the past year. Last March, I was quoted rather embarrassingly in Newsweek as saying that I thought the damage arising from the subprime mess would be limited. I was clearly wrong. And so as events have changed, my thoughts on appropriate policy responses to the crisis have changed as well.

Mass loan modification is one example of how my views have changed. Not so long ago, I worried that if contractual loan terms were not enforced, future investors would be less willing to invest in mortgages. But this point seems moot at the moment.

Three things have led me to change my mind about modification. First and foremost is that it will be difficult to preserve macroeconomic and neighborhood stability if we ignore the fact that already dangerous loans will become even more so when their payments increase, sometimes dramatically.

For reasons I will describe later in my testimony, I do not think that modification is by any means a panacea. But past experiences in the history of the U.S. mortgage market give us reason to believe that mass modification can be an effective tool for restoring stability to financial markets.

Before the Great Depression, the typical mortgage in the United States had some features in common with many current subprime mortgages, in the form of a floating interest rate, no amortization, and the possibility of payment shock arising from balloon payments. In fact, almost all mortgages originated before the Great Depression in the United States had a balloon payment feature.

The housing finance system actually worked reasonably well until the Great Depression, when bank illiquidity made lenders call loans when they were due. Households rarely had enough cash to pay off their mortgages, and so needed to sell their homes to meet the obligation. The lack of liquidity meant that buyers could not obtain financing, so sellers could not sell. This led to waves of foreclosures. The market clearly needed a "servicing solution."

In response, the Hoover Administration created the Federal Home Loan Bank system, and New Deal housing finance legislation created the FHA to ensure long-term mortgages, and the Homeowners Loan Corporation and its successor, the Federal National Mortgage Association, to tie mortgage markets to capital markets. HLC reinstated defaulted balloon loans as 20-year fixed-payment mortgages. This can be seen as the first example of mass loan modification.

Second, I have come to appreciate that transactions between borrowers and lenders are hardly typical. Even the simplest mortgage, whose cost is a function of rate, term, points, fees, and expected time in the home is not a straightforward product. Adjustable rate mortgages are even more complicated, exotic ARMs even more so.

At a conference at Harvard last week, professors of law and economics from leading universities could not explain in detail all the characteristics of their adjustable rate mortgages. To expect consumers with far less financial acumen to understand the terms of exotic ARMs is unreasonable. I have become increasingly convinced that large numbers of borrowers were persuaded to take on products that they did not understand.

Third, structured finance has made loan modification on an individual loan level more difficult. The interest of different investors in various classes of securities can be in conflict. When a loan is in default, it is possible that investors holding a senior tranche will prefer foreclosure to workout, while those holding junior tranches might prefer workout. At the end of the day, this conflict could prevent workouts in cases where borrowers and the sum total of investors would be better off with a workout, indicating that workouts are economically efficient, at least in the short run.

In my opinion, as we think about solving the current crisis and developing reforms for the mortgage market of the future, we must keep in mind how important it is to develop incentives that will allow us to get out of our current predicament and prevent future crises.

To me, a combination of incentives and improved information will be more effective than detailed regulation. For the time being, the key loan modifications would be: one, to freeze ARM payments for particular types of ARMs; and two, to allow ARM borrowers whose mortgages have prepayment penalties to refinance without having to pay these penalties.

But in determining the level at which to freeze ARM payments, we should not freeze rates below A and Alt-A fixed rates, both for equity reasons and because we want to encourage borrowers who can refinance into A and Alt-A products. And it appears there are a fairly large number of such borrowers to do so.

All that said, it is important to recognize that no amount of modification will produce a panacea to the current crisis. First of all, we know many defaults occurred before a rate reset, and so they were induced by something other than a payment shock. It is actually an interesting and open question as to whether those borrowers with the greatest propensity to default have already done so.

In the distant past, that is, the 1970's and 1980's, default usually occurred in the 3rd to 7th year of a loan's life. We now have the unusual spectacle of books of mortgages that contain a large number of loans that didn't receive a single payment. This means history gives us little guidance about how these mortgages would perform going forward.

Second, the current outlook for the housing market is grim. People's expectation about the housing market, based in part on increasing prevalence of foreclosures, could push down houses for a while all by itself, which will eat away at home equity, which will make mortgages even more vulnerable.

Reducing the possibility of payment shocks and making mortgages easier to refinance will help. But for a person who loses his job, gets sick, or sees his marriage dissolve, the fact that his mortgage balance is higher than his house value may leave him with little alternative but to default.

Reducing impediments to modification will, however, reduce the probability of foreclosure somewhat, and will therefore reduce the inventory of homes available for sale going forward. This can do nothing but help expectations about future house prices, and therefore make the market less bad than it otherwise would be.

Thanks for having me today.

[The prepared statement of Mr. Green can be found on page 124 of the appendix.]

The CHAIRMAN. Thank you. I would say to Mr. Shelton, if we were having a markup now, you would be a lot happier man than you were previously.

I will ask Mr. Silvers the first question. The foreclosure moratorium obviously is a desirable result. But legally, constitutionally, who do you believe would have the authority to promulgate that if it were to be a governmental action rather than a plea? If it is a plea for voluntary action, I very much agree. But is there any government entity who could decree it?

Mr. SILVERS. Well, first let me say that I don't think that plea has been made in any serious way.

The CHAIRMAN. I understand that.

Mr. SILVERS. So making it would be a good start. I mean, I think our—

The CHAIRMAN. I understand. But let's get to the question.

Mr. SILVERS. Our experience in New Orleans is how that got done. Now, in terms of forcing it, in terms of saying that it has to happen now, I think that, Mr. Chairman, your point earlier about

the PSLRA is a point that suggests that there are many instances in which the Congress and the President have together, through statute, done things that one might argue impinged on prior contractual rights, and done so without compensation.

The greater degree of the severity of the national crisis that is faced in circumstances like today—

The CHAIRMAN. All right. Well, let me ask this. And I obviously chose the securities litigation because that is one where the business community wanted us to, I believe, curtail some existing shareholder rights. I would be glad to have a memorandum from you on other, further precedents.

The other thing I would say is this, and I am not at this point calling for a total moratorium. But people should remember that the most important principle of legislation is that the ankle bone is connected to the shoulder bone. That is, there are financial institutions in this country who would like us in the Congress to do things, and there are things they would like us not to do. They can't make us do them or not do them, but they could ask us.

Similarly, there are things we would like them to do or not do, and we can't make them, but we can ask them. And I have to say that they should understand the more accommodating they are to our concerns, the more accommodating they might expect us to be to theirs.

And let me be very explicit here. I agree that one of the problems that we had in the bill that we passed, and I will say what I have said with regard sometimes to some of my friends with their expectations of Nancy Pelosi. During the debate on gay rights, I had some friends whom I thought had taken the Wizard of Oz to heart too much, and they had the speaker confused with Glinda the Good Witch and thought that she somehow had a wand she could wave and we as her deputy witches could just get things done, votes and political opinion to the contrary.

But we didn't get everything we wanted in that bill. In particular, I think we fell a little short in the enforcement area. But we will have a further chance at that, and we do want to work with you. I understand the concerns about pattern and practice.

I will say this, too. On the attorneys general, yes, we do think they should have a role. It is our view, by the way, that to the extent that remedies are there, attorneys general are fully free to take them on. For example, in terms of getting mortgages that were granted imprudently and against the bill, that ignored ability to pay or net tangible benefit, where you can get the mortgage rescinded and costs, I would hope some attorneys general would gather up several hundred people in their community, if that were the case in their State, and bring such a case and get full compensation. I think, properly done, the attorneys general could use this as a way to hire some staff, knowing that there would be this funding source if they could get their legislatures to allow them to use it for those purposes and bring a number of cases.

The gentleman from North Carolina, Mr. Watt, had some amendments we which talked about that we wanted to do. Mr. Miller will be working on strengthening up the language on yield spread premium. So we do plan to do that.

But on enforcement in particular, we will be going forward. But over and beyond that, I have to say this to the people in the financial services community. And I know they went down to the White House, but maybe this will catch up to them. We will be taking further action on this bill, in an open way. It is my hope that we might have a subsequent markup, for instance, on some of the enforcement measures that Mr. Watt will be working on.

And it is possibly the case that some of us want to do more than maybe the majority will want to do. The degree to which we will be able to toughen enforcement as a factual matter will be affected by how the financial services community behaves in the current crisis. That is, the fewer mortgages that are restructured, the stronger is going to be the argument for much tougher enforcement going forward.

And if in fact we were to get a very forthcoming response with regard to the modifications, beyond even what the Administration is asking for, which we should go beyond in some cases or in many cases, that is going to have an effect. And so I just want to make that very clear.

We intend to toughen enforcement. And one of the problems we had with the bill was we didn't have a lot of experience with some of these things. Well, we are going to get some experience now. We are going to get some experience with the willingness of people in the financial community to show reasonable forbearance, to show that they have learned from past mistakes. And the extent to which they are responsive will have, I think, a real impact on what is going on.

And I must say a grudging and reluctant response to this, maybe I should in some ways say okay because it is going to strengthen our hand when we go forward legislatively. But I would rather not have innocent homeowners be the victims of that.

Mr. Silvers?

Mr. SILVERS. Mr. Chairman, two further thoughts on your initial question. One is that foreclosure itself is somewhat different than the contractual remedies between the parties. Foreclosure is by operation of State government in relation to property law.

The CHAIRMAN. Yes.

Mr. SILVERS. It seems to me not impossible, although I don't have the memo for you this afternoon, that you clearly have under the commerce clause the right to do so, could you get the President to sign it, to essentially impose—

The CHAIRMAN. Okay, Mr. Silvers. But let me ask you this. Are you asking us to preempt State law in this regard?

Mr. SILVERS. I am not asking you to do this at the moment because I believe there are several ways of achieving this that are far less dramatic.

The CHAIRMAN. Right. I mean, that is the other problem. One is the kind of Fifth Amendment contract clause problem.

Mr. SILVERS. Right.

The CHAIRMAN. The other is the State problem. And I know there is more preemption in this bill than some people wanted. But there is a lot less than other people wanted. And that is one of our constraints in dealing with foreclosure, is that you don't want to set, I don't think, a wide open precedent on preemption.

Mr. SILVERS. I think the best way to achieve this is the way in which we worked in New Orleans, which is by sort of informal understanding. The second best way to achieve it is the way that you suggested a few moments ago, which is by carrots rather than sticks, by essentially defining a set of criteria that would make for a responsible player in the financial services market in this crisis, which would include participating in a 6-month foreclosure moratorium, and have certain rewards for joining that—

The CHAIRMAN. My time is expired. Before I pass it on, I will say—maybe I didn't say it clearly—when you say that my talk is carrots instead of sticks, no. I am not talking about carrots or sticks. I think the extent to which the mix of carrot and stick that they are going to see in enforcement as a practical matter is going to be affected by what happens going forward.

The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman. And I would like to thank our presenters here today.

I have a few questions that I would like to ask of Ms. Faith Schwartz, executive director, HOPE NOW Alliance. I guess we can conclude that the Alliance is very new. Is that right?

Ms. SCHWARTZ. Yes.

Ms. WATERS. And being very new, you have adopted some principles. But you are still working on specifics. Is that right?

Ms. SCHWARTZ. Well, no. These principles are adopted, and we have multiple prongs to our effort with outreach to borrowers to a technology solution.

Ms. WATERS. Well, let us talk first about the nonprofits that you are working with. And you said these are HUD-approved nonprofits. What does that mean?

Ms. SCHWARTZ. Well, the original nonprofits that are part of the HOPE NOW Alliance when it was announced are NeighborWorks America and the Homeownership Preservation Foundation, which is running the 1–888–995–HOPE hotline.

Ms. WATERS. So you describe in much detail the hotline that is managed by this entity. And they receive the calls, and they basically do counseling?

Ms. SCHWARTZ. They do counseling, and they are triaging that to bring it back in to the servicers to—because the borrowers won't call the servicers, as it has been brought up before. And this is a way for a third party support group to help bring the borrowers back into the servicers for options.

Ms. WATERS. So this hotline is responsible for counseling and helping to connect the borrowers with the servicers?

Ms. SCHWARTZ. That is correct.

Ms. WATERS. And you gave a pretty impressive list of number of calls going back to the original hotline on up until, I think, as recent as December, of the number of calls that they have received.

Ms. SCHWARTZ. As recently as November 30th.

Ms. WATERS. November 30th. Can you tell me, in all of those calls and all of the counseling, how many modifications have been realized?

Ms. SCHWARTZ. I can't tell you today how many modifications have been realized. We have a significant amount of borrowers who were counseled and handed off to the lenders and servicer shops.

Ms. WATERS. But the goal is to make sure—

Ms. SCHWARTZ. Yes, it is. Right.

Ms. WATERS. —that people are helped. And part of that is modifications. We would really, really benefit from knowing how many modifications have been done that would help us to understand the effectiveness of this hotline and the counseling that they are doing.

Ms. SCHWARTZ. There is a goal we have—

Ms. WATERS. How are you going to track it?

Ms. SCHWARTZ. Yes. We are going to track all of our workout solutions, modifications, delinquencies, as an aggregate group to get clarity around better numbers than you have had before. So that is one of our goals.

We are also reaching out to many on-the-ground counselors and grassroots—

Ms. WATERS. When do you think you will have a system in place by which you can give us the number on modifications?

Ms. SCHWARTZ. Well, we have one of our first data requests coming back in in the month of December. But we are working to collaborate with every servicer to get all of the data metrics so we will have better information to share with you and others monthly, and have a baseline for our activity.

Ms. WATERS. So you would be able to share with Congress that information on a monthly basis?

Ms. SCHWARTZ. We hope to be. We don't have it yet, but that is our goal, to have more information so that we can be transparent about the activities and the progress of the HOPE NOW alliance.

Ms. WATERS. You talk about outreach, and you mention the direct mail program—

Ms. SCHWARTZ. Yes.

Ms. WATERS. —that you are involved in. Is this a direct mail program of each of the servicers, or is this something under the HOPE NOW Alliance, or how do you do that?

Ms. SCHWARTZ. This outreach is under the brand of HOPE NOW Alliance so that the borrowers will open the letters that go out. And it is to also bring them back to a third party counselor instead of just the servicers and the—

Ms. WATERS. So who is targeted? Who gets these letters?

Ms. SCHWARTZ. Very at-risk borrowers who have not been in contact with their servicers.

Ms. WATERS. So these letters are targeted by the servicers. These are loans that they are working on.

Ms. SCHWARTZ. Yes. And they are not in contact with their borrowers, so they are trying to get them to call them. Because we know one out of two loans that goes to foreclosure never is in contact.

Ms. WATERS. Where does the database come from for this?

Ms. SCHWARTZ. Pardon me?

Ms. WATERS. Where does the database come from? They are not coming from the servicers who are working on the loans.

Ms. SCHWARTZ. No. It is coming from—

Ms. WATERS. Oh, they are?

Ms. SCHWARTZ. I am sorry. Yes.

Ms. WATERS. So the servicers, like 100 days before they are in trouble or something like that, some formula—

Ms. SCHWARTZ. I will clarify for you.

Ms. WATERS. Yes.

Ms. SCHWARTZ. The first outreach principle we got all the servicers to agree to or they can't be in the HOPE NOW Alliance is that 120 days protect an ARM reset, they must contact the borrower, educate them on the terms of the loan, tell them what that reset is going to be, and they will get feedback if there is any problem with that loan.

Ms. WATERS. So they have started that process already?

Ms. SCHWARTZ. Yes. That is in process.

Ms. WATERS. Do you have a copy of any of those letters that have gone out that you can share with us?

Ms. SCHWARTZ. Yes. Yes, we have a letter that is—that is just outreach to borrowers, phone calls or letters. The outreach—

Ms. WATERS. Do you have any with you today?

Ms. SCHWARTZ. The outreach letter that I am referring to in this testimony is a letter that is going to at-risk borrowers under HOPE NOW. It is a slightly different outreach. We have multiple things going on.

The CHAIRMAN. Let me ask you to submit a copy of every letter you send out, and without objection we will make them part of the record.

Ms. SCHWARTZ. Sure. Okay.

Ms. WATERS. Mr. Chairman, if you don't mind, just 30 seconds more.

I understand in the outreach, and Mr. Deutsch was at my meeting in Los Angeles, that neither HOPE NOW nor the servicers are spending any money on national advertising. I have been watching to see if I hear anything on the radio or see anything on television, and I have heard nothing. I have seen nothing. And nobody can tell me that one dollar has been spent out of the huge budget.

I see that some of the institutions, even ones that are in trouble like Countrywide, are spending a lot of money soliciting more business. But I have not seen anything advertising, "Call us so we can help you."

Ms. SCHWARTZ. Okay. Congresswoman Waters, the members of HOPE NOW have supported the ad campaign through the NeighborWorks Council, which is a public service ad, which does just that. And it has run in several markets, and it is an ongoing advertisement.

Ms. WATERS. We would like to know more about that. I will have some questions I will get to you in writing.

Ms. SCHWARTZ. And I will submit that.

The CHAIRMAN. I should say this: All the witnesses should recognize that there may be additional questions submitted by the members, and we will have them in the record.

The gentlewoman from New York.

Will the gentlewoman yield? Our colleague from North Carolina, who has had such an active role in this, has to be in an interview at 12:30. You just want to go ahead? All right. The gentlewoman from New York.

Mrs. MALONEY. Sorry. We are having a few technical problems. I thank all of the witnesses for your testimony.

And Mr. Deutsch, how did the secondary market contribute to the foreclosure crisis?

Mr. DEUTSCH. Could you be slightly more specific?

Mrs. MALONEY. Well, I would say that some have said that the secondary market played a key role in the subprime crisis by purchasing and soliciting unaffordable and in some cases abusive loans. And a very striking quote that I saw was from one of the chief executive officers, now from a company that has gone bankrupt, Own It Mortgage Solutions, and this is what he said. And I am quoting from a quote that was in the paper.

He said, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loan." And he says, "What would you do? If you were paid more to do a no-doc loan than one that is substantial and can prove that the person can pay for it," he literally said he was paid more for a no-doc loan than for a legitimate loan.

And in spite of this, what is happening, basically what I am concerned about, is I believe your organization has opposed any assignee liability standards in the bill that actually we passed. And if we don't have some rules to play by, how are we going to protect ourselves or protect consumers or protect our economy from going in this direction again?

And we have to have some standards. We tried to build in standards, assignee liability as a standard. I thought it was a balanced standard, a safe harbor. And your comments on the role of the secondary market in the foreclosure crisis, and resistance to building in standards to bring in accountability so that we can protect consumers and help our economy.

Mr. DEUTSCH. Maybe in response to I believe it was Bill Dallas's quote, the chairman of Own It, I guess first to note is Own It, as you indicated, is no longer in business. I can't comment and don't know or understand, in particular, the incentives that they had in their structures. Obviously, their business model did not work out as I am sure they would have liked or hoped. So I really can't comment specifically on their incentives or how they worked.

But I think the secondary market is critical to providing capital not only on a going-forward basis to those first-time home buyers and others, but it is also very critical—and I think in some of the discussions that were just released a bit earlier by the Administration, refinancing right now is the number one opportunity for those borrowers in subprime ARMs. In well over have the cases of current subprime borrowers, they are able to refinance into other industry products, FHA products, or FHA secure.

So the number one way to cut off that financing is to have institutional investors pull credit from the markets or to walk away. And I think in particular relation to, say, Representative Castle's bill, that would be a very poor signal right now to send to those institutional investors where their contracts may potentially be abrogated by such a provision.

And I think that would be quite a concern, not only to existing homeowners but also those who would like to own homes in the near future.

Mrs. MALONEY. Well, everyone applauds the really dramatic creative role that the secondary market has played in building and

having liquidity and the opportunity for homeowners. But my question is back to standards. We want the secondary market there, but we want a secondary market that is healthy.

And if your organization could possibly look into what Mr. Own It, the owner or the chief executive of Own It Mortgage Solutions—what were the standards that he was talking about? I found that as an astonishing quote. And basically, my question is: What steps did your members take during this time leading up to the crisis that we have reached?

There were many warnings from consumer groups and advocates. I would say industry analysts were out there warning that many of these subprime loans had payment shocks in, that they were unsustainable. One constituent said to me, you know, I couldn't afford my rent so I went out and bought a home because I didn't even have to prove anything. The standards for renting were higher than the standards for getting a mortgage.

So my question really is: What steps did your members take to ensure that people were purchasing—that you were purchasing sustainable loans, that people could literally pay for the loans that they were getting? And again, why is your industry opposing assignee liability or any standards to make sure that the loans that you are buying, people can pay for them?

This is, I think, a legitimate question, and I just would like an answer. Thank you.

Mr. DEUTSCH. Maybe to the first question, in terms of lending standards, you have seen quite dramatically this summer lending standards tighten significantly so that, say, a year ago if you were eligible for a particular loan, as of this summer some of those borrowers would no longer be eligible for a loan. So there was quite a significant restriction of credit in that sense, and a strengthening of underwriting criteria and guidelines.

Mrs. MALONEY. And did that come from your organization, or where did these new standards come from?

Mr. DEUTSCH. It is part of the market development and evolution. And I think a backdrop of all of this that is a big part of all of the different analyses so far is the housing price appreciation or depreciation in certain markets. It is obviously a very important backdrop.

Mrs. MALONEY. Okay. My time is up. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MILLER. Thank you, Mr. Chairman. And I think I would like to pursue the questions that Ms. Maloney was asking.

Mr. Deutsch, I have always agreed that we need a vibrant secondary market, that lenders need to be able to sell loans to have the liquidity to make more loans, to make credit available for Americans to buy homes. And I think homeownership is the way most middle class American families really build wealth. And good mortgages help people build wealth; bad mortgages steal wealth from them.

And I thought to do that, we needed to have some limitation on the liability in the secondary market, that they could not be responsible for everything that happened at the retail level. They couldn't know of every conversation.

And I have supported some limitation. But looking at what has happened in the market is kind of hard for me to imagine that you all have really proceeded in good faith and had no idea of what was going on at the retail level of the market. Five years ago, 8 percent of the total mortgages made were subprime; last year, 28 percent. That is a 3½ fold increase.

Mr. Shelton just left the room when I was about to ask a question I wanted him to hear. But more than half of African-American families who took out mortgages in the last year took out subprime mortgages; among white families, it was 22 percent. We know from the HMDA data or from analysis of it you cannot explain that by any criteria, any explanation, except race. You can't explain it by credit score. You can't explain it by income. You can't explain it by loan to value. You can only explain it by race.

We know from the Wall Street—well, 5 years ago, Freddie Mac said that 25 percent of subprime loans were made to people who qualified for prime loans. The Wall Street Journal said this week that it is now 55 percent of the people who take out subprime loans qualify for prime loans.

Ninety percent of the subprime loans made in the last 2 years, in 2006 and 2007, had adjustable rate mortgages with a short adjustment, 2 or 3 years, typically a 30 to 50 percent increase in monthly payment. Seventy percent of subprime loans had prepayment penalties, many of them short of the time of the—I mean, that extended beyond the adjustment period. Seventy-five percent, no escrow for taxes and insurance. Half—I have seen a range, estimate of a range, of 43 to 50 percent were made without full documentation of income.

Now, the vast, vast majority of Americans can easily document their income. They can do it with payroll records. They can do it with employment verification. They can do it with bank statements. They can do it with tax returns. It is easy. People who are self-employed can verify their income. People who own businesses and make their income that way can verify their income. And yet almost half of the loans that were coming to the secondary market, and they were buying, were made without full income verification. And consumers paid more, higher interest rates, if there was not full documentation.

Now, that is what you were seeing coming towards you. Those were the loans that you were buying. And you didn't know anything was going on? You didn't think something funny was happening at the retail level?

Mr. DEUTSCH. Well, I guess in answer to the question is part of the institutional investors that were purchasing these loans, that were purchasing the securities backed by these loans, obviously were trying to pay close attention to them.

But at the time, and again going back to my previous statement, is that the housing price appreciation market, especially in particular areas like California where the home prices were increasing quite dramatically—many people have noted that there were a number of speculators in the market trying to increase, trying to obtain homes, and multiple homes, in certain areas where they were able to create quite a dramatic increase in their wealth by speculating on different homes.

So obviously, the secondary market was purchasing, and institutional investors in particular were purchasing, these subprime loans. And in particular, in 2006 there was a significant deterioration in credit quality of some of the underlying borrowers.

Mr. MILLER. The figure I have seen of the percentage of the loans now in default, the subprime loans that went to speculators, people who did not occupy the home that they had purchased, is well less than 10 percent, the 5 to 7 range. Do you have different information? Because my understanding is that is a pretty small percentage of the problem.

Mr. DEUTSCH. I don't have different information. I don't have the data on the exact number of the various investor properties. But it is also very difficult to verify by verifiable data to know who is an owner-occupied versus investor. There are a number of concerns about how verifiable that data is.

Mr. MILLER. Well, do you think it is dramatically different from 5 to 7 percent?

Mr. DEUTSCH. I just don't have the information. I don't have the data associated with that.

Mr. MILLER. I am done.

Mr. WATT. [presiding] The gentleman from Texas, Mr. Green, is recognized.

Mr. GREEN. Thank you, Mr. Chairman. And I thank the witnesses for appearing today, and regret that I did not have an opportunity to speak to the first panel. However, I will try as best I can to extract some of my concerns—not extract, address some of my concerns to this panel.

The prime rate in January 2005 was 5.25 percent; in June 2005, it was 6.1 percent; in January 2006, it was 7.25 percent; in June 2006, it was 8.02 percent; in January 2007, it was 8.15 percent; and we currently have a rate of about 7.74 percent. We heard testimony today indicating that about 7 to 9 percent of these entry level rates were—actually, more than half of these entry level rates were at 8 percent, over 8 percent, and that most of them were 7 to 9 percent.

So if they are 7 to 9 percent and most of them are over 8 percent, and the prime rate has consistently been pretty much not more than 8.25 percent, the question becomes: Does anybody think that freezing the rate is a bad idea? If you think freezing the rate is a bad idea, raise your hand, please.

[A show of hands]

Mr. GREEN. All right, sir. Address it, please. Tell me.

Mr. SILVERS. I think you are pointing out here sort of the insufficiency of freezing the rate as a solution by itself. If you freeze the rate on loans that are inherently exploitative, which I think is what your point—what you are getting at, and then leave people in a situation where they are being threatened with foreclosure on the one hand, and on the other hand being offered a "solution" that remains something that remains something that they either can't afford or can't afford without destroying their family's ability to do other things like feed themselves and provide for their health care and their education, then you are not doing anyone any favors at all.

And it may very well be the case that for loans of the type you are describing, in a landscape in which housing prices are falling and in which, contrary to what the industry folks have represented to you this afternoon, investors have already completely lost confidence in the secondary market so that anything that is not completely generic, completely safe, that is all-conforming, can't get any investor money right now, in that landscape saying to the borrower, oh, we are going to save your house because we are going to let you stay in a loan that is, as you put it, 2 or 3 points above prime, is not really a solution.

The true solution for that person is going to be one in which the lender and the servicer and potentially the investors are going to take a bigger hit because the only thing that that homeowner may really be able to afford, or that any potential purchaser of that house may really be able to afford, is either a lower rate or a lower principal amount on that loan.

And so the notion of sort of freezing the rate for that situation, which you raise, is not going to be enough. And that is just one example of the various ways in which today is a day in which, unfortunately, some false solutions are being promoted. Some really, truly dangerous things are being unaddressed. And some dangers are being raised, like the danger that "we will damage confidence in the market." Confidence in it is gone. We will "damage confidence in the market," so we can't save actual, real homeowners. That notion that is being promoted here is utterly false.

Mr. GREEN. It looks like we have another vote coming up, so let me just move quickly and ask the HOPE NOW representative—Ms. Schwartz, is that correct?

Ms. SCHWARTZ. Yes.

Mr. GREEN. Ms. Schwartz—well, hold that for just a second. Let me come back to you again, sir.

If we are talking about refinancing these loans, and we have all of the financial institutions at the table now talking about the possibility of freezing, who is going to refinance? The people—you have the answer, Ms. Schwartz? Please.

Ms. SCHWARTZ. Sure. With my testimony, I talked a little bit about what today is about and then kind of some ongoing efforts longer term. So if there is a current 2/28 or 3/27 loan, and we are looking at that today, and there is either a refinance option or a freeze on a rate, it would be whether they can refinance and they have the ability and willingness to stay in their home and pay to be modified into an accelerated modification.

It does not preclude having a different interest rate, a lower interest rate or principal reduction or forbearance plan or any other workout solution for all those other borrowers. The point of not being able to accelerate modifications across the whole segment of loans is that they take a little more thorough analysis. That is the only difference. It is not saying they won't get a modification or they won't get a better workout solution.

Mr. GREEN. Is there empirical evidence to indicate that this is happening? Because I have talked to persons, and I have not talked to as many as you have, but the people that I talk to are very frustrated about the system.

Ms. SCHWARTZ. Right.

Mr. GREEN. They don't seem to think that the system is working as announced.

Ms. SCHWARTZ. Right. Well, I think it has been a frustrating time for borrowers and for servicers. And what we are hoping is that while all the good efforts are going on and have been going on within a lot of servicing shops to address the change in the market, we are hoping that a more unified and systematic approach—some of what has been announced today. But that is just a beginning.

Mr. GREEN. I yield back, Mr. Chairman. Thank you.

Mr. WATT. Thank you. And I was going to cut you off anyway since your time had expired.

But let me explain the situation because I think I am not going to ask any questions of this panel. This is our situation. We have been called for a quorum call, which is 15 minutes. And then there are going to be some closing remarks on the bill that is on the floor, which will probably take another 10 minutes or so. And then we are going to vote, 15 minutes.

We probably have enough time, if we go ahead and take the last panel, to get in the testimony of that last panel so that they don't—there are three votes and quorum calls and discussions. It would probably be another hour before we get back here.

So I think we are better off to go ahead, release this panel, and call up the third panel for their testimony. Whomever feels like they need to go to the quorum call—I never have thought much of quorum calls myself. I know where I am, and I know I will be there when it is time to vote on substance. So we thank these witnesses for testifying, and I would like to call up the third panel of witnesses and proceed promptly with their testimony.

Okay, this panel has three witnesses, I think. Oh, yes, we do have three witnesses, and let me introduce them all at one time and ask them to proceed in this order so that I don't waste time.

The first is Laurence Platt, partner, K&L Gates on behalf of the Securities Industry and Financial Markets Association. The second is Michael Calhoun, who was on the second panel and agreed to move to the third panel, he is the president of the Center for Responsible Lending. The third witness is Josh Silver, vice president for policy at the National Community Reinvestment Coalition.

We thank you for being here. And, Mr. Platt, you are recognized.

STATEMENT OF LAURENCE PLATT, PARTNER, K&L GATES, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. PLATT. Thank you Chairman Frank, Ranking Member Bachus, and members of the committee. Good afternoon.

I thank you for the privilege of testifying here today on behalf of the Securities Industry and Financial Markets Association on a proposal that would materially expand the remedies available for a violation of title 2 of H.R. 3915.

Under the proposal, regulators will have authority to impose civil money penalties of a million dollars plus at least $25,000 per loan on any creditor, assignee, or securitizer that exhibits a pattern and practice of making, buying, and securitizing loans without regard

to a consumer's ability to repay the loan or a loan's provision of a net tangible benefit to the borrower.

While we appreciate the continuing efforts of the committee to strive to find ways to protect borrowers who are victims of unlawful lending practices, we oppose this measure as offered during Floor consideration of H.R. 3915.

We would like to make three general points for your consideration this afternoon and refer you to our written submission for a more detailed response. First, we believe that consumers can benefit from residential mortgage loans that neither qualify for the safe harbor under H.R. 3915, nor constitute high-cost mortgages under HOEPA. As you all know, title 2 of H.R. 3915 divides residential mortgage loans that are not high-cost loans subject to HOEPA into two types.

One type is loans that are presumed to satisfy the new law's requirements on ability to repay and net tangible benefit, because of their cost or features. We refer to these as "safe harbor" loans. The second type of loan is loans that do not benefit from such a presumption. We call those "non-safe harbor" loans.

H.R. 3915 provides significant remedies for non-safe harbor loans that violate the new law. A consumer is entitled to monetary damages from the creditor, and in addition, the consumer generally may rescind the loan against the creditor, the assignee, or the securitizer, although one of those parties may cure the violation by providing the consumer with a safe harbor loan. In addition, title 3 of H.R. 3915 significantly expands the universe of mortgage loans that are considered high-cost mortgages under HOEPA.

The secondary market presently does not finance, buy, sell, or securitize high-cost mortgages, because of the huge penalties that may be imposed on assignees under HOEPA. We firmly believe that there is nothing inherently or per se wrong with a non-safe harbor mortgage. Indeed, the new law expressly rejects any presumption that a non-safe harbor loan is illegal.

A non-safe harbor mortgage can serve a valuable role in helping subprime and other underserved borrowers obtain mortgage credit, subject of course to a creditor satisfaction of its new legal responsibilities under H.R. 3915. We therefore believe that public policy should support and not impair the availability of non-safe harbor mortgages.

Our second point is our belief that adoption of this amendment on pattern and practice will cause the real estate finance industry to treat non-safe harbor mortgages like high-cost mortgages under HOEPA and cease funding them. Why do we believe that?

Well, purchasers of loans are unwilling to assume material legal risks for the acts, errors and omissions of others unless they can determine in advance of purchase whether the third party complied with applicable law. But title 2's substantive requirements on ability to repay and net tangible benefit are inherently subjective in nature. A purchaser cannot conduct conclusive due diligence in advance to determine compliance with a subjective standard. And this means that errors in judgment made in good faith could create liability.

As we understand the proposal, a single, good faith error regarding the propriety of a single practice that's repeated by a creditor

or assignee, could create direct pattern and practice liability. Experience indicates, as I referenced with HOEPA, that the real estate finance industry will not make, buy, sell, finance, or securitize residential mortgage loans carrying a huge financial risk that exceeds the amount necessary to compensate a consumer for actual harm. Assignees are not likely to assume such a huge risk at all, much less in cases where they cannot tell in advance if they are buying loans that comply with the law, because of the inherently subjective nature of such law.

So the effect of the proposal, whether it's intentional or not, is to impose direct, not derivative liability on assignees and securitizers, for the mere act of purchasing loans. Thus, we believe the amendment effectively will prohibit non-safe harbor loans, much like HOEPA effectively outlaws high cost mortgages. Again, we believe that public policy should support and not impair the availability of non-safe harbor mortgages.

The third point I want to make is to articulate our belief that the House should give the remedies under H.R. 3915 a chance to prove their effectiveness before essentially throwing them out and replacing them with an unfeasible arrangement for non-safe harbor loans. H.R. 3915 sought to balance the interests of consumers and industry.

How did they do it? Well, on one hand, under the law consumers are given the ability to get out of a non-safe harbor mortgage that never should have been made. Assignees and securitizers generally must cure a violation to ensure that a consumer gets an affordable loan providing a net tangible benefit or face rescission of the loan.

On the other hand, assignees and securitizers are not generally subject to monetary damages under H.R. 3915. For example, H.R. 3915 doesn't include the statutory or enhanced damages that are provided under HOEPA, and as I said, those are loans that the market won't buy. We think that the remedy of cure and rescission will cost assignees significantly. The risk of loss is material enough to influence secondary market purchasers to be more vigilant in evaluating the types of loans that they purchase.

But the proposed amendment eliminates the carefully crafted balance of H.R. 3915 by imposing huge monetary penalties that are punitive in nature on assignees and securitizers. We see no reason to declare the existing remedies ineffective until they're given the opportunity to work.

So we respectfully request that the committee give existing H.R. 3915 a chance in order to support the availability of non-safe harbor mortgage loans that comply with the new law. We appreciate the opportunity to testify, and we'd be pleased to answer any questions.

[The prepared statement of Mr. Platt can be found on page 178 of the appendix.]

The CHAIRMAN. Mr. Calhoun?

STATEMENT OF MICHAEL D. CALHOUN, PRESIDENT, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Chairman Frank, and members of the committee, first individually, and then on behalf of the Center for Responsible

Lending, I want to thank you for your diligent work in addressing one of the largest housing and financial crises of our generation.

In my testimony, I'll first address several aspects of the current mortgage market crisis, and then we'll address the two amendments before the committee today and the Treasury plan that is being announced today. This committee has heard much testimony about the mortgage crisis with focus on the 2/28 ARMs. The first point and perhaps most important point is that as bad as things seem right now, they will get much worse over the next 2 years.

Moody's has estimated that 3 million families will face foreclosure, with 2 million of those families ultimately losing their homes. Unfortunately, we are still on the front side of two large waves of payment resets as shown in a chart that's included in my testimony there are two, large events in groups of loans coming for payment resets. The first and the one getting most of the publicity now are the so-called subprime "hybrid" ARMs or 2/28 loans. And this chart, which many of you have seen, is set out on page 3 of my testimony. And the important thing is there are two large waves. The one on the left is primarily generated by subprime ARMs, and noteworthy is we are on the front side of this wave. The front side of this wave. These loans, the resets, will peak around May of next year and with foreclosures trailing 6 to 12 months after that.

Something that has gotten very little publicity is there is an equally large wave of even greater payment shocks that will follow that. And those are generated by the payment option ARM loans shown towards the middle and right side of this chart. And, surprisingly, those payment shocks are even much larger for the typical borrower. Under payment option ARMS, when the loan goes from the low option payment to a full amortizing payment, that issue is usually a doubling or more of the required payment for the borrower. Again, loans that very few people or families can actually absorb those payment shocks, and if there's not a rapidly appreciating housing market where they can refinance out of that payment shock, we once again will be dumping more houses onto the market through foreclosures.

I will address the Treasury plan and the two amendments, briefly. The Treasury plan we support, and it will help those families that receive it, but it will be, and it's important, a relatively small percentage of those families who need help will actually benefit from the plan. The challenge is that the structural obstacles in the mortgage market that prevented modifications this year are still there and are not really addressed at all in the Treasury plan.

One of those that's been discussed today is through Mr. Castle's amendment, is that while it is good for investors at large to modify rather than foreclose, it is often worse for individual investors for there to be a modification rather than a foreclosure, because under the structure of securities, the security that bears the loss of a default and a foreclosure depends on when that loss occurs. And so some security holders who are protected from losses if they happen under typical structures in the first 3 years of those loans become liable for them after 3 years. And so their approach and their explicit threats to servicers has been do not delay this loss. Foreclose now rather than put this loss on my watch. And so we have sup-

ported the Castle amendment with the caveat that the language needs to be clarified that it does not immunize servicers from claims by consumers for violations of law and for predatory features, but it is a necessary clarification. The industry press is filled with statements that servicers are still regularly threatened by lawsuits from investors and that that is thwarting modifications.

The second structural obstacle is simple financial incentives. Servicers are generally not paid for doing modifications. In contrast, as has been reported in the press, foreclosing has in fact become a profit center and quite lucrative for many servicers who have added on additional fees and made that a source of additional revenue. And so if you're a servicer, you have a choice of doing a public good for which you're not paid and may get sued, or proceeding with a standard procedures and foreclosing and increasing your bottom line. Well in our capitalist system, most of the servicers are going to proceed with the foreclosure.

An even greater obstacle that has received no discussion today is that approximately 40 percent of the subprime ARMs have second mortgages. Often they were included as a way to make the first mortgages more marketable securities, and to avoid mortgage insurance. It is very difficult to modify those loans voluntarily in that the first mortgage holder is not going to take a reduction in their stream of payments and allow the second mortgage holder to benefit from that. And the second mortgage holder is not going to give up their position and say, wipe my lien out, without receiving compensation.

So you take out almost half of the subprime ARMs out of feasible modifications under the current treasury plan, just by virtue of the second mortgages. And then finally, as several witnesses have already addressed, this is a voluntary plan with very, very little accountability. I note that even the statistics promised by my good friend Faith Schwartz were, if you noted, aggregate statistics where you have no accountability of which lenders, which servicers, are actually performing.

A more effective remedy that the Center for Responsible Lending has supported and which is pending before other committees in the house how is narrowly targeted bankruptcy reform. Moody's estimated that that reform would save over half-a-million family homeowners, and yesterday made statements that they believe perhaps even more important that it could be instrumental in preventing the American economy from slipping into recession.

In contrast, our estimates are that the Treasury plan would serve somewhere at the most optimistic in the range of 145,000 of these 2 million families likely to lose their homes.

Let me comment quickly on the two amendments.

The CHAIRMAN. We have to do it very quickly. You're about 3 minutes over.

Mr. CALHOUN. I apologize, Mr. Chairman.

We also support the pattern and practices set out in my testimony.

Finally, I think we need to send out a message that is important, that the Treasury plan could cause real harm if there are not appropriate warnings about it. It should not lull current homeowners into the belief that their problems had been solved, that if they

have one of these loans with a big payment shock, relief is on the way. Their homes are secure. They still need to be vigilant and fight hard and face great obstacles and need further help from this Congress to be able to save their homes.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Calhoun can be found on page 99 of the appendix.]

STATEMENT OF JOSH SILVER, VICE PRESIDENT FOR POLICY, NATIONAL COMMUNITY REINVESTMENT COALITION

Mr. SILVER. Good afternoon, Chairman Frank, Representative Watt, and members of the committee.

I thank you for the honor and the opportunity to present testimony on behalf of the National Community Reinvestment Coalition. NCRC is the Nation's association of 600 community nonprofit member organizations dedicating to increasing access to capital and credit for working class and minority community. I am also testifying today on behalf of the National Consumer Law Centers low-income clients.

We have not seen anything like this foreclosure crisis in modern history. You have to go back to the Great Depression to find such a period of reckless lending. In the first 10 months of 2007, 1.8 million American families suffered foreclosures. If current trends continue, millions of borrowers will lose their homes, wiping out hundreds of billions of dollars of wealth, costing local governments billions of dollars in foregone tax revenue, and possibly and probably plunging the economy into a recession.

Given this national crisis, strong and decisive legislation is desperately needed. H.R. 3915 has the best of intentions and includes comprehensive protections against abusive lending. A flaw in the legislation, however, is that the bill does not contain effective enforcement mechanisms. In addition, the bill pre-empts State law. Wall Street banks and mortgage brokers are protected by not violating the law. These actors should not be protected by setting such a high bar against liability that American families cannot protect themselves from abusive bad actors.

I will comment on the pattern and practice amendment, the Castle amendment, and then propose an individual right of action in all cases. The pattern and practice amendment had admirable intentions of bolstering enforcement, but provides a remedy that is difficult to achieve. Pattern and practice cases are time consuming and require a high standard of proof. It can take several months or years, and considerable resources to succeed in a pattern and practice case.

In the last 7 years, NCRC found that the Department of Justice settled just five cases involving discrimination in mortgage lending. Moreover, none of these cases involved new pricing information in HMDA data, although the Federal Reserve Board referred 470 lenders over a 2-year time period to their primary, regulatory agency based upon the new HMDA data. The Federal agencies are either unable or unwilling to bring pattern and practice cases.

Another unintended consequence is that pattern and practice standards may create an unrealistically high standard. After a Federal pattern and practice standard is established, defendants

may be able to convince courts that plaintiffs, such as State agencies, would need to win cases using a pattern and practice standard.

Consequently, the number of successful cases against predatory lenders may decline. In addition, the damages in the pattern and practice amendment are limited to $1 million. Previous settlements against major predatory lenders have been in the hundreds and millions of dollars. The amendment's penalty is unlikely to serve as an effective deterrent.

Representative Castle's H.R. 4178 is also well-intentioned, but it is not necessary to facilitate modifications. H.R. 4178 provides immunity from all liability for a creditor or servicer if the entity has enacted a loan modification. A blanket protection from liability in return for unspecified obligations is a risky exchange for borrowers.

For example, the bill did not specify if the modification is to be permanent and does not establish parameters concerning terms and conditions of the modification. As a result, temporary fixes with usurious fees could qualify a financial entity for immunity from liability. An alternative approach is to require servicers to make reasonable efforts to engage in loss mitigation prior to foreclosure.

Failure to engage in reasonable loss mitigation efforts should be a defense to foreclosure. If the House Financial Services Committee is contemplating boosting enforcement and remedies, we recommend that the committee allow individuals to pursue private action on all loans. Currently, H.R. 3915 prohibits private action if the borrower has received a qualified mortgage and a qualified safe harbor mortgage.

Moreover, a borrower of a loan outside the safe harbors has very limited remedies under the bill including when a securitizer has engaged in due diligence, or when the borrower's loan violates certain requirements, such as the ability to repay. Under H.R. 3915, it is conceivable that a borrower could be suffering due to a predatory loan, but have absolutely no means to seek redress, not even a limited venue.

Currently, the interest of the borrower, the lender, and all other actors, through the investor, are not aligned. The misalignment of interests has created dysfunctional market that engages in dangerous lending in order to maximize profits without consideration of the borrower's interest. Only when the financial institutions are accountable to the borrower, the basic principles of fairness and affordability are the interests of all aligned. And, ultimately, the only way to hold financial institutions accountable to the borrower is to make financial institutions liable to the borrower to remedy abusive loans.

Please give Americans aggrieved their day in court. Thank you so much for this opportunity to testify on this important matter.

The CHAIRMAN. Mr. Calhoun, I was struck on page 8 when you said: "The performance of the subprime originally illustrates that it is easier to prevent bad loan terms than to pursue bad actors, particularly through public enforcement." That is what sort of drew me to the bill. And there have been a lot of questions about the enforcement piece, but let me go back to that.

What in the bill that passed would you add in terms of preventing bad loans as opposed to enforcement?

Mr. CALHOUN. Well, I think the key point is you prevent the bad loans by having a deterrence there.

The CHAIRMAN. Well, then I don't understand your sentence.

Mr. CALHOUN. The goal here is to make investors look, but also for them to still be willing to buy.

The CHAIRMAN. Okay, when you said, "prevent bad loans rather than to pursue bad actors."

Mr. CALHOUN. It's what we're saying is the primary goal of the remedies should be deterrents, not restitution. Because that's the lesson of the crises we're in now.

The CHAIRMAN. But I will say public enforcement, one of the things that I think has not been focused on, everything we've talked about doing included in this would be empowering the attorneys general. Nothing in here, in fact, I would hope that attorneys general, whatever enforcements were in here, including if there was ever any pattern or practice. The attorneys general would bring these and we'd get in a conversation. And on that I know there has been concern. People said, well, you're going to be preempting with the attorneys general if you do.

First, it ought to be made clear under the amendment by Mr. Watt, and I think it is that no current cause of action is in any way pre-empted, that is until this bill is signed into law and regulations promulgated, if I'm correct. There is no bar, so my question then is, because I'll be honest, I have heard more talk about attorneys general action recently than I'd seen. Can either of you two gentlemen, Mr. Silver or Mr. Calhoun, can you tell me what are the examples we've had of attorneys general going after the securitizers and the servicers?

I hadn't seen much of it. Is it more than I know? Could I ask you, what have the attorneys general been doing? Because obviously, there's no bar now to their doing it. So what have they been doing so far? Mr. Silver?

Mr. SILVER. There are two cases not against securitizers.

The CHAIRMAN. Excuse me?

Mr. SILVER. It's not against securitizers. You're right, Mr. Chairman.

The CHAIRMAN. Well, all right. Answer my question though, because this bill, if it's against lenders or brokers, this bill doesn't pre-empt anything. So the attorney general will be free if this bill became as it is exactly to go after lenders and brokers; it is only with regard to securitizers.

And again I'm told, well this is a problem, because you've taken away the right of attorneys general to go after securitizers. So how much have attorneys general been going after securitizers up until now?

Mr. SILVER. In comparing with the pattern and practices, you might be setting such a high standard.

The CHAIRMAN. Well, I'm not asking you that, Mr. Silver. You know that. I mean, look. We're trying to get evidence on which to legislate, and I'm told well wait, you can't do this. Well, we have trade-offs to make if we're going to get a law passed.

I know there are people who have a touching faith in the Federal Reserve, but all of a sudden they've become born-again regulators and they're going to take care of everything under HOEPA and we don't need a bill. Good luck to those who believe. This is the Christmas season, so far be it from me to be in a skeptical mood right now. But, to the extent that we're told, look, this is a problem because you're taking away from the attorneys general the right to go after securitizers. How much have they gone after them so far, Mr. Calhoun?

Mr. CALHOUN. Your point is well taken.

The CHAIRMAN. I didn't make a point. I asked a question.

Mr. CALHOUN. They have not to-date gone after them.

The CHAIRMAN. Why?

Mr. CALHOUN. One of the biggest obstacles is that we have seen some of the most abusive lending in a generation. And one of the biggest problems, most of it, has been legal due to the absence of standards at either the Federal or the State level to make them illegal.

The CHAIRMAN. Well, then, if they can't go after them, how are we taking away the right to go after them?

Mr. CALHOUN. Well, I think to the extent you pre-empt assignee liability of State laws, State laws are now moving forward. For example, the ability to repay.

The CHAIRMAN. All right. Excuse me.

Mr. CALHOUN. Many States are now imposing that.

The CHAIRMAN. But you say that they can't go after them because they're not against the law, but now you say we're taking away State law. I mean, we haven't pre-empted any State laws yet. What stopped them from going after them?

Mr. CALHOUN. That the State laws have been recently enacted.

The CHAIRMAN. When?

Mr. CALHOUN. And are considered now: Ohio, Minnesota, North Carolina.

The CHAIRMAN. When was the North Carolina law enacted?

Mr. CALHOUN. The provisions on ability to repay on subprime loans was enacted this summer and just went into effect this fall.

The CHAIRMAN. Are there none that have any longer period?

Mr. CALHOUN. Not that really went to the core abuse of the last several years, which was loans made without ability to repay.

The CHAIRMAN. How many States have such laws?

Mr. CALHOUN. Only about half a dozen right now.

The CHAIRMAN. All right, well then that's the other issue then. That's the dilemma we have, because the Federal bill that we're talking about does impose that standard. So the trade-off is a couple of States, six States maybe, that have the law and the right of the attorney general to do it versus 44 States that have no such protection.

Mr. CALHOUN. And there are a half a dozen or more that are seriously engaged in it.

The CHAIRMAN. But there is no other basis in which the attorneys general could have brought suits against securitizers?

Mr. CALHOUN. We believe and have pushed some of the attorneys general that they could pursue these practices as unfair trade practice claims.

The CHAIRMAN. But they haven't done that.

Mr. CALHOUN. But they have not.

The CHAIRMAN. All right, you know, look. I understand this and I want to work together, but sometimes I get the feeling I'm being accused of moth-balling the Swiss Navy. The gentleman from North Carolina.

Mr. WATT. Mr. Chairman, I want to look very closely at Mr. Platt's testimony. Maybe I will ask Mr. Platt one question. You didn't especially like the pattern in practice proposal. Except for the six States, or maybe less than six States, does the secondary market securitizers have any liability if they don't exercise any responsibility, or are you saying they shouldn't have to exercise any responsibility, all of the responsibility should be placed on the lenders.

Mr. PLATT. Well, let me first say that H.R. 3915 explicitly imposes liability on securitizers. The scope of the liability is more limited than some would like.

Mr. WATT. The scope of the liability is very limited, and one of the things that we proposed was to expand it substantially, and it was like we had dropped a skunk in the room. So given your choice, would you prefer to have that liability extended, or would you prefer the pattern in practice, or neither one of them?

Mr. PLATT. Well, let me respond in two ways. First, to the extent that any liability is imposed on the secondary market, we believe that it is really important that the market be able to determine in advance whether the loans they purchase comply with law. And when there is an inherently subjective standard, that is very hard to do. That is one reason why if there were to be any assignee liability, the more limited assignee liability in this law, we believe, tried to balance the interests of the two. Let me say secondly, that at a State level, there are many States that have imposed liability on assignees for the purchase of loans that violate the primary standards to which the creditors are subject.

In some of those States, the assignees continue to purchase loans, because they believe that the liability is well within the risk that they are willing to bear for expanding their capital. But in those States where the liability is too high, they have withdrawn from the market. And one good example of that is the first State predatory lending law that Georgia enacted a few years ago.

Mr. WATT. And Georgia modified the law, and securitizers went back in?

Mr. PLATT. Yes.

Mr. CALHOUN. Congressman Watt, if I could add just two things quickly. One, there is a little bit of disconnect. I think it is important to remember that the securitizers have a right of indemnification all the way down the chain, back to the originators. And it seems somewhat disingenuous that they are saying, "borrowers you should be able to go collect from the originators, the lender, that should be your primary remedy and that should be sufficient." But they find it an ineffective remedy for them, as a much better funded corporate body, to exercise their blanket indemnity provisions that they have in every agreement when they purchase loans.

The other point to respond to the testimony was there was concern about liability for loans outside of the qualified safe harbor.

Essentially, the qualified safe harbor in the bill requires that you underwrite the loan. And then, the other primary factors are that it has to be either fixed rate for 5 years, or underwritten to a debt to income ratio set by Federal regulators. That does not seem, to follow up with the chairman's nautical analogies, a small harbor to steer a ship into.

Mr. WATT. What would be the problem with ramping up the extent of liability on the originator? I guess what I hear Mr. Platt saying is that you have these people buying loans. If you have a level of responsibility on the originator, an acceptable level of responsibility and liability, let's say deterrent, for them being bad actors, why does there also have to be that level of liability on the securitizers?

Mr. SILVER. A lot of subprime knowledge is sold on the secondary market. Probably most subprime loans are sold on the secondary market. So Representative Watt, we applauded you when you offered the amendment to qualify for immunity from liability. If you were a secondary market agent, or a securitizer, you had to either offer a cure, and have due diligence procedures. Right now, it is offer a cure, or have due diligence procedures, and that is a huge problem.

Mr. WATT. So assume we can put that back in there, I am trying to figure out what would be the problem with wrapping up responsibility on the originator, and giving this securitizer less, substantially less responsibility, because they would like to be able to come in and buy a package of loans without having to do a bunch of work, they are just providing the money. They are not making the loan, they are not looking at the documents, but the originators are, and ought have, in my opinion, higher responsibility. What is the problem with that?

Mr. CALHOUN. If I can respond, I think the two main are that those originators are often very thinly capitalized, and many of them have gone out of existence, and just a very practical obstacle, it is the trust, the holder of the loans, that forecloses. And so if you are a family facing foreclosure, it is little consolation to say I can go sue the creditor, but still be foreclosed and put out on the street, and maybe a few years later collect some money.

One suggestion that we made, and I think at times this was considered, and it may even be the intent of the law, was you could obviate some of this by requiring foreclosure to be sent back down the chain if you will, the loan to be sent back down the chain. You can't have it both ways, you can't say I can foreclose, but I am not subject to any claims. You can not be subject to any claims, but if you want to foreclose, send the loan back down the chain.

Mr. WATT. Thank you, Mr. Chairman, I am just trying to figure out the interplay that is taking place here. I mean, I think we are trying to get something that works and is effective, and is a deterrent to bad conduct. I agree with Mr. Calhoun, he may not have said it artfully in his statement, but the remedies need to be sufficient to deter bad conduct. That is more important than the remedies being sufficient to compensate, because if you can keep the bad conduct from taking place, then there won't be any bad conduct to be compensated.

The CHAIRMAN. Well, let me say that I appreciate it, because that does clarify it for me, but I also think that I agree with part of the question, if we can work it out, that is if you are trying to do that, then it is the person who is engaging in the conduct where you want to have the most focus, which is where we are, maybe we can find some ways to link the foreclosure. Let me also ask you, let me ask another question.

The staff here, who work for the government, tells me a number of States, you said six States, but they were aware of only two where that applied beyond the HOEPA level. They told me that they thought that some of the States where they have done ability to pay, like my own State of Massachusetts, it is only at the HOEPA level, not at a high enough level, we felt, to do it. Do you know how many of the States have done it at only the HOEPA level? There were six you mentioned.

Mr. CALHOUN. It is typical in States that have the so-called mini-HOEPA. When I was referring to it, and I was talking about how it applied more broadly than the mini-HOEPA, for example, North Carolina applies it to subprime loans.

The CHAIRMAN. How many have the ability to pay standard at the full subprime level; that was the question?

Mr. CALHOUN. I would have to check, but I would be happy to provide that information.

[After the hearing, Mr. Calhoun provided the following answer to Chairman Frank's question: "Maine, North Carolina, Illinois, Massachusetts, Ohio, and Minnesota."]

Mr. CHAIRMAN. Okay, yes.

Mr. PLATT. Let me add, if I may, that the Conference of State Bank Supervisors promulgated a uniform version of the agency's bank statement on subprime lending, which includes the obligation to determine the ability to repair. Virtually every State has adopted that as a guideline.

The CHAIRMAN. But that is for State banks. If only banks made loans, I would not have spent the whole day here.

Mr. PLATT. No, no, it is for mortgage companies.

The CHAIRMAN. But there are States where they don't have any enforcement on that. I mean, the State Bank Supervisors can say it, but how do the State Bank Supervisors enforce that against mortgage companies in States where they don't have the jurisdiction over them? It is not my understanding that all States regulate the mortgage brokers.

Mr. PLATT. It is adopted principally as a guideline, although sometimes a regulation by State—

The CHAIRMAN. I appreciate that, but it is getting late, and let me cut to it, "guideline, schmideline." I mean, nobody every lived in a guideline. Well, we will pursue this, we now have our votes coming up, so we will see you.

[Whereupon, at 3:13 p.m. the hearing was adjourned.]

A P P E N D I X

December 6, 2007

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

BEFORE THE FINANCIAL SERVICES COMMITTEE

HEARING ON ACCELERATING LOAN MODIFCATIONS, IMPROVING FORECLOSURE PREVENTION, AND ENHANCING ENFORCEMENT

THURSDAY, DECEMBER 6, 2007

Mr. Chairman, I commend you for convening this hearing on loss mitigation. I share your concerns about the need to advance workable solutions to help borrowers who might lose their homes as a result of deceptive lending. We must also protect the stability of our financial institutions, protect against systemic risk, and maintain the strength of the U.S. economy.

Predatory lending is a complex problem that requires a comprehensive national solution. I have long believed that a solution must consist of five main parts:

- Reforming underwriting standards;
- Establishing registry systems for originators;
- Bettering housing counseling;
- Improving mortgage servicing; and
- Enhancing appraisal independence.

As a result of the amendment that I offered on the floor last month on escrow, appraisal, and mortgage servicing reforms, the House-passed lending reform package addresses each of these issues.

However, I am now convinced that a comprehensive solution requires a sixth part because of the market uncertainty. We need to address the issue of homeownership preservation. As a result, I and the other leaders on the Capital Markets and Financial Institutions subcommittees sent a letter this week to the corporate executives in discussions with the Treasury Department about a private solution to this problem.

While I look forward to the Treasury Secretary's announcement on these matters later today, we will likely need to move a bill on these matters, and I am putting together such legislation. I have identified three principles that can help to guide our decisions for this task.

First, we should refrain from using government resources to bail out those lenders who made bad loans or relied on faulty underwriting standards. We should also limit the use of government resources to subsidize those homeowners who actively participated in schemes to purchase homes beyond their means or who are here illegally.

Second, we should to the maximum extent possible apply market-based approaches that rely on minimal government involvement to address these problems. While the Treasury Department is making progress on this point with its plan, we need to do more. For example, my approved mortgage servicing proposal already mandates swifter response times by mortgage servicers to consumer inquiries. If enacted, this change ought to help ensure that homeowners will receive expedited assistance in the months ahead.

Third, we should identify those initiatives that have worked to address similar problems in the past and apply them around the country. Pennsylvania has recently pioneered efforts to

provide help to homeowners in danger of losing their homes with its Refinance to an Affordable Loan (REAL) program and its Homeowners' Equity Recovery Opportunity (HERO) loan program. We might consider how to implement these initiatives in the national arena.

In conclusion, Mr. Chairman, identifying and putting in place policies to decrease foreclosures, preserve homeownership opportunities, and protect our economy is a complicated set of tasks. We need to approach this situation with an open mind and have flexibility to consider and advance the most pragmatic and practical policy solutions that can obtain bipartisan support. I am committed to achieving this consensus.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

ACCELERATING LOAN MODIFICATIONS, IMPROVING FORECLOSURE PREVENTION AND ENHANCING ENFORCEMENT

before the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

December 6, 2007

2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding loan modifications of subprime hybrid adjustable rate mortgages (ARMs). Problems in the subprime mortgage markets are affecting the broader U.S. housing markets and the economy as a whole and pose a significant policy challenge for the industry and regulators.

Between now and the end of 2008, subprime hybrid ARMs representing hundreds of billions of dollars in outstanding mortgage debt will undergo payment resets. Our calculations based on owner-occupied subprime mortgages included in private mortgage-backed securitizations (MBS) indicate that almost 1.3 million hybrid loans are scheduled to undergo their first reset during 2008.[1] An additional 422,000 subprime hybrid loans are scheduled to reset in 2009, which means these problems will not end anytime soon. The combination of declining home prices and scarce refinancing options will stress these mortgage holders and could result in hundreds of thousands of additional mortgage foreclosures over the next two years. These foreclosures will inflict financial harm on individual borrowers and their communities as they potentially drive down home values. Studies show that property sales associated with foreclosures tend to reduce average home prices in the surrounding neighborhood, placing stress on remaining homeowners and their communities.

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[1] FDIC estimates are based on the Loan Performance Securities Database. They reflect data collected through August 2007 on first-lien mortgages secured by owner-occupied properties where the mortgage has been securitized in private MBS issues. These figures have been adjusted to include an estimate of subprime securitized loans that are not included in the Loan Performance database.

My testimony will provide some brief background on the current situation and describe an approach that I believe provides the best means we have at this juncture to avoid unnecessary foreclosures and provide for long-term, sustainable solutions. I also will comment on legislative proposals that address the issues of servicer liability for participating in loan modifications and penalties for market participants who engage in a pattern or practice of making loans that borrowers cannot repay.

U.S. Housing Markets and Mortgage Credit Performance Have Deteriorated

The U.S. housing boom of the first half of this decade ended abruptly in 2006. Housing starts, which peaked at over 2 million units in 2005, have plummeted to just over half of that level, with no recovery yet in sight. Home prices, which were growing at double-digit rates nationally in 2004 and 2005, are now falling in many metropolitan areas and for the nation as a whole. With declining home prices, there are large increases in problem mortgages, particularly in subprime and Alt-A portfolios.[2] The deterioration in credit performance began in the industrial Midwest, where economic conditions have been the weakest, but has now spread to the former boom markets of Florida, California and other coastal states.

Over the past year, investors and ratings agencies have repeatedly downgraded their assumptions about subprime credit performance. A study published over the

[2] Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.

summer by Merrill Lynch estimated that if U.S. home prices fell by just 5 percent, subprime credit losses to investors would total just under $150 billion and Alt-A credit losses would total $25 billion. Subsequent to this report came news that the Case-Shiller Composite Home Price Index for the 10 large U.S. cities had fallen in August to a level that is already 5 percent lower than a year ago, with futures traded on this index now pointing to the likelihood of a similar decline over the coming year.

The complexity of many mortgage-backed securitization structures has heightened the overall risk aversion of investors, resulting in what has become more generalized illiquidity in global credit markets. These disruptions have led to the precipitous decline in subprime lending, a significant reduction in the availability of Alt-A loans, and higher interest rates on jumbo loans. The reduced availability of mortgage credit has placed further downward pressure on home sales and home prices in a self-reinforcing cycle that now threatens to derail the U.S. economic expansion.

Subprime Hybrid Mortgages and Securitization

The current problem in subprime mortgage lending arose with the rapid growth of 2- and 3-year adjustable rate subprime hybrid loans after 2003. Between year-end 2003 and mid-2007, some 5 million of these loans were originated. Of these, just over 2.5 million loans with outstanding balances of $526 billion remain outstanding.

The typical structure of these loans is to provide for a starter rate (usually between 7 and 9 percent), followed in 24 or 36 months by a steep increase in the interest rate (typically 300 basis points within the first year after the reset) and a commensurate rise in the monthly payment. Almost three quarters of subprime mortgages securitized in 2004 and 2005 were structured in this manner, as were over half the subprime loans made in 2006. Most of these loans also imposed a prepayment penalty if the loan was repaid while the starter rate was still in effect.

Despite the steep "payment shock" these loans impose on subprime borrowers, they actually performed reasonably well in recent years. Rapid home price appreciation in many areas of the U.S. allowed even highly-leveraged borrowers to refinance or to sell their home if necessary when the loans reset without a loss to themselves or mortgage investors, thereby masking the underlying weakness of the structure and underwriting of these products. In today's much more challenging environment, payment reset will lead less often to refinancing and more often to default and foreclosure.

The securitization of these 2/28 and 3/27 subprime hybrid ARMs has been very common in recent years and increases the complexity of achieving loan modifications. The servicer's primary objective is to maximize the value of the assets in a securitization trust; therefore the servicer's interests are primarily aligned with the investors. The pooling and servicing agreement (PSA) describes the roles and responsibilities of the servicer. It also discusses the servicing of the mortgage loans and addresses foreclosure and loss mitigation alternatives, including modifications. While initially there was

concern that the securitization documents and the PSAs might place limits on the ability of servicers to modify loans in the securitization pool, most documents provide the servicers with sufficient flexibility to modify loans. In practice, however, third party servicers have been slow to exercise this flexibility on a large scale.

Two key elements of most PSAs determine how servicers can modify loans. While the language varies, the majority of PSAs require that servicers: (1) protect the interests of investors, and (2) conduct a net present value (NPV) analysis when determining the appropriate loss mitigation strategy in a default scenario.

Under the guidance developed by the American Securitization Forum, servicers should be bound to the interests of bondholders in the aggregate.[3] This guidance provides a common sense approach to a very thorny issue because it simplifies the servicer role in attempting to protect investor interests overall by limiting losses to the pool, instead of trying to consider how each loss mitigation decision will impact each class of bondholder and speculating as to what the various classes might desire.

Servicers must also ensure that they pursue loss mitigation actions that will present the least amount of loss to the pool. While the PSA language varies, the industry calls this an "NPV analysis." Generally, servicers that document that the net present

[3] American Securitization Forum Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, June 2007 (page 4). ("Generally, the ASF believes that loan modifications should only be made: a. consistently with applicable securitization operative documents (including amendments that can be made without investor or other consents); b. in a manner that is in the best interests of the securitization investors in the aggregate; c. in a manner that is in the best interests of the borrower...")

value of the payments on the loan as modified are likely to be greater than the anticipated net recovery that would result from foreclosure will establish that the modification is in the best interest of the securitization of the pool as a whole. Particularly in the case of a declining housing market, the loss on modification will generally be less than the cost of foreclosure. The use of the NPV guideline is also discussed in the American Securitization Forum statement of principles.[4]

Studies show that foreclosure costs can run to half or more of the loan amount.[5] These loss rates will only rise in today's troubled housing markets -- particularly if more subprime borrowers are needlessly pushed into foreclosure. Studies also show that foreclosures tend to drive down the value of other homes located nearby.[6] As these loans reset from the starter rate to the full contract rate, credit losses will mount as more borrowers default and enter foreclosure. This will be self-defeating for investors, impose hardships on homeowners, and have wider negative effects on local communities and the overall economy.

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[4] "The ASF believes that loan modifications meeting the criteria in Loan Modification Principles point 4 above are generally preferable to foreclosure where the servicer concludes that the net present value of the payments on the loan as modified is likely to be greater than the anticipated net recovery that would result from foreclosure."

[5] Karen Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," Federal Reserve Finance and Economics Discussion Paper 2003-16, May 13, 2003, p. 1.

[6] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006), www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf

A Proposal for Loan Modification

It appears that subprime borrowers can be split into four basic groups: the small subset of borrowers whose loans can be expected to perform after reset, without modification; those borrowers whose loans became past due under the starter rate and whose loans will have to be individually re-underwritten to determine whether there is a way to restructure the loans so that they can repay; borrowers who might be able to refinance their loans; and, finally, borrowers who generally have been able to keep their loans current prior to reset, but will likely not be able to make the much higher monthly payments.

Based on the limited data, it is difficult to estimate exactly how large each group might be. It is important to emphasize, however, that these loans were underwritten to perform only at the starter rates and may include other risk factors, such as limited documentation of the ability to repay the loan. In addition, as two or three year loans with embedded payment shock, these loans inherently required refinancing by the initial reset date, an option no longer readily available to most borrowers. The FDIC's calculations, based on owner-occupied subprime mortgages included in private MBS, indicate that about 1.7 million hybrid loans worth $367 billion are scheduled to undergo their first reset during 2008 and 2009. Of these, over 200,000 loans are already 90 days or more past due or in some stage of foreclosure prior to reset. For loans that remain current or less than 90 days delinquent, only 2.9 percent show both a loan-to-value ratio below 80 percent at origination and a debt service-to-income ratio below 30 percent --

attributes that might indicate a high probability of remaining current even after reset. Based on these criteria, our numbers suggest that the group of loans scheduled to reset that are current but may not remain so after reset are on the order of at least 1.4 million loans.

With regard to that small subset of borrowers who have the ability to repay without modification, these loans should continue according to their contractual terms. As for loans that are already past due prior to the reset, servicers should work with these borrowers to determine whether these loans can be restructured on a long-term, sustainable basis. For some who cannot reasonably be expected to repay, even with restructuring, there may be no alternative except for foreclosure. The same is true for loans that were made under fraudulent circumstances or by speculators.

For the group of borrowers who are able to refinance their high cost loans into affordable fixed rate loans, this may be the best option available to them. However, refinancing is not without its own risks and problems. There are a number of potential pitfalls inherent in refinancing, as opposed to restructuring, which borrowers should carefully consider. While loans can be restructured for little or no cost, refinancing, if it is available under today's market conditions, can involve substantial fees for the borrower. There is also the possibility of prepayment penalties in a refinancing if it is not timed properly, whereas prepayment penalties would not be associated with a restructuring. Servicers should strongly consider waiving prepayment penalties in these

circumstances. Restructuring existing loans also may provide more flexibility than refinancing through a lender.

In addition, a borrower should carefully evaluate refinancing options to ensure that they will result in a long-term, sustainable loan. Loans that are refinanced by regulated financial institutions will be made under the *Interagency Guidance on Nontraditional Mortgage Product Risks* and the *Statement on Subprime Mortage Lending* issued by the federal banking regulators that will require that the new loan be underwritten to the fully indexed rate and that its terms be appropriately disclosed. However, borrowers should be aware that there are currently no national standards for mortgage lending and that many non-bank lenders are not covered by the guidance issued by the banking regulators -- which could result in the borrower trading one high cost loan for another.

Long-term, Sustainable Modifications

A key issue is how to address the mortgage loans for owner occupied properties where the borrowers are current on their payments but will not be able to maintain the payments following reset. If servicers do nothing and allow all of these loans to reset to the full contract rate, the result will be the eventual default and foreclosure on hundreds of thousands of additional loans.

For this group of borrowers, I have recommended that servicers take a systematic and streamlined approach to restructuring these loans into long-term, sustainable loans at the starter rate -- which is already above market rates for prime loans. Servicers should reach out proactively to borrowers approaching their reset dates to determine the borrowers' ability to make the payment following reset using common matrices, such as debt-to-income ratios. Commonly used matrices, such as debt-to-income ratios (DTI), can help define which borrowers are most likely to be unable to make payments after reset. For example, the FDIC, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have jointly advised that DTIs for all recurring debts in excess of 50 percent will increase the likelihood of future difficulties in repayment, as well as delinquencies or defaults.

Where the homeowner has generally remained current at the starter rate, but cannot make the higher reset payments, the loan should be modified to keep it at the starter rate for a long-term, sustainable period of five years or more. In today's market, it is virtually certain that this modification will exceed the net present value of allowing the loan to go into foreclosure. In addition, with the volume of resets that many servicers are facing, loan-by-loan approaches will not maximize the value of the loan pool because servicers lack the resources to address the loans on a timely basis.

There are several advantages to the approach I am recommending. A streamlined approach can be undertaken much more rapidly than a loan-by-loan restructuring process. Also, this approach does not involve a bailout involving federal tax dollars. Finally, this

policy does not involve government action that would affect the contractual rights of mortgage investors because it is based on voluntary action by servicers and existing legal rights and responsibilities. This approach makes economic sense and is an appropriate, proactive response to rapidly changing market conditions. Modifying loans before reset will avoid negative credit consequences for borrowers, permit borrowers to keep their homes while making payments they can afford, and provide investors with a return that exceeds any return they would receive from foreclosures. Under today's conditions, we believe that the net present value analysis itself can be streamlined for many markets. Declining housing prices and experience point to the likelihood of substantial losses through foreclosure in contrast to the income stream that can be achieved by sustainable, long-term loan modifications.

Correcting Misconceptions about Mortgage Restructuring

Let me turn now to a number of misconceptions about the impact of the loan modification proposal I have recommended and how it would work.

Misconception: Restructuring Will Create a Windfall for Subprime Borrowers

Some have expressed concern that restructuring subprime loans to a long-term, sustainable mortgage at the starter rate will result in a windfall for subprime borrowers. This misconception is based on the belief that the starter rates for these loans are similar to the low 1 to 2 percent "teaser" rates that were aggressively advertised for prime

borrowers. In fact, of subprime hybrid mortgages originated in 2006, the average starter rate was 8.29 percent, which exceeded the average rate on subprime fixed rate loans made in that same year (8.06 percent), and was well above rates paid on prime fixed rate loans. These subprime borrowers will continue to pay higher subprime rates even after restructuring.

Misconception: Restructuring Will Deny Investors Their Expected Return

Another popular misconception is that restructuring will deny investors a large stream of interest payments that would rightfully accrue to them after the loans reset to the full contract rate. The reality is that very few hybrid borrowers actually remain in the pools after reset and pay the full contract rate. Among such loans made and securitized in 2003, only one in 30 continues to pay at the full contract rate after four years.

Clearly, these loans generally were never designed or underwritten to perform at the full contract rate after reset. Among subprime hybrid loans made in 2006, nearly half had loan-to-value ratios above 90 percent, and more than half had monthly debt service-to-income ratios above 40 percent. Given that, on average, the full contract rate on these loans is five full percentage points above the starter rate, it is clear that they are not designed for long-term repayment.

Misconception: Restructuring Just Delays Eventual Default

Some have argued that this proposal will just delay inevitable defaults. However, borrowers who are current after two years have clearly demonstrated a consistent willingness and ability to repay at the starter rate, which bodes well for their ability to repay at that rate over the long run. The likelihood that these borrowers will continue to make payments at the starter rate is strong because it is the features of the loan causing the current economic distress, not the changed circumstances of the borrower. Restructuring these loans by extending the starter rate provides a sustainable long-term solution, rather than just pushing the problem off to a future date.

Misconception: Restructuring is Unnecessary Based on Past Levels of Credit Losses

Some have argued that standardized and widespread restructuring is unnecessary based on past levels of credit losses. However, previous experience with losses of subprime hybrid ARMs provides very poor guidance regarding how these loans will perform going forward. For example, through August 2007 the cumulative default rate (CDR) for subprime hybrid loans originated in 2004 has been 10 percent; that is, of 1.6 million such loans originated that year, 162,000 have defaulted according to the latest data. However, with the benefit of rapidly rising home prices in many areas of the country, the vast majority of 2004 borrowers were able to repay their loans through refinancing or the voluntary sale of the property.

By contrast, loans resetting today are doing so in an era of declining home prices in many areas of the country and a virtual absence of private subprime lending. Of hybrid loans originated in 2006, the CDR is already 10.5 percent -- before any of these loans have reset. Under today's market conditions, interest rate reset is likely to drive the CDR much higher than levels experienced on previous vintages. This means that the benefits of restructuring cannot be measured against what credit losses were in previous years, but rather must be viewed in the context of how many borrowers can actually afford to pay at the full contract rate where refinancing options are extremely limited and the value of the property has decreased or not increased as anticipated.

Misconception: Standardized Loan Restructuring Cannot Be Accomplished on a Wide Basis

Critics of the proposal to restructure loans to the starter rate as described above argue that such an approach is untested and cannot be implemented on a broad basis. However, the FDIC is aware of servicers that have already begun to use a similar approach with borrowers. Those servicers are reporting that the approach is feasible and significantly reduces the cost of restructuring and its complexity.

Some loan servicers and investors have said that the approach cannot be applied consistent with PSAs because the duty to maximize NPV requires servicers to review loan by loan to set a new payment between the starter and reset rate. As I will explain below, this argument fails to consider that a loan-by-loan approach, given the current and

anticipated rate of resets, will prevent maximization of NPV for the pool as a whole due to inherently limited servicer resources.

First, the volume of resetting loans means that in practical terms, the choice is between foreclosures on the one hand and systematic loan modifications for eligible borrowers on the other. A loan-by-loan calibration of what each borrower can pay will take too much time and too many resources. This increases the likelihood that a loan-by-loan approach will mean more foreclosures and loss of value to borrowers and investors. In contrast, following a streamlined modifications approach for eligible borrowers, as we have suggested, will free up resources to address the historic levels of resets that will occur in the coming 18 months and the more difficult loans and borrowers, such as those already delinquent and those with loans, such as Alt-A, that have risk layering characteristics. With any systematic loan modification program, you create categories of borrowers. While an individual determination needs to be made as to the category for each borrower, systemizing the categories and the modifications that are appropriate for that category of borrower will streamline the modification process.

I would also note that applying a modification that increases the starter rate by 1 or 2 percentage points, though not completely to the reset rate, will increase the potential delinquency rate without significantly increasing the actual cash flow into the trust. "Squeezing" the maximum increase out of a current borrower clearly increases the likelihood of delinquency compared to proven payments at the starter rate. In today's

declining home market, it is against investors' interests to modify loans in a way that will increase the likelihood of default down the road.

Finally, I would note that brief extensions of the starter rate will not provide stability to the borrower, investors, or the market. Brief extensions simply increase the resource stress on servicers and decrease the ability of the market to determine market prices for mortgage assets.

On November 20th, the Governor of California announced that he has reached an agreement with several large loan servicers, including Countrywide, GMAC, Litton and HomEq, to streamline "fast-track" procedures to help keep more subprime borrowers in their homes. This agreement is based on the proposal described above, and together these four enterprises service more than 25 percent of issued subprime mortgage loans. I am greatly encouraged that servicers are recognizing the benefits of addressing problematic loans on a systematic basis. We believe that this is a very positive step because it is a public commitment to support stream-lined loan modifications by the governor of our most populous state and to implement that commitment by loan servicers who service loans throughout the country. We hope that this action will encourage other servicers to adopt this approach to speed up the pace of loan modifications.

Finally, I would like to pay tribute to Treasury Secretary Paulson's leadership in advocating systematic, sustainable loan modifications. Through the Treasury-led Hope

Now effort, I am optimistic that national agreements on systematic loan modifications, combined with reporting templates for effective monitoring, are coming to fruition.

Legislative Proposals

A number of proposals have been introduced in Congress to address the fallout from the subprime mortgage crisis. Recently, the House of Representatives passed legislation drafted by this Committee to address some of the market excesses that have created problems. While this legislation would impact future loan originations, it cannot address loans that have already been made.

Legal Protections for Servicers Engaging in Loan Modifications

Although some servicers have expressed concerns regarding possible legal liability for engaging in loan modifications, the loan modification proposal described above is consistent with existing legal authority and the best practices of the industry. In addition, a number of servicers, representing a significant portion of the mortgage servicing industry, have already begun to engage in loan modifications without seeking additional legislative protection. While legislative action might be appropriate to clarify servicers' existing legal authorities, legislation should be carefully drafted to avoid the unintended consequence of slowing activity that is already underway or creating different litigation risks.

H.R. 4178, introduced by Representative Michael Castle, is laudable in its goal to spur loan modifications by providing certain legal protections. Specifically, it seeks to provide additional legal protection for servicers engaged in loan restructuring by exempting servicers and other loan holders from liability when they implement qualified loan modifications or workout plans. However, as originally drafted, the legislation would appear to override existing contracts which could create a Constitutional issue.[7]

If Congress determines that it is appropriate to assist servicers engaging in loan modifications, the FDIC would suggest consideration of a provision stating that, absent specific contract language to the contrary, (1) servicers have a duty to maximize the net present value of a loan pool for all investors and parties having an interest in the pool, not to any individual party or group of parties, and (2) servicers act in the best interests of all parties if they agree to or implement a modification or workout plan for a residential mortgage loan, or a class of residential mortgage loans, that meet specified criteria.

Penalties for Pattern or Practice Violations

The amendment to H.R. 3915 proposed by Chairman Frank and Representatives Miller and Watt would have imposed certain civil penalties on any originator, assignee, or securitizer that engages in a pattern or practice of originating, assigning, or securitizing residential mortgage loans that violate the requirements in Title II of H.R. 3915. Under current law, the federal banking agencies can bring enforcement actions against their

[7] Fifth Amendment takings issues have arisen in the financial services context. *See, e.g., Cienega Gardens v. United States*, 331 F.3d 1319, 1334 (Fed. Cir. 2003).

regulated institutions, including civil money penalties, for violations of law. H.R. 3915 currently imposes limited civil liability (i.e. a private right of action) against assignees and securitizers with respect to loans that do not satisfy the requirements in Title II of the bill, but the bill does not make assigning or securitizing such loans a *per se* violation of law enforceable by the regulators. Because the FDIC does not anticipate that many of its supervised institutions are currently engaged in activities as assignees or securitizers, we would defer to the views of regulators with institutions that are more extensively involved.

Conclusion

Poor underwriting and abuses in the subprime mortgage market are having a significant negative impact on the housing markets and the U.S. economy. In the coming months, large numbers of subprime adjustable rate mortgages will reset to higher interest rates and borrowers will generally be facing default and possible foreclosure.

The FDIC is advocating a systematic approach to loan restructuring that will create long-term, sustainable solutions that enable borrowers to stay in their homes and provide a better financial result for investors than foreclosure. By restructuring subprime hybrid ARMs into long-term, sustainable loans at the starter rate for borrowers occupying their homes, servicers can proactively address a wave of likely defaults and foreclosures that will harm individuals and communities and instead provide for long-term, sustainable results. A systematic approach to restructuring for these borrowers also will

free up servicer resources to work with troubled borrowers who will require more individualized solutions.

Thank you for the opportunity to testify. I would be happy to answer any questions the Committee might have.

Testimony of Michael D. Calhoun
Center for Responsible Lending

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

Before the U.S. House Committee on Financial Services
December 6, 2007

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

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

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

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

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

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

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

My remarks today will focus on these points:

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

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

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

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

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

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

I. The Scope of the Subprime Problem

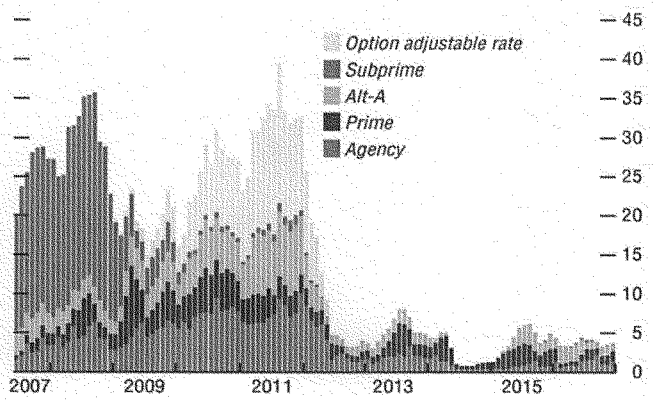
It is important to recognize that while the rate of subprime foreclosures is alarming today, the worst is still ahead.

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

of these rate resets will occur later this year and throughout 2008, peaking in October 2008.[2]

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

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



Source: Credit Suisse.

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

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

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

II. The Role of Wall Street

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

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

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

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

III. The Urgent Need for Widespread, Sustainable Loan Modifications

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

One of the reasons loan modifications make sense is that they would put people into the position they would have been if they had not been sold a dangerous product. This week, the *Wall Street Journal* reported that more than half of the people who received subprime loans during 2005 had credit scores that would have qualified them for prime loans.[7] Even lending industry leaders have acknowledged that many homeowners who received

subprime ARMs could have qualified for sustainable, 30-year fixed rate subprime mortgages, typically at a cost of only 50 to 80 basis points above the introductory rate on the unsustainable exploding ARM they were provided;[8] in some cases, the introductory teaser rate for these ARMs was higher than the rate for a 30-year fixed loan.

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

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

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

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

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

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

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

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

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

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

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

- Fear of investor lawsuits. The servicer has obligations to the investors who have purchased the mortgage-backed securities through pooling and servicing

contracts, but there are conflicting interests among the different levels of investors. Servicers are hesitant to modify the loans because they are concerned that it will impact different tranches of the security differently, and thereby raise the risk of investor lawsuits when one or more tranche inevitably loses income. This phenomenon is known as "tranche warfare." For example, a modification that defers loss will favor the residual holder if the excess yield account is released, but will hurt senior bondholders. Servicers see foreclosure as the safest course legally.

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

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

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

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

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

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

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

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

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

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

VI. Bankruptcy Reform is the Most Effective Solution

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

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

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

Conclusion

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

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

APPENDIX

The Center for Responsible Lending and Self-Help

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

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

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

END NOTES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[15] The National Community Reinvestment Coalition reports that the Department of Justice has only brought seven enforcement actions related to lending discrimination, and only five related to mortgages. Similarly, the Federal Reserve Board has made hundreds of referrals for pricing disparity problems to the various banking regulatory agencies, yet zero enforcement actions have ensued. See NCRC testimony, December 6, 2007.

For Release Upon Delivery
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TESTIMONY OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

U.S. HOUSE OF REPRESENTATIVES

DECEMBER 6, 2007

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Frank, Ranking Member Bachus, and members of the Committee, today's hearing focuses on recent developments to enhance the pace of mortgage loan modifications that may help troubled borrowers remain in their homes, and to explore two proposals that arose in connection with consideration of H.R.3915, the "Mortgage Reform and Anti-Predatory Lending Act of 2007." Both proposals raise important points for consideration. But they also highlight other, broader issues that are raised by subprime resets and by provisions of H.R. 3915 that are intended to prevent similar subprime mortgage problems in the future.

Approaches to Deal with
Impending Mortgage Interest Rate Resets

Subprime adjustable rate mortgages (ARMs) typically provide for a relatively low starter interest rate that resets to a significantly higher rate over a 2- to 3-year period – the so-called 2/28s and 3/27s. The volume of such mortgages increased substantially beginning in 2004 and extending through the first part of 2007. As a result, with the passage of time, the nation's mortgage markets are now contending with a large volume of subprime ARMs that reset each month, a process that will continue through at least the end of 2008. Because the monthly payment on these loans can increase substantially at reset – by 25 percent or more – borrowers almost always refinance into new mortgages at the time of reset, assuming they are able to do so.

During the recent years of significant house price appreciation in many parts of the country, the vast majority of subprime ARM holders were able to refinance at reset into new mortgages, due largely to the increased value of the underlying homes. Conversely, with house prices becoming flat or declining in many parts of the country during 2007, it has become increasingly difficult for many subprime ARM borrowers to refinance at reset. While many such borrowers remain current on their loans or are still able to refinance at market rates or into FHA

products, an increasing number have either fallen behind on their existing payments, or face the prospect of falling behind when rates reset and they are unable to refinance into new mortgages. Many forecasters project unprecedented levels of delinquencies and foreclosures with the sharply increased volume of resets expected to occur in a climate of flat or declining house prices.

There has been a vigorous and very healthy debate about how best to address the widespread subprime ARM interest rate resets and the prospect of large numbers of defaults and foreclosures. The outcome of this debate is obviously critically important to subprime borrowers and their creditors, typically investors who hold interests in securities backed in whole or in part by pools of subprime ARMs. But another critical stakeholder in the process is the mortgage servicer, part of whose job it is to implement foreclosure when necessary, or any loan modifications that may be appropriate for keeping mortgage borrowers in their homes while mitigating the substantial losses that would accrue to mortgage lenders from foreclosure.

In this regard, banks supervised by the OCC have a significant role to play. As I have previously testified, national banks did not originate subprime mortgages to the same extent as other market participants – for example, only about 10 percent of subprime loans issued in 2006, with default rates significantly lower than the national average. They do, however, occupy a more significant role as subprime servicers, with several large national banks currently servicing approximately $175 billion of subprime loans, constituting nearly 18 percent of the subprime servicing market.

In their role as servicers, these banks are working to balance the sometimes competing interests of borrowers and investors. As borrowers become delinquent and face the prospect of loan modification or foreclosure, the servicer's job becomes much more time consuming and labor intensive. As a result, given the large number of resetting ARMs and the potentially large

number of borrowers who may be unable to afford the higher monthly payments at reset, there is good reason to explore new approaches to handling the attendant issues on a broader scale. Under these circumstances, identifying a programmatic approach – that is, an approach that would facilitate modifications of large numbers of mortgages in a short period of time using a common set of criteria – could make very good sense. Of course – and this is important – any programmatic approach would not foreclose the possibility that borrowers who do not qualify under the programmatic criteria might still qualify for loan modifications based on a case-by-case evaluation of their ability to repay under modified terms. Indeed, for the many borrowers who are already delinquent on their payments, have already entered foreclosure proceedings, or will not qualify for the programmatic approach, the loan-by-loan approach will continue to be the best hope for avoiding foreclosure.

As we look for solutions, it is important to recognize that, although the volume of subprime ARMs facing interest rate resets is large, it is divisible into distinct segments, only some of which are realistic candidates for loan modifications. At one end of the spectrum, there unfortunately will be a significant number of borrowers who are overextended, delinquent on their payments even at the starter rate, and face no realistic alternative other than foreclosure. At the other end is a substantial portion of borrowers with the capacity to refinance their mortgages into new mortgages at market rates or pursuant to programs administered by the Federal Housing Administration (FHA).

In between the two are segments of borrowers where loan modifications are possible and in many cases will be the most appropriate course of action. Where borrowers are not current on their loans, and even for some borrowers for whom foreclosure proceedings have begun, a loan

modification may still be possible – but given the clear indications of credit problems, the only realistic approach for such modifications is a loan-by-loan approach.

On the other hand, there will also be a significant number of borrowers who are current on their payments at the initial rate, but are projected not to be able either to afford payments at the higher reset rate or to refinance into market or FHA mortgages. It is this segment of borrowers for whom some kind of programmatic approach to modification would make the most sense – and interested stakeholders in the lender, servicer, and investor community have been in intense discussions over the past weeks to develop just such an approach.

The formidable challenge has been to develop criteria for a programmatic approach for this category of borrower so that modifications can be completed quickly, allowing more borrowers to avoid foreclosure in ways that mitigate costs to the mortgage holders. Indeed, I believe it is critical for key stakeholders – lenders, servicers, and investors – to hammer out parameters for a programmatic approach that would strike a balance among their diverse interests and is broadly acceptable.

To be sure, such an approach won't be perfect from any one perspective. But its chances for success will be greatly improved because of the stakeholder participation that allowed all the different interests to weigh in to try to find a workable solution. It is our understanding that the different stakeholders are very close to reaching such an agreement, and although I have not yet seen the details, we very much support the approach in principle.

H.R. 4178: The Emergency Mortgage Loan Modification Act of 2007

For today's hearing, the Committee has particularly asked for our views on H.R. 4178, the "Emergency Mortgage Loan Modification Act," which would provide a safe harbor from liability for mortgage market participants that modify troubled mortgage loans according to

certain criteria. H.R. 4178 would amend the Truth-in-Lending Act (TILA) to provide a safe harbor from liability for any creditor, assignee, servicer, securitizer, or any other holder of certain troubled residential mortgage loans that enters into qualified loan modifications and workout plans with respect to a troubled mortgage loan. The safe harbor, which would apply to loan modifications initiated within six months after enactment, covers subprime loans consummated on or after January 1, 2004, and extends to any liability that might be imposed under any law, regulation, or contract.

H.R. 4178 is a timely and important step to facilitate efforts by creditors and servicers to respond to the volume of potential loan modifications that may be needed. It has added to the momentum of achieving this goal. Very recent events – the progress made by key interested stakeholders – lenders, servicers, and investors – to hammer out parameters for a programmatic approach that would strike a balance among their diverse interests – may demonstrate, however, that a legislative solution may not be the optimal approach to achieving the desired results.

Legislating a particular solution or approach to modification of troubled subprime ARMs becomes very challenging in view of the competing interests of different market participants that I just described, and it carries downside risks. Legislation effectively undertakes to referee the different interests of the various parties interested in the transaction, specifying criteria for a single approach. In this regard, while I applaud the goals underlying H.R. 4178, the legislation itself presents several significant concerns.

First, the retroactive application of H.R. 4178 could create additional anxiety in the mortgage markets about the reliability of legal obligations upon which investors' expectations are based. If the legislation is enacted, will investors face new qualms about investing in

mortgage-backed securities? A loss – or even a significant diminution – of investor confidence in this market could adversely affect the flow of funds for housing credit for some time to come.

Second, to the extent that it would effectively modify existing contract rights under servicer or investor agreements, the legislation may create a new field of potential litigation that is more challenging and inhibits loan modification efforts just as much, if not more than the legal issues industry participants are facing today.

In light of these potential downside risks, and particularly in view of the progress key stakeholders have made is reaching consensus on a programmatic approach, I would respectfully suggest that, at this time, on balance, the new issues that the bill would raise would outweigh its potential benefits.

Amendment to Increase Enforcement Authority

The Committee also has asked for our views on a proposal that would add authority to impose civil money penalties on mortgage originators, assignees, and securitizers for a "pattern or practice" of violations of H.R. 3915's core lending standards concerning a borrower's ability to repay and the net tangible benefit standard for refinanced mortgage loans. The proposal would amend TILA to make mortgage loan creditors, assignees, and securitizers liable for civil money penalties (CMPs) if they engage in a "pattern or practice" of originating, assigning, or securitizing loans that violate the "ability to repay" or "net tangible benefit" standards under H.R. 3915. The penalties would be mandated at $1 million for engaging in the pattern or practice, plus at least $25,000 per loan involved. All penalties collected would be paid to a trust fund administered by the Treasury Department. This money would then be awarded through a claims process, governed by Treasury regulations, to consumers who were entitled to relief under

the rescission and cure provisions of H.R. 3915, but who have no party against whom to assert these remedies.

These penalties are in addition to the remedies against creditors, assignees, and securitizers already contained in H.R. 3915, and remedies already available under current law. TILA currently authorizes the federal banking agencies to institute administrative enforcement action addressing TILA violations at depository institutions (and their subsidiaries) through the broad enforcement powers afforded to the banking agencies under section 8 of the Federal Deposit Insurance Act.[1] Moreover, TILA currently provides consumers with private civil remedies against creditors and assignees for actual damages and attorneys' fees, as well as statutory damages that will be doubled under H.R. 3915.[2]

The federal banking agencies oversee TILA compliance by the entities subject to their supervision, using comprehensive and ongoing supervisory processes designed to assure compliance with applicable standards. Through supervision, compliance weaknesses can be identified at an early stage and can be corrected before they evolve into significant violations of the law. To address the most serious problems identified through the supervisory process, the banking agencies also may employ a flexible range of enforcement tools available to us under section 1818. These enforcement tools range from a cease and desist order under which the institution agrees to address compliance weaknesses, to CMPs against the institution and individuals involved with the violation, and industry-wide lifelong employment bans on institution-affiliated parties in egregious cases.

There is no comparable system of oversight and enforcement for non-depository institution mortgage market participants organized and operating exclusively under state law.

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[1] 12 U.S.C. § 1818. *See* 15 U.S.C. § 1607.

[2] 15 U.S.C. §§ 1640, 1641.

While the Federal Trade Commission has authority to take enforcement action against these non-depository institutions under TILA, the FTC does not engage in ongoing supervision of lenders' activities.

In its current form, H.R. 3915 does not address how the application of the legislation's qualitative lending standards to non-depository institution lenders and their employees will be supervised and enforced. Clearly, the new standards established by H.R. 3915 are intended to apply to them. The missing link is – how will they be applied in practice?

Therefore, I am concerned that the additional mandatory "pattern or practice" CMP penalties will serve to magnify the already disproportionate compliance impact of the legislation on federally regulated depository institutions. I would have these same concerns even if the proposed amendment were limited only to securitizers since the same imbalance of supervision and oversight also exists in the case of depository institutions and non-depository institutions that engage in securitization activities.

For example, the legislation establishes certification standards that will encourage states to enact effective licensing requirements for non-bank mortgage professionals, including requiring, as a condition of certification of a state licensing system, that there be a state supervisory authority that provides effective supervision and enforcement of the *licensing requirements.* This licensing system certification mechanism assures minimum standards for state licensing systems by requiring that state systems meet specified minimum criteria to be certified, and in so doing helps to minimize inconsistencies between different state licensing systems. If a state licensing system fails to meet the standards for certification, H.R. 3915 provides for a backstop system for licensing non-depository institution lenders in that state, administered by the Department of Housing and Urban Development.

There is no comparable mechanism in H.R. 3915 to assure minimum standards and a level of consistency in state supervision and enforcement of the bill's *substantive standards* on duty of care, anti-steering, ability to repay, and net tangible benefit and the specific restrictions and prohibitions on mortgage terms – as they apply to non-depository institution lenders and their employees. In practice, achieving this requires two elements: a supervisory system adequate to oversee mortgage loan originators and other parties subject to the bill's standards, and the authority under federal or state law to enforce those standards. Very few states today have both.

The licensing system certification standards do not fill that gap because they do not require that there be a state authority that provides effective oversight and enforcement of the bill's *substantive standards* on mortgage marketing and underwriting. Nor does the bill require any minimum criteria for state supervision or enforcement over the creditors, assignees, or securitizers that employ state-licensed mortgage origination personnel and set the policies under which loans are actually made.

In contrast, comprehensive and ongoing supervision of depository institutions subjects them to independent scrutiny of their TILA compliance efforts. Failure to address this difference in the oversight of depository institutions and these non-depository institution entities risks creating a gap in actual achievement of the new standards and protections created under H.R. 3915.

Because of this gap, the enforcement remedies in the legislation will fall most heavily on depository institutions, which have not been the major source of subprime lending abuses. This result seems inconsistent with the bill's goal to ensure that mortgage lending is conducted

according to uniform standards that are applied consistently regardless of whether the lender or broker is, or is affiliated with, a depository institution.

The amendment's mandate of large CMPs for a "pattern or practice" of violations would amplify the effects of these oversight differences. The existing precedent establishing the level of conduct that constitutes a "pattern or practice" that has been used in the lending context sets a very low threshold for liability. A relatively small number of instances of prohibited conduct could well rise to the level of a "pattern or practice." I have attached to my testimony an appendix briefly discussing the relevant precedent on what may constitute a "pattern or practice" under other statutes. Depository institutions under comprehensive ongoing federal supervision will face constant scrutiny, unlike their non-bank counterparts under state jurisdiction, and thus a heightened prospect that in the examination process, practices could be found that would trip the low "pattern or practice" trigger.

TILA already authorizes the federal banking agencies to seek redress of TILA violations through the very same administrative enforcement actions we can pursue for violations under the banking laws, using the broad array of remedies available to us under those laws against depository institutions and institution-affiliated parties. Thus, the new provisions added to TILA by H.R. 3915 could be effectively enforced by the Federal banking agencies using the same tools we already have available. While the proposed amendment would add to the federal enforcement regime one new penalty applicable on its face to all mortgage market participants, in practice, because of the disparate supervision and enforcement applied to different types of mortgage lenders, the force of the amendment would appear to fall most heavily on already regulated depository institutions.

As an alternative, I would respectfully suggest further exploration of other amendments to H.R. 3915 that could help achieve more consistent oversight and enforcement of the bill's qualitative standards as they apply to non-depository institution lenders and their employees. We would be happy to work with the Committee and other interested parties to further that effort.

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Appendix: The Meaning of "Pattern or Practice" in Federal Legislation

The Mortgage Reform and Anti-Predatory Lending Act of 2007 (H.R. 3915) would establish licensing requirements and origination standards relating to residential mortgage loans, additional restrictions on high-cost mortgages, and other substantive changes in the law. The bill would also make significant changes to the liability provisions in the Truth in Lending Act (TILA). For example, rescission remedies are extended to circumstances involving violations of the new ability to repay and net tangible benefit requirements, and the civil liability provisions are amended by increasing both statutory damages amounts and class action damages caps.

The amendment offered by Reps. Miller, Watt, and Frank would further enhance penalties for certain TILA violations. In particular, the Miller-Watt-Frank amendment would increase the potential administrative sanctions against violations of the ability to repay and net tangible benefit requirements. The amendment provides that:

> [A]ny creditor, assignee, or securitizer which engages in a pattern or practice of originating, assigning, or securitizing residential mortgage loans that violate [the new ability to repay or net tangible benefit requirements] shall forfeit and pay a civil penalty of—
>
> (i) not less than $25,000 for each such loan; and
> (ii) $1,000,000 for engaging in such pattern or practice.

Penalties collected under this provision are to be held in trust by the Secretary of the Treasury for the benefit of borrowers with residential mortgage loans that were originated in violation of the ability to repay and net tangible benefit requirements.

The amendment does not define the term "pattern or practice." Similarly, a number of existing federal statutes employ the "pattern or practice" terminology, without definition, in their respective enforcement provisions. For example, the term is used in Title VII of the Civil Rights Act of 1964 (Equal Employment Opportunities),[3] the Fair Housing Act,[4] the Equal Credit Opportunity Act,[5] and federal flood insurance legislation.[6] It is likely that regulators and others would look to interpretations of this language in other statutes for guidance in interpreting the proposed amendment, if enacted in its present form.[7]

Courts and regulators have considered the facts and circumstances of a given case in determining whether a pattern or practice of violations exists. The Supreme Court explained in a Title VII case that the "pattern or practice" language "was not intended as a term of art, and the words reflect only their usual meaning."[8]

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[3] 42 U.S.C. § 2000e-6(a), (e).
[4] 42 U.S.C. § 3614(a).
[5] 15 U.S.C. § 1691e(g).
[6] 42 USC § 4012a(f)(1).
[7] See United States v. DiMucci, 879 F.2d 1488, 1497 n.11 (7th Cir. 1989) ("pattern or practice" is not "a term of art, but appears in several federal civil rights statutes, and is interpreted consistently therein").
[8] International Bhd. of Teamsters v. United States, 431 U.S. 324, 336 n.16 (1977).

While isolated, sporadic, or accidental occurrences do not constitute a pattern or practice,[9] there is no necessary minimum number of acts required.[10] As one court has stated, "there is no threshold number of incidents that must occur before the government can bring suit against a party."[11] In cases under the antidiscrimination laws, courts have stated that the number of persons adversely affected is not determinative; rather, the question is whether discrimination is the defendant's usual policy, regular practice, or standard operating procedure. For instance, in a case challenging the use of a written examination for employment, the Fourth Circuit Court of Appeals rejected the argument that the United States had not demonstrated a pattern or practice because the number of black applicants affected was small. United States v. Commonwealth of Virginia, 620 F.2d 1018, 1024 (4th Cir. 1980), cert. denied, 449 U.S. 1021 (1980). The court stated that:

> The question . . . is not the number of applicants which were affected, but rather whether the United States established "by a preponderance of the evidence that racial discrimination was the (Commonwealth's) standard operating procedure rather than the unusual practice."[12]

Thus, courts have found pattern or practice discrimination even where the number of identified victims is as few as two or three.[13] For example, in United States v. Big D Enter., Inc., 184 F.3d 924, 931 (8th Cir. 1999), cert. denied, 529 U.S. 1018 (2000), the court found that evidence of discrimination against three identified victims, along with the testimony of the defendants' employees that they were instructed not to rent apartments to black applicants, demonstrated a pattern or practice of discrimination. Indeed, some courts have stated that the mere existence of a policy that would result in discrimination is sufficient to satisfy the pattern or practice requirement.[14] The focus on the defendant's policies, practices, and procedures does not mean that the defendant must be found to have discriminated uniformly in order to find a pattern or practice.[15]

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[9] See id. at 336; see also E.E.O.C. v. Federal Reserve Bank of Richmond, 698 F.2d 633, 644 (4th Cir. 1983), rev'd and remanded on other grounds sub nom Cooper v. Federal Reserve Bank of Richmond, 467 U.S. 867 (1983) ("two incidents of failure to promote . . . , even if regarded as discriminatory, . . . would not support the District Court's finding of a pattern of class discrimination in promotions . . . or offer any reinforcement to an inference of discrimination derived from statistical proof").

[10] United States v. Habersham Prop., Inc., 319 F. Supp 2d 1366, 1372-73 (N.D. Ga. 2003).

[11] Id.

[12] United States v. Commonwealth of Virginia, 620 F.2d at 1024, quoting Teamsters, 431 U.S. at 336.

[13] See United States v. West Peachtree Tenth Corp., 437 F.2d 221, 227-28 (5th Cir. 1971) (discrimination against two individuals, in combination with other evidence, established a pattern or practice of discrimination); United States v. Lansdowne, 713 F. Supp. 785, 818 (E.D. Pa. 1989), aff'd, 894 F.2d 83 (3d Cir. 1990) (evidence of discriminatory rejection of three families from swim club membership, along with evidence of discouragement of black applicants, established a pattern or practice).

[14] See, e.g., United States v. City of Parma, Ohio, 494 F. Supp. 1049, 1095 (N.D. Ohio 1980), aff'd in part, rev'd in part on other grounds, 661 F.2d 562 (6th Cir. 1981), cert. denied, 456 U.S. 926 (1982); see also United States v. Garden Homes Mgmt. Corp., 156 F. Supp. 2d 413, 423-24 (D.N.J. 2001) ("[o]nce a discriminatory policy has been established or admitted, the plaintiff does not have to introduce specific instances of discrimination to prove a pattern or practice").

[15] United States v. Lansdowne, 713 F. Supp. at 807, 894 F.2d at 89.

Testimony of Richard K. Green

Oliver T. Carr, Jr. Chair in Real Estate and Finance, The George Washington University

Before the House of Representatives Committee on Financial Services

December 6, 2007

Chairman Frank, Representative Bachus, and members of the committee, thank you for inviting me to testify today as part of this hearing on "Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement." My name is Richard K. Green, and I am the Oliver T. Carr, Jr. Chair in Real Estate and Finance at the George Washington University. Before teaching at George Washington, I taught at the University of Wisconsin-Madison and the Wharton School of the University of Pennsylvania. In the interest of disclosure, let me note that I worked for Freddie Mac for about 16 months in 2002-03, and that I own a small amount of Freddie Mac stock (whose value is considerably lower than it was six months ago!)

Let me begin by saying that my thoughts on the subprime crisis have evolved considerably over the past year. Last March, I was quoted in *Newsweek* as saying that I thought the damage arising from the subprime mess would be limited. I was clearly wrong. And so as events have changed, my thoughts on appropriate policy responses to the crisis have changed as well.

Mass loan modification is one example of how my views have changed. Not so long ago, I worried about the moral hazard problems that could result from effectively allowing a large class of borrowers to change the rules of a loan after it was originated. When initial loan terms are not

enforced, future investors will be less willing to invest in mortgages, which in turn can reduce the availability of mortgage credit. But this point seems moot at the moment.

Three things have led me to change my mind about modification. First, and most important, is the fact that it will be difficult to preserve macroeconomic stability if we ignore the fact that already dangerous loans will become even more so when their payments increase, sometimes dramatically. For reasons I will describe later in my testimony, I do not think that modification is by any means a panacea. But past experiences in the history of the US mortgage market give us reason to believe that mass modification can be an effective tool for restoring stability to financial markets.

Before the Great Depression, the typical mortgage in the United States had some features in common with many current subprime mortgages: floating interest rates, no amortization, and the possibility of "payment shock.[1]" The payment shock arose from the fact that mortgages had balloon payments: borrowers were forced to refinance regularly. If they could not refinance, they owed a balance roughly equal to half the purchase price of the house.

This housing finance system worked reasonably well until the Great Depression, when bank illiquidity made lenders call loans when they were due. Households rarely had enough cash to pay off their mortgages and so needed to sell their homes to meet their obligations. The lack of liquidity meant that buyers could not obtain financing, so sellers could not sell. This led to waves of foreclosures, followed by real estate owned by financial institutions, which in turn created more illiquidity; and soaring default rates. The market clearly needed a "servicing" solution.

[1] One big difference is that pre-Depression loans usually had low loan-to-value ratios.

In response, the Hoover Administration created the Federal Home Loan Bank System, and New Deal housing finance legislation created the FHA to insure long-term mortgages and the Home Owners Loan Corporation (HOLC) and its successor, the Federal National Mortgage Association, to tie mortgage markets to capital markets. HOLC, backed by the full faith and credit of the U.S. government, raised money in the bond market to purchase non-performing mortgages from depository institutions. HOLC reinstated the loans as 20-year fixed-payment mortgages (Green and Wachter 2005). This can be seen as the first example of mass loan modification. Borrowers were removed from an impossible position (where they had to raise a large amount of cash to pay off a mortgage balance) and placed in a manageable position. At the same time, by changing the terms, the federal government reduced the embedded risk of the loans and therefore increased their value to depositories,[2] which ultimately bought them back from HOLC.

Second, I have come to appreciate that transactions between borrowers and lenders are hardly typical. Even the simplest fixed-rate mortgage, whose cost is a function of rate, term, points, fees, and expected time in the home, is not a straightforward product. Adjustable rate mortgages are more complicated than fixed-rate mortgages; exotic ARMS are even more so. At a conference sponsored by the Joint Center for Housing Studies last week, professors of law and economics from leading universities could not explain in detail all the characteristics of their adjustable rate mortgages. To expect consumers with far less financial acumen to understand the terms of exotic ARMS is unreasonable. It is particularly noteworthy that as we gather more evidence about the characteristics of subprime borrowers, we find that increasing numbers of

[2] This was particularly true since they were insured by the FHA.

subprime loans were going to borrowers with relatively high FICO scores.[3] I have become increasingly convinced that large numbers of borrowers were pursuaded to take on products that they did not understand (I also leave open the possibility that some of the brokers who sold the loans did not really understand them either).

Third, structured finance has made loan modification on an individual loan level difficult. The interests of the different investors in various classes of securities can be in conflict: when a loan is in default, it is possible that investors holding a senior tranch will prefer foreclosure to workout, while those holding junior tranches might prefer workouts. At the end of the day, this conflict could prevent workouts in cases where both borrowers and the sum total of investors would be better off with a workout, indicating that workouts are economically efficient, at least in the short run. But let me raise a flag about problems that might arise: trusts that hold mortgages are supposed to be passive entities. Large numbers of workouts could turn them into active entities, which in turn could, under the terms of the trust, lead to dissolution. The legal implications of all this are well beyond my ken (I am not a lawyer), but they need to be considered as Congress moves forward with legislation such as HR 4178.

In my opinion, as we think about solving the current crisis and developing reforms for the mortgage market of the future, we must keep in mind how important it is to develop incentives that will allow us to get out of our current predicament and prevent future crises. To me, a combination of incentives and improved information will be more effective than detailed regulation (big picture regulation is another matter, and something I will get to in a minute).

[3] Tabulations of Loan Perfomance Data show that the share of subprime borrowers with FICO scores in excess of 660 rose steadily over the course of the decade.

For the time being, the key loan modifications would be: (1) to freeze ARM payments for particular types of ARMS and (2) to allow ARM borrowers whose mortgages have prepayment penalties to refinance without having to pay these penalties. But in determining the level at which to freeze ARM payments, we should not freeze rates below A and alt A rates, both for equity reasons and because we want to encourage borrowers who can refinance into A or alt A products do to so. We also should be sure only to modify loans for borrowers who occupy the house under mortgage.

As we look forward, new regulation should focus on aligning incentives to mitigate against the adverse selection and moral hazard issues that led to the current crisis. To be more specific, changes in policy should accomplish three things:

(1) It should make sure that all parties in the lending chain have "skin in the game." While reputational risk mitigates against bad behavior, there is not a substitute for financial incentives.

(2) It should make sure that all parties in the lending chain are subject to federal supervision. This will reduce regulatory arbitrage.

(3) It should do what it can to improve disclosures throughout the lending chain. Borrowers must be better informed as to the consequences of their lending choices (although this will be difficult); bond ratings must be consistent, and securities must be more transparent.

All this said, it is important to recognize that no amount of modification can produce a panacea to the current crisis. First of all, we know that many defaults occurred before a rate reset, and so they were induced by something other than payment shock. It is actually an

interesting and open question as to whether those borrowers with the greatest propensity to default have already done so. In the distant past (i.e., the 1970s and 1980s), default usually occurred in the third to seventh year of a loan's life. We now have the unusual spectacle of books of mortgages that contain large numbers of loans that didn't receive a single payment. This means history gives us little guidance about how these mortgages will perform going forward.

Second, the current outlook for the housing market is grim. Economic theory tells us that one of the key determinants of current house prices is expectations of future house prices. A very small change in expectations can actually lead to a very large change in house prices. One of the best ways to look at expectations for house prices is to look at the S&P/Case-Shiller futures market for houses[4]; in this market, people actually place money behind their opinions about future house price movement. And right now the market is telling us that people's expectations are not positive. This by itself could push down house prices for awhile, which will eat away at home equity, which will make mortgages more vulnerable. Reducing the possibility of payment shocks and making loans easier to refinance will help, but for a person who loses his job, gets sick, or sees his marriage dissolve, the fact that his mortgage balance is higher than his house value may leave him with little alternative but to default.

Reducing impediments to modification will, however, reduce the probability of foreclosure somewhat, and will therefore reduce the inventory of homes available for sale going forward. This can do nothing but help expectations about future house prices, and therefore make the market less bad than it would otherwise be. I think for the time being, reducing the damage from the subprime crisis is the best we can expect to do.

[4] See http://housingrdc.cme.com/.

STATEMENT

OF

THE HONORABLE GIGI HYLAND
BOARD MEMBER

NATIONAL CREDIT UNION ADMINISTRATION

"ACCELERATING LOAN MODIFICATIONS, IMPROVING FORECLOSURE PREVENTION, AND ENHANCING ENFORCEMENT"

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

THURSDAY, DECEMBER 6, 2007

I. Introduction

NCUA's primary mission is to ensure the safety and soundness of federally-insured credit unions. It performs this important public function by examining all federal credit unions, participating in the supervision of federally-insured state chartered credit unions in coordination with state regulators, and insuring federally-insured credit union members' accounts. In its statutory role as the administrator for the National Credit Union Share Insurance Fund, NCUA provides oversight and supervision to 8,163 federally-insured credit unions, representing 98 percent of all credit unions and approximately 87 million members.

II. Credit Union Industry Mortgage Lending - NCUA Overview

Through the first half of 2007, the Mortgage Bankers Association estimated mortgage loan originations in the marketplace of over $1.33 trillion, of which federally insured credit unions originated only 2.14% or $28.3 billion.[1] Mortgage loans in federally-insured credit unions represent only 9% of mortgage loans outstanding in all federally-insured depository institutions.[2]

Nearly 60% of federally insured credit unions offer mortgage loans to their members. Those not offering mortgage loans are generally smaller credit unions that cannot afford the expertise or infrastructure to grant mortgages or manage mortgage portfolios. Additionally, smaller federal credit unions have difficulty implementing a wide range of mortgage products since loans to a single member are statutorily limited to 10% of a federal credit union's total unimpaired capital and surplus.[3] Consequently, the majority of federally-insured credit union mortgage lending occurs in larger credit unions.

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[1] Based on information available at the Mortgage Banker's Association website for 2007 Originations http://www.mbaa.org/files/Bulletin/InternalResource/57620 .pdf

[2] NCUA data and *FDIC- Statistics on Depository Institutions Report, 1-4 Family Residential Net Loans and Leases for all depository insured institutions as of 12/31/2006.* 31 Dec. 2006. Federal Deposit Insurance Corporation. < http://www2.fdic.gov/SDI/SOB>.

[3] 12 C.F.R. 701.21(c)(5). Unimpaired capital and surplus equals shares plus post-closing, undivided earnings.

Demand for mortgage loans in federally insured credit unions remains high. Mortgage loans led all loan types in growth in the first half of 2007, increasing $11.2 billion (93% of all new loan growth) to a new high of 50% of total loans. NCUA continues to closely watch performance indicators in the mortgage lending area through data collection and the examination and supervision process.

Impact of Legislation on Specific Mortgage-Based Products

The proposed legislation will not have a significant financial impact on federally-insured credit unions, since these credit unions are not heavily involved in the types of products NCUA expects to be impacted by the legislation (e.g. nontraditional real estate loans, participation loans, and mortgage-backed investment securities).

Real Estate Loans

As the following table indicates, federally-insured credit unions typically grant traditional mortgage loans:[4]

Types of Federally-Insured Credit Union Real Estate Loans[5]					
Quarter Ending:	**Sep-06**	**Dec-06**	**Mar-07**	**Jun-07**	**Sep-07**
Total Fixed Rate First Mortgages	37.2%	37.2%	37.6%	38.3%	38.2%
Total Balloon/Hybrid First Mortgages	16.7%	16.9%	17.1%	16.9%	17.1%
Total Adjustable First Mortgages	11.5%	11.3%	11.1%	11.0%	10.8%
Total Other Real Estate	34.6%	34.6%	34.2%	33.8%	33.9%
Total Real Estate Loans	100.0%	100.0%	100.0%	100.0%	100.0%
Non-Traditional: Interest Only/Optional Payment Loans[6]	N/A	N/A	1.9%	1.8%	2.1%

[4] NCUA uses a data collection tool, 5300 call report, to obtain credit union financial and operational information.
[5] The table reflects the percentage of each real estate loan type to total outstanding real estate loans.
[6] NCUA only captures the balance of Interest Only/Optional Payment Loans and does not distinguish the type of such loans. Therefore, the Interest Only/Optional Payment Loans dollars are intermixed into the various types of loans listed in the table.

The non-traditional loans (Interest Only/Optional Payment Loans), the loans likely to be most impacted by the legislation, only make up approximately 2 percent of total real estate loans outstanding and .8 percent of total assets.

Delinquency in real estate lending has increased in 2007; however, it still remains at a manageable level.

Real Estate Loan Delinquency > 2 Months					
Quarter End:	**Sep-06**	**Dec-06**	**Mar-07**	**Jun-07**	**Sep-07**
1st Mortgage Fixed/Total 1st Mtg Fixed Loans	0.24%	0.28%	0.28%	0.36%	0.44%
1st Mortgage Adjustable Rate/Total 1st Mtg Adjustable Rate Loans	0.28%	0.33%	0.31%	0.33%	0.46%
Interest Only & Payment Option First Mortgage/Total Int Only and Pmt Opt First Mtg Loans	N/A	N/A	0.34%	0.34%	0.89%

As noted in the table, nontraditional loans (interest only and optional payment loans) experienced an increase in delinquency. Federally-insured credit unions will continue manage this increase through their existing collection policies and procedures. NCUA examiners will review federally-insured credit union delinquency control efforts during their examinations and, when needed, issue Documents of Resolution with federally-insured credit union officials to ensure proper controls are in place and functioning.

Federally-insured credit unions typically have experienced low real estate foreclosure rates as demonstrated in following table:

Foreclosed Real Estate					
Quarter Ending:	**Sep-06**	**Dec-06**	**Mar-07**	**Jun-07**	**Sep-07**
Amount (in Millions)	$143.8	164.1	190.2	213.4	271.8
Percentage Increase	N/A	14.11%	15.93%	12.17%	27.40%
Percentage of Total Real Estate Loans Outstanding	0.06%	0.07%	0.08%	0.08%	0.10%

Although there has been a significant percentage increase in total real estate foreclosures in 2007, the actual dollar amount ($272 million) represents only a small fraction, .1 percent, of total real estate loans ($264 billion) outstanding in federally-insured credit unions.

Credit Union Service Organizations

Federally-insured credit unions may invest in, or loan to, credit union service organizations (CUSOs).[7] As of September 2007, 81 CUSOs provide loan support services to federally-insured credit unions. These services include: debt collection services; loan processing, servicing, and sales; and sale of repossessed collateral. The proposed legislation potentially could impact a CUSO's loan services provided to members as well as the value of the CUSO on FCU balance sheets. However, since investments and loans to CUSOs are minimal ($1.05 billion and $579 million respectively), any negative impact is not deemed material.

Participation Loans

Federally-insured credit unions may buy and sell participation loans.[8] These types of loans include, but are not limited to, real estate loans which may be impacted by the legislation. Should the participation loan reprice in accordance with the proposed legislation, the participating federally-insured credit unions would not realize the originally contracted and expected rate of return. However, the legislation also could prevent foreclosure and preserve the loan's collateral value.

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[7] Credit Union Service Organization is an entity through which credit unions may provide services to their members.

[8] Participation loan means a loan where one or more eligible organizations [credit unions] participates pursuant to a written agreement with the originating lender. Buyer credit unions may only participate in loan types that it is legally empowered to make and only participate in loans to its own members or members of the selling credit union.

Participation loans do not comprise a significant portion of federally-insured credit union loan portfolios as indicated by the following table:

Participation Loans (in Billions)					
Year End:	**Dec-03**	**Dec-04**	**Dec-05**	**Dec-06**	**Sep-07**
Outstanding	$4.10	6.28	7.49	8.41	10.31
***Purchased YTD**	$1.99	3.15	2.95	2.87	2.39
***Sold YTD**	$1.36	1.70	1.77	1.69	1.03
Participation Loans Outstanding / Total Loans	N/A	1.5%	1.6%	1.7%	2.0%

*Sep '07 data is annualized

As of September 2007, participation loans represented 2 percent of total federally-insured credit union assets. As indicated by the following table, the significant majority (92 percent) of total loan participations are held in federally-insured credit unions with assets of $100 million or more:

Participation Loans				
Asset Size	**Number of Credit Unions**	**Percentage of Credit Union Assets**	**Percentage of Participation Loans**	**Sum of Percentage of Participation Loans**
>1Bil	5.98%	46.87%	43.64%	43.64%
500Mil-1Bil	9.08%	21.23%	23.61%	67.25%
100Mil-500Mil	32.30%	25.30%	24.78%	92.02%
50Mil-100Mil	15.84%	3.84%	3.84%	95.86%
<50Mil	36.80%	2.75%	4.14%	100%

Since participation loans do not comprise a material portion of federally-insured credit union assets, the proposed legislation is not expected to materially affect this area of federally-insured credit union operations.

Mortgaged-Backed Investments

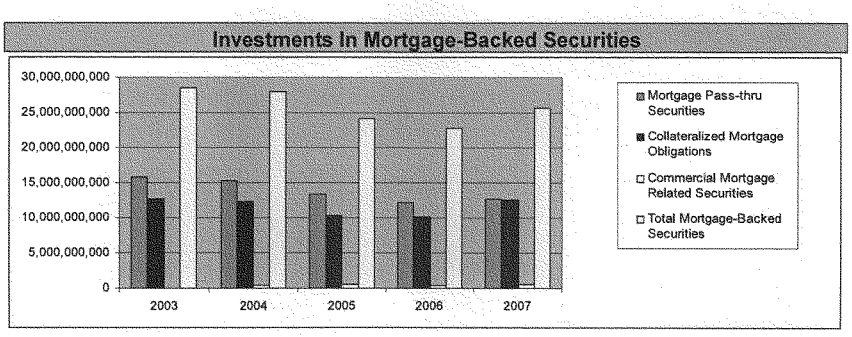
The bill may have an impact on those federally-insured credit unions that have purchased investment securities backed by mortgage obligations. Restructuring or modifying the terms of the underlying mortgage obligations could have an impact

(reduced cash flow, reduced earnings, etc.) on the value of the investment. Though these federally-insured credit unions have a responsibility to weigh the risks of such investment instruments, the effect of a new law upon these investments can not be reasonably foreseen.

Federally-insured credit union investments securitized by mortgage products represent 3.5 percent of federally-insured credit union assets and 30 percent of federally-insured credit union net worth. With the exception of a slight increase in 2007, mortgage-backed securities in relation to total assets have been declining since at least 2003.

Mortgage-Backed Securities - Percentage of Federally-Insured Credit Union Assets					
Year End:	**Dec-03**	**Dec-04**	**Dec-05**	**Dec-06**	**Sep-07**
Mortgage Pass-Thru Securities[9]	2.59%	2.36%	1.96%	1.72%	1.70%
Collateralized Mortgage Obligations	2.08%	1.89%	1.52%	1.43%	1.69%
Commercial Mortgage Related Securities	N/A	0.07%	0.08%	0.05%	0.06%
Total Mortgage-Backed Securities	4.67%	4.32%	3.55%	3.21%	3.45%

As indicated by the following graph, federally-insured credit union investments in mortgage-backed securities has generally declined over the last several years.



[9] A mortgage pass-through security consists of a set of marketable shares in a portfolio (pool) of real estate mortgages for which investors receive monthly payments of both interest and principal. Normally the package is secured by credit insurance so that investors are protected from the credit risks of the individual mortgages in the portfolio. However, no protection is provided against the cash flow and return volatility associated with unanticipated principal prepayments, which typically occur when interest rates drop and homeowners refinance their mortgages.

Given that mortgage-backed securities do not comprise a significant portion of federally-insured credit union assets, and the declining trend of ownership in such investments, NCUA does not expect the proposed legislation will significantly impact the value of federally-insured credit union investments or create a safety and soundness issue for the credit union industry.

Mortgage-Backed Investments – Corporate Credit Unions

NCUA regulates and/or insures thirty Corporate Credit Unions.[10] These credit unions are permitted to purchase and hold investments backed by mortgage products; however, by regulation these investments must be AAA or AA rated.[11] These higher rated investments assist in mitigating the risk of loss associated with the particular investment. Though these investments may include subprime loans, such loans are not predominant in the pool thereby mitigating risks which may impact investment value and performance.

Credit Union Industry Guidance

The NCUA supports efforts by lenders to develop workout plans for borrowers to reduce foreclosure risk. In April 2007, NCUA issued joint guidance with the Federal Financial Regulators,[12] Letter to Credit Unions 07-CU-06 Working with Residential Mortgage Borrowers, encouraging federally-insured credit unions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment

[10] A Corporate Credit Union is a credit union devoted to providing products and services to natural-person credit unions which are in its field of membership.
[11] Investments rated as AAA or AA represent high credit-quality investment grade products.
[12] The Federal Financial Regulators consist of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

obligations. NCUA believes prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the federally-insured credit union and the member. To further educate federally-insured credit unions on mortgage risk, in October 2006, NCUA issued joint guidance with the Federal Financial Regulators (Letter to Credit Unions 06-CU-16 Interagency Guidance on Nontraditional Mortgage Product Risk) which discussed prudent underwriting and risk management practices for nontraditional mortgage loans,[13] as well as the need to ensure consumer understanding of loan terms and underlying product risks. While nontraditional and subprime mortgage loans are not major components of federally-insured credit union mortgage portfolios, NCUA was concerned that predatory and unsound lending in other areas of the marketplace may increase members' monthly debt burdens significantly, resulting in a "ripple effect" that would not only impact federally-insured credit union members but also federally-insured credit union asset quality. If federally-insured credit union members begin to experience difficulty making payments on homes they have financed elsewhere, loan accounts at their federally-insured credit unions could also be impacted.

In May 2007, NCUA issued joint guidance with the Federal Financial Regulators, Letter to Credit Unions 07-CU-07 Consumer Information for Nontraditional Mortgage Products, to assist federally-insured credit unions in implementing the consumer information recommendations of the recently issued Interagency Guidance on Nontraditional Mortgage Product Risks (NTM guidance). The NTM guidance states that institutions offering nontraditional mortgage products should provide consumers with information

[13] Nontraditional mortgage loans are also referred to as "exotic," or "alternative" mortgage products.

that is designed to help them make informed decisions when selecting and using these products.

III. NCUA Comments on the Legislative Proposals

NCUA is pleased to offer comments regarding H.R. 4178, the Emergency Mortgage Loan Modification Act of 2007, introduced by Congressman Michael Castle. NCUA will also comment on suggested changes to the legislation offered by the Federal Deposit Insurance Corporation, the recent commitment by four mortgage lenders to freeze adjustable rate mortgages for California borrowers, and the recent amendment to H.R. 3915 authored by Congressmen Frank, Miller, and Watt.

H.R. 4178, The Emergency Mortgage Loan Modification Act of 2007

NCUA believes prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the federally-insured credit union and the member. NCUA has encouraged its federally-insured credit unions to work with troubled borrowers using appropriate loss mitigation strategies including loan modifications and workout plans when available and practicable.[14] NCUA supports H.R. 4178's goal of facilitating the ability of residential mortgage loan holders to assist consumers facing foreclosure. NCUA offers the following comments concerning specific aspects of the bill.

[14] Joint Interagency Media Release, *Federal Regulators Encourage Institutions to Work with Mortgage Borrowers Who Are Unable to Make Their Payments*, (July 17, 2007), http://www.ncua.gov/indexnews.html; Letters to Credit Unions 07-CU-09, *Statement on Subprime Mortgage Lending* (July 2007); Joint Interagency Media Release, *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages* (September 4, 2007), http://www.ncua.gov/indexnews.html.

Paragraph (a)

The bill provides residential mortgage loan holders with a safe harbor from contractual liability for entering into a qualified loan modification or workout plan. The safe harbor applies to a limited circumstance involving a loan: where payment is in default or payment default is reasonably foreseeable; is secured by a lien on an owner-occupied dwelling; was consummated on or after January 1, 2004; and where the annual percentage rate (APR) exceeds the yield on a Treasury security of a comparable maturity period by more than 3 percentage points for a first lien (5 percentage points for other than a first lien) or the most recent conventional rate mortgage by more than 175 basis points for a first lien (375 basis points for other than a first lien). The safe harbor does not apply to Veteran Administration (VA) loans.

NCUA believes the safe harbor will enable residential mortgage loan holders to offer modified loans or workout plans on loans previously ineligible for modification because of contract restrictions, for example, participated loans and loans included in a loan pool. The six-month duration of the safe harbor, beginning with the enactment of Section 129A, means that holders will need to act quickly to identify eligible loans and initiate a qualified loan modification or workout plan.

Paragraph (b)(1) Qualified Loan Modification or Workout Plan

Paragraph (b)(1) indicates that, in order to be exempt from contract liability, a residential mortgage loan must meet certain criteria. The loan must be in payment default, near payment default, or payment default is reasonably foreseeable; and, the holder must

reasonably believe the net present value to be realized on the loan will be maximized under the modification or workout plan.

NCUA believes clearly defined terms and criteria will be beneficial to holders in determining to which loans the safe harbor applies. NCUA suggests including the same definition of reasonably foreseeable default used in the September 2007 interagency statement issued by NCUA, the other Federal Financial Regulators, and the Conference of State Bank Supervisors. A footnote in the bill explains default is reasonably foreseeable when the lender actually makes contact with the borrower, assesses the ability to pay, and has a reasonable basis to conclude the borrower will be unable to continue to make mortgage payments in the foreseeable future.[15]

Paragraph (b)(2) Qualified Mortgage

A residential mortgage loan meeting the definition of a qualified mortgage is not eligible for safe harbor protection. Under the bill, "qualified mortgage" describes a residential mortgage loan where the annual percentage rate on the loan does not equal or exceed the yield on a Treasury security with a comparable maturity period by more than 3 percentage points for a first lien (5 percentage points for other than a first lien), or the most recent conventional mortgage rate by more than 175 basis points for a first lien (375 basis points for other than a first lien). A loan made or guaranteed by the Secretary of Veterans Affairs is also a qualified mortgage.

[15] Joint Interagency Media Release, *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages* (September 4, 2007), http://www.ncua.gov/indexnews.html.

The effect of this paragraph is to exclude residential mortgage loans written to more traditional standards or made or guaranteed by the Secretary of Veterans Affairs. NCUA supports the bill's focus on loans that, by their terms, are at higher risk for default. In light of this focus, the agency suggests the definition also should include loans insured by the Federal Housing Authority.

Paragraph (b)(3) Residential Mortgage Loan

A residential mortgage loan is defined in the bill as a loan secured by an owner-occupied dwelling and is not a qualified mortgage. NCUA recommends changing the definition of "residential mortgage" loan from a loan secured by a lien on an owner-occupied dwelling to a loan secured by a lien on the borrower's principal dwelling. This change would specifically target the benefits of the bill to borrowers in danger of losing their primary residence and not seasonal or other homes.

Paragraph (c) Effective Period

The bill applies only to a qualified loan modification or workout plan initiated during the six-month period beginning on the date of the enactment of Section 129A. NCUA has concerns about the six-month period in which borrowers may restructure their real estate loans. First, it will be difficult for a federally-insured credit union to determine the foreseeable likelihood of foreclosure of a borrower whose loan does not reprice in the short-term, given the multitude of variables (employment, income, housing market value changes, etc.). Second, because loan modification, or a workout plan, is not automatic, borrower awareness and timely communication with creditors will be important to the process, particularly where impending foreclosure may not be apparent through the

borrower's payment or income data. Third, NCUA anticipates an increased volume of real estate documentation processing required to modify the terms of real estate loans impacted by the bill.

As indicated in the table below, only 24 percent of federally-insured credit union 1st mortgage adjustable rate loans will reprice within one year.

Adjustable Rate 1st Mortgage Loans Maturity To Total Adjustable Rate Real Estate Loans					
Year End:	**Dec-03**	**Dec-04**	**Dec-05**	**Dec-06**	**Sep-07**
Adjustable Rate < 1 year	N/A	27.11%	24.94%	23.92%	24.47%
Adjustable Rate >1 year	N/A	72.89%	75.06%	76.08%	75.53%

Because of the restricted time period and the potential for default scenarios arising late in the time period, it would be beneficial for holders to know what must occur for a modification or a plan to be considered "initiated." NCUA recommends Congress consider extending the timeframe to at least twelve months.

Alternatives to H.R. 4178

FDIC Loan Modification Amendments

The FDIC has offered two alternatives to H.R. 4178: a non-binding Sense of Congress provision, and a statutory provision. Both alternatives would establish certain presumptions. First, a servicer's duty to maximize the net present value of pooled loans is owed to all investors and parties having an interest in the pooled loans, if there is no specific contractual provision to the contrary. Second, a loan modification or workout plan is deemed in the best interest of all investors and parties if payment default on the

subject loan(s) is reasonably foreseeable, the dwelling securing the loan is owner-occupied, and the anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis. The best interest presumption recognizes a view that securitization trusts generally permit loan modifications when used appropriately to maximize the value to bondholders.[16] Neither amendment would use the loan's annual percentage rate as a basis for determining the loan's eligibility for modification or workout.

The proposals may bear additional consideration. They appear to reflect a servicer's existing duty to investors and include a presumption that a creditor acts in the best interest of investors where the servicer modifies a loan or implements a workout plan for residential mortgage loans meeting certain criteria. The creation of a rebuttable presumption could encourage servicers to use loan modifications and workout plans as an alternative to foreclosure. The presumption does not terminate an investor's rights under contract but requires the investor to meet a burden of proof in order to proceed with a claim.

The proposals potentially have a broader reach than H.R. 4178 as they do not include an effective period and are not limited to "subprime" loans. NCUA believes the FDIC's proposals have merit but warrant further detail and discussion.

[16] July 24, 2007 letter from SEC Chairman Cox to Chairman Frank, House Committee on Financial Services.

California Agreement with Lenders

Details of the agreement reached between California Governor Arnold Schwarzenegger and California's four largest loan servicers were not available. Our understanding of this agreement is that the participating loan servicers will freeze adjustable interest rates on mortgages for California subprime borrowers. We further understand this agreement is limited to borrowers who occupy their homes, are current and timely on their monthly payments, and would not be able to afford the higher interest rates associated with a reset of their adjustable rate mortgages.

NCUA notes that the agreement reached in California includes ideas similar to information provided in the September 4, 2007 interagency letter referenced earlier in our testimony. This interagency letter encouraged residential mortgage loan servicers to work constructively with borrowers at risk of default to avoid unnecessary foreclosures. The letter also suggested servicers review the governing documents for mortgage loans transferred into securitization trusts to determine the full extent of their authority to restructure delinquent or defaulting loans. Similar to the California agreement, the letter supports offering workout plans to residential borrowers who are at risk of default, for example, from resetting interest rates.

NCUA believes the proactive nature of the California agreement is beneficial for both the borrower and the lender encouraging action before a default scenario arises. NCUA also believes the California agreement may be an indication that states are well-positioned to promulgate these types of solutions for borrowers and servicers within a state.

IV. PATTERN or PRACTICE of VIOLATION AMENDMENT to HR 3915

Congressmen Frank, Miller, and Watt have authored an amendment to H.R. 3915 imposing civil penalties on creditors, who as a pattern or practice, violate the following minimum standards for mortgages: to determine in good faith the consumer's ability to repay the loan; or, in the case of a refinancing, to determine in good faith the refinanced loan will provide a net tangible benefit to the consumer. The civil penalties imposed are in addition to any money penalty imposed under an administrative enforcement action by the Federal Financial Regulators or the Federal Trade Commission. The amendment would also permit any person to submit information regarding the violation to any Federal Financial Regulator or the Federal Trade Commission regardless of whether the regulator has jurisdiction over the entity involved in the alleged violation.

NCUA believes the additional penalty may deter pattern or practice violations but is concerned that any additional penalty be applied in a balanced and consistent manner. It appears that under this amendment, a federally regulated entity would be subject to an administrative monetary penalty and a civil penalty in contrast to non-federally regulated entities. This result would be inconsistent with the general direction of H.R. 3915 of applying similar regulatory standards to all mortgage loan originators. Additionally, in assessing whether and to what extent to impose an administrative penalty, whether a violation is part of a pattern or practice of violations is one of several factors considered in determining the amount of the penalty.

Additionally, NCUA believes permitting information to be submitted to any of the regulatory agencies could potentially hinder a timely investigation of the alleged violation. Information regarding an entity's regulatory authority is included in many consumer disclosures and consumers should be encouraged to provide information directly to the appropriate regulator.

V. CONCLUSIONS

Consumers face an increasingly complex financial landscape where the expansion of choices has been accompanied by a corresponding number of potentially disadvantageous and costly options. While the availability of new and innovative mortgage products has been beneficial to a large segment of the American public, recent market volatility has presented problems for consumers who may lack the financial flexibility to deal with changing rates and terms.

NCUA supports Congressional scrutiny of the complex issues involved, as well as any responsible legislative effort that enhances consumer protection while preserving the mortgage financing market's ability to attract and retain capital and liquidity. In this statement NCUA has offered several specific suggestions for enhancing the legislative approach, and continues to appreciate the opportunity to provide input to an important and timely issue.

For release on delivery
10:00 a.m. EST
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Statement of

Randall S. Kroszner

Member

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

December 6, 2007

Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to appear before you today to discuss recent problems in the subprime mortgage market and possible legislative responses. The challenges facing the housing market at the moment are significant. Increasing numbers of homeowners and communities are experiencing problems. We continue to work to find and implement the best and most sustainable solutions to the current challenges.

Background

In recent years, the subprime market has grown dramatically, enabling more and more borrowers to obtain credit who traditionally would have been unable to access it. Increasing numbers of lenders entered this market, with underwriting standards, industry practices, and risk-based pricing evolving along with the subprime market.

The growth of this market is well recognized. Also well recognized are the problems that have arisen with these changes. The Board believes that responsible subprime lending has an important role to play in expanding credit to traditionally underserved borrowers. It also recognizes, however, that some of the lending undertaken in recent years was neither responsible nor prudent.

Mortgage delinquency and foreclosure rates have increased substantially over the past few months. Over 17 percent of subprime adjustable-rate mortgages were in serious delinquency at the end of September, a rate over three times higher than that in mid-2005. Serious delinquencies also increased among near-prime and prime mortgages, although these delinquencies remain much lower than among subprime mortgages. Lenders initiated foreclosure proceedings for an average of 320,000 loans per quarter in the first half of this year, up from 240,000 loans per quarter in the preceding two years.

One significant factor in the increase in delinquency rates has been the slowing of house prices. Prices decreased slightly for the nation as a whole in the third quarter of 2007, and declined more dramatically in some regions. Over a quarter of homeowners report that their houses decreased in value over the past year, just a bit above the level last seen in the early 1990s.[1] These price changes will affect homeowners' abilities to resolve financial troubles by refinancing their mortgages or pulling equity out of their homes, and may lead to increased defaults. In addition, some borrowers whose mortgage balances exceed their house values may be tempted to walk away from their loans. Borrowers who purchased properties solely for investment purposes may be more likely to default in this situation; indeed, the Mortgage Bankers' Association has found a disproportionate share of serious delinquencies are associated with non-owner-occupied properties in some of the states with the highest increases in delinquencies. A recently released study by the Federal Reserve Bank of Boston attributes most of the recent rise in foreclosures in Massachusetts to declining house prices.[2]

Borrowers who have lost their jobs, not surprisingly, may have difficulty meeting their mortgage payments. Thus, increases in unemployment in certain areas, such as states in the Midwest struggling with job cuts in the auto industry, are another major factor contributing to higher delinquency rates.

The final major factor explaining the current increase in delinquency rates is the apparent deterioration in underwriting standards beginning in late 2005. An increasing number of subprime loans were made with layers of additional risk factors, such as a lack of full

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[1] Reuters/University of Michigan Survey of Consumers, November 2007.
[2] Kristopher Gerardi, Adam Hale Shapiro, and Paul Willen, "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures," Federal Reserve Bank of Boston Working Paper 07-15, 2007.

documentation or very high loan-to-value ratios. Much of this weakening in underwriting standards happened outside of institutions regulated by the federal banking agencies. For instance, in 2006, over 45 percent of high-cost first mortgages were originated by independent mortgage companies.[3] In addition, prior to late 2005, high demand for housing and rising house prices allowed borrowers to recover from these risks through profitable home sales and refinancings, hiding the weakened underwriting standards from view. The slowdown in house prices, coupled with shifts in underwriting standards, are the most likely explanation for the pronounced rise we have seen in defaults occurring within a few months of origination, before most borrowers would have experienced significant changes in their payment obligations or in their financial situations.

Looking forward, we expect the substantial payment increases often experienced at the first interest-rate reset to result in higher delinquencies. From now until the end of next year, each quarter roughly one out of ten borrowers with an adjustable-rate subprime mortgage is scheduled to experience the first rate reset.[4] In addition, tightening credit conditions as reported in the Federal Reserve's Senior Loan Officer Surveys suggest that refinancing may become more difficult. In the past, many borrowers experiencing these resets were able to avoid the payment increases by refinancing their mortgages. The recent declines in house prices and the current tighter credit conditions, however, reduced the viability of this option for significant numbers of borrowers.

The Federal Reserve's Response to Problems in the Subprime Market

As I testified before this Committee in October, the Federal Reserve is actively working to respond to these challenges. If the benefits of homeownership are to be realized, we believe

[3] 2006 Home Mortgage Disclosure Act data.
[4] Federal Reserve Board staff calculations based on data from First American LoanPerformance.

that homeownership must be sustainable and that access to responsible lending be available for consumers. To achieve this, the Board believes that there must be appropriate consumer protection and responsible lending to traditionally underserved borrowers. Accordingly, we continue to coordinate with other federal and state agencies, and consult with consumer advocates, lenders, investors, and others. We take these issues very seriously, and, along with the other federal banking regulators, began issuing guidance on subprime lending in 1999 for the institutions we regulate. We significantly expanded that guidance in 2001, issued guidance on non-traditional mortgage products (such as payment-option and interest-only loans) in 2006, and issued guidance on adjustable-rate subprime mortgages earlier this year. I would like to take this opportunity to share a brief update on some of the work that the Federal Reserve is undertaking on these issues.

Coordinated enforcement of consumer protection laws

First, the enforcement of consumer protection laws and regulations is critical and the Federal Reserve enforces these measures through oversight of the institutions it examines. As the mortgage industry has diversified, increasing coordination among regulators has been helpful. In particular, our need to cooperate with state bank regulators has increased in importance, and we have responded to that need. In that vein, we launched a cooperative pilot project with other federal and state agencies to conduct reviews of certain non-depository lenders involved in the subprime market.

The reviews will evaluate underwriting standards, risk-management strategies, and compliance with certain consumer protection laws and regulations. This initiative brings together the Federal Reserve, the Office of Thrift Supervision, the Federal Trade Commission, and state agencies represented by the Conference of State Banking Supervisors (CSBS) and the

American Association of Residential Mortgage Regulators (AARMR). The companies being reviewed include those that are supervised by the federal agencies, as well as independent entities that are licensed by the states.

Loss mitigation efforts

Second, the Board, along with the other federal financial agencies, has worked to guide federally supervised institutions as they deal with mortgage defaults and delinquencies. The federal financial institution agencies issued a *Statement on Working with Mortgage Borrowers* in April 2007, and, in cooperation with the CSBS, a *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages* in September 2007. Together, these statements encourage institutions to work proactively with borrowers who may be facing delinquency or foreclosure, and encourage servicers of securitized residential mortgages to determine the full extent of their authority to restructure failing loans and to pursue appropriate loss mitigation strategies.

The Board continues to encourage servicers and investors to make every effort to keep troubled borrowers in their homes. I, and other members of the Board, have had numerous meetings in recent months with a wide array of market participants and consumer advocates to understand the complexity of the issues and to encourage appropriate responses. Each of the twelve Federal Reserve Banks has been working with financial institutions and community groups around the country to address challenges posed by loan performance problems. And the Federal Reserve Board's staff has been working with consumer and community affairs groups throughout the Federal Reserve System to help identify localities that are most at risk of high foreclosures, with the intent to help local groups better focus their outreach efforts to borrowers.

We have also been talking with lenders, servicers and investors, independently as well as through the Hope Now alliance, to support prudent efforts to reach out to as many borrowers as

possible. Many servicers have established procedures to identify segments of borrowers who are current but could face trouble at reset, to contact these borrowers ahead of the reset, and to systematically evaluate the ability of borrowers to make higher payments. On the basis of this analysis, they can sometimes present prudent refinancing or loan modification alternatives to the borrower. Other efforts, such as the FHASecure product and various state and local efforts, can play a role in avoiding foreclosure. As I will discuss further in a moment, we support these efforts because foreclosure is generally the worst possible option for consumers, investors, *and* communities, and should be avoided whenever other viable options exist. Changes to existing terms, however, should not be made lightly, should be consistent with safe and sound lending practices, and should not be made when they are only delaying losses to investors and consumers. In short, we should pursue sustainable solutions.

Consumer protection regulations

Finally, the Board continues to work toward more effective consumer protection rules. We will soon begin extensive consumer testing to ensure that new disclosures are effective and comprehensible. Later this month, we will propose changes to the Truth in Lending Act (TILA) rules to require earlier disclosures by lenders and to address concerns about misleading mortgage loan advertisements.

The Board recognizes, however, that improved disclosures are necessary but not sufficient to address the problems. In addition to these actions, therefore, the Federal Reserve will exercise its rulemaking authority under the Home Ownership and Equity Protection Act (HOEPA) to address unfair or deceptive mortgage lending practices. At the same time we propose the TILA rule changes on advertising and timing of disclosures, we will issue, for public comment, significant new rules that would apply to subprime loans offered by all mortgage

lenders. In formulating our proposal, we are looking closely at practices in the subprime mortgage market, such as prepayment penalties, failure to offer escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the failure to give adequate consideration to a borrower's ability to repay.

I can assure you that our proposed rules will be based on detailed analyses of the issues and our statutory authority to address them, extraordinary outreach efforts to gather a wide range of information and opinions, and attempts to balance the needs of adequately protecting consumers and maintaining responsible lending markets. The rules will reflect input obtained through public meetings in 2006 and a hearing that dealt specifically with these issues that I chaired this past June. We also considered nearly 100 comment letters, following the June meeting, and consulted with other federal and state agencies and our own Consumer Advisory Council. Finally, we have continued to meet with, and listen to informed opinions from, consumer groups, the financial services industry, lawmakers, and others to ensure that our proposed rules are likely to achieve the goal of adequate consumer protection without shutting off access to responsible credit.

Legislative Responses

Congress has expressed understandable and appropriate concern about subprime lending and the challenges in the mortgage market more generally. We commend leaders in Congress who are looking into these problems and wrestling with the challenges of addressing abusive lending while encouraging responsible lending.

The Mortgage Reform and Anti-Predatory Lending Act of 2007, which was passed by the House of Representatives last month, would extend additional oversight and consumer protections to the market. We were asked in today's testimony to comment on two issues, not

addressed in the current version of the Act, that could be addressed through amendments or other actions.

Loan modifications

One issue is the possible legal exposure of servicers of mortgages who enter into loan modifications or workout plans. Because loan servicers play a critical role in implementing possible loss mitigation strategies, this is a timely and important question.

We believe that investors and servicers generally want to work with borrowers to avoid foreclosure. Prudent loss mitigation techniques that avoid foreclosure not only help homeowners, they are usually cost-effective for investors. Borrowers who have been current in their payments but could default after reset, for instance, may be able to work with their lender or servicer to adjust their payments or otherwise change their loans to make them more manageable. Working with borrowers before they experience payment problems has other benefits; for instance, late payments will not have affected such borrowers' credit scores, preserving a wider range of options including refinancing. Such proactive outreach by servicers may mean the difference between loan payment and default, particularly for lower-income families who may have little financial cushion.

Given the substantial number of resets expected from now through the end of 2008, it is in the interest of the industry to go further than it has historically to join together and explore collaborative, creative efforts to develop prudent loan modification programs and other assistance to help large groups of borrowers systematically. Such programs can streamline and speed the process of anticipating and addressing delinquent loans, reduce transaction costs, and provide guidance to borrowers and to mortgage counselors. Many servicers are, in fact, working with counselors who can play a crucial role in helping homeowners, many of whom do not even

communicate with their servicers out of fear, embarrassment, or misinformation about their options. Loan modification programs should be a bottom-up approach designed to balance the needs of all parties, and we are encouraged by the progress being made by the industry in advancing such programs.

Because systematic approaches to dealing with troubled loans are often likely to lead to better aggregate investor returns than foreclosures, we are encouraged by industry efforts to pursue these approaches. When servicers modify loans, however, they may face potential litigation risk from investors because of their contractual obligations under the servicing agreements. One particular source of litigation risk, we understand, may be that different asset classes have conflicting interests. Therefore, we encourage ongoing industry efforts to agree to standards for addressing these issues. We are hopeful that the industry can resolve these conflicts on a consensual basis so that they do not preclude servicers from taking actions that are in the overall best interests of consumers and the industry.

More generally, the Board supports efforts by the industry and others to develop reasonable and standardized approaches to dealing with these challenges. Such approaches, when applied consistently and predictably, can reduce uncertainty and ultimately help the markets function. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower, but there may be instances when such arrangements are not prudent or appropriate. In trying to help homeowners, we must also be careful to recognize the existing legal rights of investors, avoid actions that may have the unintended consequence of disrupting the orderly functioning of the market, or unnecessarily reducing future access to credit. Provisions intended to immunize servicers from liability should be crafted to avoid creating moral hazard of parties

disregarding their contractual obligations, which would ultimately have negative impacts for markets and consumers. Sustainable solutions, and not those that simply hide for the short term real repayment challenges, should be our goal.

Patterns or practices of violations

A second issue is the possible imposition of civil money penalties when the enforcement agencies find that there is a pattern or practice of violations. Penalties collected would be used to establish a trust fund for those consumers whose interests had been harmed but who lack a remedy in the event, for instance, that the responsible party has gone out of business.

The proper magnitude for any such penalties, or under what circumstances they should be imposed, is Congress' decision to make. As a general rule, the Board believes that penalties for any violation of law should be sufficient to deter the prohibited conduct, and also reasonably related to the injury caused by the violation. Penalties that are clearly articulated, and that reasonably match the magnitude of the violation, are the most appropriate and effective forms of deterrence.

We would recommend that the amount of such civil money penalties, if imposed, be given a ceiling as well as a floor because of the market uncertainty that can be introduced by open-ended liability. We would also suggest that some discretion in the actual amount of the penalty, within such a range, be given to the enforcing agencies. This sort of flexibility in enforcement would help the agencies adjust the punishment to fit the infraction.

The proposed increase in civil money penalties draws attention to the critical role that enforcement plays in ensuring compliance with the new responsibilities enacted by Congress. But the effectiveness of increased penalties can be diminished by a lack of enforcement resources. As Congress weighs the merits of the bill and possible amendments, we would

encourage you to also look at the resource needs of the agencies that are authorized to take enforcement actions to ensure that sufficient resources for this important role are available.

Conclusion

The Board recognizes the magnitude of the challenges facing mortgage borrowers today. We understand the uncertainty and harm being experienced by consumers across the country as the housing market challenges continue. We are engaged in an array of activities to respond to these concerns. In coming weeks, we will propose new rules regarding advertising, the timing of disclosures, and practices that we find to be unfair or deceptive under our HOEPA authority, all of which we believe will offer increasing protection to consumers. We look forward to continuing to work with Congress to achieve sustainable solutions to challenges in the mortgage market.

Statement of George Miller
Executive Director
American Securitization Forum

Before the
Committee on Financial Services
United States House of Representatives

December 6, 2007

Good morning and thank you for the opportunity to testify here today. I am honored to be here representing the American Securitization Forum (ASF) on actions that mortgage market participants can undertake to help prevent mortgage foreclosures and mitigate losses. We commend you for calling this hearing, and look forward to offering our views on these important matters.

Background

The American Securitization Forum is a broad-based, not-for-profit professional forum that advocates the common interests of the securitization market and its participants. ASF members include over 375 firms, including issuers, investors, financial intermediaries, trustees, rating agencies, financial guarantors, legal and accounting firms, mortgage insurers, and data analytics vendors, among other firms. ASF's mission and goals can succinctly be summarized as: (1) build consensus on best practices in the market; (2) advocate on behalf of our members; and (3) provide high quality educational events for industry participants and policymakers. ASF is an affiliate of the Securities Industry and Financial Markets Association.

As a general matter, no securitization market constituency--including lenders, servicers and investors--benefits from subprime loan defaults and foreclosures. Foreclosure is usually the most costly means of resolving a loan default. As a result, it is typically the least-preferred alternative for addressing a defaulted loan, whether or not the loan is held in a securitization trust. ASF therefore strongly supports the policy goal of avoiding foreclosures wherever reasonable alternatives exist.

Overview of Typical Securitization Document Modification Provisions

A basic principle underlying the servicing of subprime (or other) loans in securitization transactions that are unable to perform according to their contractual terms is to maximize recoveries and minimize losses on those loans. This principle is embodied in the contractual servicing standards and other provisions that set forth the specific duties and responsibilities of servicers in securitizations. In turn, these contractual provisions

are relied upon by investors in mortgage-backed securities, who depend primarily upon cash flows from pooled mortgage loans for the return on their investment.

Servicing of subprime residential mortgage loans included in a securitization is generally governed by either a pooling and servicing agreement (PSA) or servicing agreement (SA). Typical PSA and SA provisions require servicers bound by those contracts to follow accepted servicing practices and procedures as they would employ "in their good faith business judgment" and that are "normal and usual in its general mortgage servicing activities."

Most subprime securitization transactions authorize the servicer to modify loans that are in default or for which default is imminent or reasonably foreseeable. The "reasonably foreseeable" default standard derives from and is permitted by the restrictions imposed by the Real Estate Mortgage Investment Conduit sections of the Internal Revenue Code of 1986 (REMIC) on modifying loans included in a securitization for which a REMIC election is made.

Contractual loan modification provisions in securitizations typically also require that the modifications be in the best interests of the securityholders or not materially adverse to the interests of the securityholders, and that the modifications not result in a violation of the REMIC status of the securitization trust.

In addition to the authority to modify the loan terms, most subprime PSAs and SAs permit other loss mitigation techniques, including forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owed but may extend the term of payment. In addition, these arrangements typically permit loss mitigation through non-foreclosure alternatives to terminating a loan, such as short sales of deeds-in-lieu.

Based upon the economic and contractual principles outlined above, and consistent with applicable governing documents and regulatory and accounting standards, we support the use of loan modifications (along with other loss mitigation tools) by servicers in securitization transactions in appropriate circumstances. In general, "appropriate circumstances" would include situations where a servicer has concluded that a particular loan is in default or that default is reasonably foreseeable, and that the loan modification or other loss mitigation action contemplated by the servicer is likely to maximize recovery and minimize loss on that loan.

Servicers' Foreclosure Prevention and Loss Mitigation Efforts

Given the volume and deteriorating credit performance of subprime residential mortgage loans originated in 2005 and 2006 that are approaching their initial interest rate reset dates, servicers are now confronting a formidable loss mitigation challenge. A significant number of these loans have already defaulted, and additional defaults are likely. In some cases, these defaults are caused by the borrower's inability to afford the higher interest payment upon rate reset. In other cases, borrowers were unable to afford even the

introductory, fixed rate of interest. To the extent that defaulted loans ultimately progress to foreclosure, borrowers lose their homes, and securitization investors face the prospect of substantial losses on their investments.

As a consequence, servicers of mortgage loans have redoubled their efforts both to help borrowers avoid foreclosure and to minimize losses to securitization investors.

Based on our experience, most servicers have developed and are implementing procedures to reach out to hybrid ARM borrowers well in advance on an interest rate reset, in an effort to identify and prevent potential payment problems before they occur. Much of this outreach is being centralized and coordinated through the HOPE NOW Alliance, further outlined below. Among other things, this initiative—in which ASF has been an active participant—is designed to connect borrowers with servicers and non-profit counseling organizations more efficiently, and on a national scale.

In addition, most servicers have made substantial additional investments in loss mitigation personnel, and have developed and implemented enhanced internal processes and procedures to identify and pursue home retention options with borrowers wherever possible. In addition to loan modifications, these options include pursuing refinancing opportunities for qualified borrowers, structuring forbearance arrangements and repayment plans, establishing trial periods for reduced payments (which in some cases may be converted into formal loan modifications), and other deferments that can reduce or postpone payments owing under the loan

Recent Industry Developments

The application of loan modifications and other loss mitigation techniques to distressed or potentially distressed subprime loans has received intensive focus from servicers and the broader securitization industry. Working with a broad range of industry members, ASF has taken concrete steps to facilitate wider and more effective use of loan modifications in appropriate circumstances.

Last June, we published recommended industry guidance designed to establish a common framework relating to the structure, interpretation and application of loan modification provisions in securitization transactions. This document, entitled "Principles, Guidelines and Recommendations for the Modification of Securitized Subprime Residential Mortgage Loans" (attached hereto as Exhibit A) concludes that loan modifications, for subprime mortgage loans that are in default or for which default is reasonably foreseeable, are an important servicing tool that can often help borrowers avoid foreclosure as well as minimize losses to securitization investors.

Promulgation of the above loan modification recommendations was an important step toward broader securitization market collaboration toward foreclosure avoidance solutions. For example, both ASF have been active participants in the HOPE NOW Alliance that was formed on October 9, 2007 under the leadership of Treasury Secretary Paulson and HUD Secretary Jackson, and with support and participation from many of

our member firms. HOPE NOW, a collaboration of counselors, servicers, investors, and other mortgage market participants, seeks to maximize outreach efforts to homeowners in distress, and to provide effective counseling and other resources to help them remain in their homes.

Simultaneously with the announcement of the HOPE NOW Alliance, ASF also released guidance supporting the view that borrower counseling expenses may be viewed as servicing advances, and where consistent with operative securitization documents, can be reimbursed from securitization trust cashflows. We believe that the engagement of borrower counseling services and reimbursement of related expenses can serve as an important complement to servicers' existing obligations to service loans, mitigate losses and maximize recoveries in securitization transactions. ASF's statement should help to provide funding directly from securitization trusts for the delivery of these important borrower counseling resources.

Notwithstanding these important steps, additional action can be taken. In particular, given the large volume of impending interest rate resets on subprime hybrid ARMs and potential defaults on those loans, questions have been raised regarding whether it is operationally feasible for servicers individually to underwrite and renegotiate individual loan terms, absent guidance on more streamlined approaches that servicers might apply. Members of Congress, federal regulators and others have encouraged servicers to develop and implement more systematic approaches for evaluating loans for potential refinancing and modification.

In response to this challenge, we are actively working with servicers and other industry members to lever their existing efforts, and to encourage and facilitate their ability to implement more streamlined approaches to meeting the loan modification and broader loss mitigation challenge they now face.

In particular, ASF is now involved in an effort, working with subprime mortgage servicers and in consultation with investors, other securitization market participants and federal regulatory agencies, to:

1) Develop criteria by which servicers can systematically evaluate their subprime ARM portfolios, for the purpose of efficiently segmenting loans and borrowers to identify various potential loan disposition options, including the identification of loans that may be suitable candidates for refinancing, modification or other loss mitigation arrangements; and

2) Develop analytic tools and methods that servicers can apply on a more systematic and streamlined basis to evaluate loan affordability, borrower capacity and willingness to repay, and other factors that are relevant to decision-making regarding refinancing opportunities, loan modifications and other loss mitigation actions that may be appropriate for individual borrowers.

The purpose of this effort is to assist servicers in their efforts to streamline their loan evaluation procedures, and to expedite their decision making process relating to loss mitigation actions for individual borrowers who may be unable to fulfill the original terms of their loans. While this effort is designed to streamline servicers' decision making processes, it preserves the essential requirement that loan affordability and maximization of recovery to investors must be determined on an individual, loan-by-loan basis--including through the systematic application of reasonable, presumptive criteria in appropriate circumstances.

We believe that streamlining the process of evaluating borrower characteristics and matching them up efficiently with the appropriate loss mitigation options will ultimately help servicers manage their responsibilities in a changing market, while appropriately balancing the interests of borrowers and investors. We are pursuing these efforts in earnest and hope to report out progress on these efforts in the near future.

Much attention has been given to loan modifications as a potential foreclosure avoidance solution for distressed subprime mortgage borrowers. However, it should be noted that for those borrowers who are coming up on a reset date, have generally been current in their introductory mortgage payments, and have built up some equity in their home, refinancing options--either private industry products or FHA products--remain an important option to achieve a sustainable, long-term solution.

For borrowers with significantly impaired credit or little equity in their home, these refinancing opportunities may not be available. However, if a borrower has been able to stay relatively current in their introductory rate, but cannot afford the reset rate, servicers should be able to consider various loss mitigation options, including but not limited to loan modifications, to maintain the loan in a performing status and help that borrower stay in his or her home.

H.R. 4178, Emergency Mortgage Loan Modification Act of 2007

The Emergency Mortgage Loan Modification Act of 2007 would create a safe harbor from liability for servicers or others who modify certain types of residential mortgage loans. While we appreciate and support the need for clarity and legal certainty for servicers in effecting loan modifications, we have concerns about H.R. 4178 as introduced.

As a general matter, we have concerns with any legislation that would abrogate or interfere with previously established, private contractual obligations. PSAs typically require that the actions of the servicer, among other requirements, not be materially adverse to the interests of the certificate holders. Changing this standard would alter the commercial expectations of investors and could undermine the confidence of investors in the sanctity of agreements which are central to the process of securitization, and would

discourage investment in markets that need liquidity -- both now and over the longer term.

As indicated above, we believe that market-driven initiatives to streamline the process of effecting loan modifications in appropriate circumstances is in the best interests of homeowners and investors alike. However, members of the servicing community have raised legitimate concerns about their legal exposure for implementing this framework, partly in response to the strong encouragement of regulators and policymakers to do so. Therefore, we would like to continue to work with Representative Castle and the Committee to determine if additional steps may be necessary or helpful to address any legal, regulatory, accounting or other obstacles to the delivery of loan modifications and other loss mitigation relief to borrowers pursuant to industry-developed frameworks, including the streamlined approach outlined above.

In summary, the securitization industry shares your goal of delivering assistance to borrowers who are otherwise at risk of default and foreclosure. Therefore, while we believe that that legislation should be carefully crafted to avoid the perception that it is a revision of existing contracts, an acknowledgement that a prudent servicer may rely on reasonable analytic tools and presumptions, such as those outlined above, could be an effective and necessary tool to reach this goal.

Conclusion

Chairman Frank Chair and distinguished Members, I thank you for the opportunity to participate in today's hearing. We believe that the interests of secondary mortgage market participants continue to be aligned with borrowers, communities and policymakers to help prevent foreclosures. To that end, ASF stands ready to assist, and commend your leadership on these important matters.

Thank you.

TESTIMONY OF

MARK PEARCE
DEPUTY COMMISSIONER OF BANKS FOR THE STATE OF NORTH CAROLINA

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

ACCELERATING LOAN MODIFICATIONS, IMPROVING FORECLOSURE PREVENTION, AND ENHANCING ENFORCEMENT

Before the
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

December 6, 2007
Room 2128, Rayburn House Office Building

Good morning, Chairman Frank, ranking member Bachus, and members of the Committee. I am Mark Pearce, Deputy Commissioner of Banks for the state of North Carolina. I am pleased to be here today to discuss efforts already underway at the state level and future efforts needed to improve the pace and volume of modifications to mortgage loans that will help homeowners stay in their houses.

I appear today as a member of the State Foreclosure Prevention Working Group, a joint effort of state attorneys general, state bank regulators, and the Conference of State Bank Supervisors (CSBS). CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,206 state-chartered commercial and savings banks, and 400 state-licensed foreign banking offices nationwide. For more than a century, CSBS has given state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state bank regulation.

In addition to regulating state-chartered banks, the states provide regulatory oversight of the residential mortgage industry. State mortgage regulators work together through their own organization, the American Association of Residential Mortgage Regulators (AARMR), of which I am also Vice President and legislative and policy liaison with CSBS. Additionally, I am a member of the State Foreclosure Prevention Working Group chaired by Iowa Attorney General Tom Miller.

In total, states regulate and oversee more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals.[1]

In my testimony today, I want to place the rising delinquency and foreclosure rates in context of the subprime origination market over the past couple of years and the traditional operation of mortgage servicers. This context is essential to understanding the limitations on and opportunities for preventing unnecessary foreclosures. In particular, I wish to make the following points:

1. **Mortgage servicers are being asked to fix problems created by poor origination practices over the past few years.** Loose underwriting practices, especially in the subprime market, led to a significant number of risky mortgage loans dependent on continued home price appreciation. Many subprime loans have experienced severe delinquency rates before the rates reset, as a result of weak or nonexistent underwriting, risk layering, fraud, and/or life events. Rate resets for hybrid adjustable rate mortgages exacerbate this problem, but are only one aspect of a larger challenge of dealing with risky subprime loans.

2. **A significant disconnect between aspirations and results remains as servicers struggle to meet the current and ongoing foreclosure crisis.** Mortgage servicing operations historically have been structured to promote efficiency in collection of regular mortgage payments. Their loss mitigation

[1] The above numbers do not include the State of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

efforts have traditionally been limited to a small percentage of borrowers in default who are most often dealing with adverse life events, such as loss of a job, health problems, or divorce. This collections system was not designed to deal with a large number of homeowners with longer-term problems created by payment shock, house price depreciation, and limited refinance options. While servicer executives are to be applauded for their encouraging statements on efforts to prevent foreclosures, the reality has been that many homeowners, non-profit counselors, and state officials are frustrated by the inability of servicers to make sustainable loan modifications that would benefit borrowers and investors alike. The transition from a "no touch" or "low touch" debt collection model to a "high touch" foreclosure avoidance model has been and continues to be very bumpy.

3. **Proposing to freeze rates for current homeowners that will default due to payment shock is an important step forward.** Investors will benefit from systemic approaches to prevent large numbers of homeowners facing payment increases from entering into foreclosure. This makes good economic sense. The success of any proposed rate freeze will depend on the ability of servicers to analyze likelihood of default in advance and make a pre-qualified offer to modify the loan for at least five years. If servicers continue to use the traditional "waterfall" system, which relies on extensive homeowner interaction and documentation requirements, this rate freeze option will never reach many eligible homeowners. While dealing with rate reset loans may prevent a number of unnecessary defaults, we should not be lulled into thinking this proposal solves the foreclosure crisis. As Treasury Secretary Paulson has said, freezing rates for a portion of borrowers facing rate resets is not a silver bullet. We are at the start of this road, not the end.

4. **States will continue to work with subprime servicers in a collaborative fashion to monitor progress of foreclosure prevention efforts and to promote systemic and innovative approaches.** State attorneys general and state banking and mortgage regulators have worked with the 20 largest subprime servicers for several months regarding this crisis. We have sought opportunities to discuss innovative approaches to preventing foreclosures, recognizing that servicers have important contractual obligations to investors and that not every foreclosure can be avoided. We believe these efforts will improve servicers' ability to prevent unnecessary foreclosures and will track progress through our collection of data on loss mitigation activities. States continue to seek cooperation with federal efforts in this arena, as we continue our traditional role in protecting our citizens.

State Efforts Regarding Foreclosure Prevention

This Committee has already heard from the state regulators multiple times on their efforts to improve regulation of the mortgage market. We believe state and federal cooperative approaches have the best chance to eliminate regulatory gaps, and we continue to work to

make sure regulators are better able to address weak lending practices. In addition to our regulatory efforts, state officials have also been very active in addressing increasing foreclosures. Despite these efforts, we believe the current situation of elevated foreclosures is only the tip of the iceberg.

State banking and mortgage regulators have been working together formally with State Attorneys General during the past year to develop a comprehensive strategy to address increasing foreclosure rates. The partnership between state regulators and attorneys general is long-standing, and had led to the largest consumer protection settlements in our nation's history, including most recently the $325 million settlement with Ameriquest.

In July 2007, representatives of 37 state attorney general offices and state banking regulators gathered in Chicago for a summit meeting on the growing crisis in subprime mortgage foreclosures. The news was alarming: nearly two million subprime mortgages with an adjustment feature, such as hybrid ARMs and option ARMs, were set to adjust between the latter part of 2007 and the end of 2008. These loans had been made with an expectation that borrowers could refinance before the rate adjusted, an expectation that was no longer justified in light of the rapid decline in home values. Many of these loans had been made based on incorrect stated incomes and/or inflated appraisals, with little if any underwriting having been done to assure that borrowers could afford to make monthly payments after the initial "teaser" rate had adjusted upward. The likely outcome of this situation was an unprecedented flood of foreclosures.

A State Foreclosure Prevention Working Group formed out of this summit meeting, to gather more information and to attempt to work with participants in the subprime mortgage industry to find ways to modify loans on a mass scale so that as many borrowers as possible could retain their homes with affordable mortgages. The Working Group consists of representatives of the attorneys general of 11 states, two state banking departments, and the Conference of State Bank Supervisors.

Since September, this Working Group has met with representatives of the 20 largest servicers of subprime mortgages. Collectively, these top 20 companies service approximately 93 percent of the nation's subprime loans. We have asked them to work with us to start identifying and implementing collective, consistent and scaleable solutions to prevent foreclosure. Our guiding principle is simple: any solution must be in the interests of both the borrower and the investor. We see ample opportunities for improvement that will lead to win-wins for investors and homeowners.

In addition to the multi-state joint effort of the State Foreclosure Prevention Working Group, individual states have taken the initiative to reduce foreclosures through various efforts, such as:

- foreclosure prevention hotlines, such as those in Iowa, Colorado, and Massachusetts;
- hosting "road shows" of servicers in hard-hit economic areas, such as Ohio and Michigan, to promote face-to-face contact between servicers and struggling homeowners;

- meeting directly with servicers in states such as Texas, Ohio, and California, to determine if there are solutions to local problems;
- foreclosure moratoriums to deal with abusive lending practices of particular lenders; and
- enactment of legislation to improve servicing practices.

Numerous states have foreclosure prevention task forces that bring together local resources to deal with local conditions. In this case, Ohio is truly not the same as North Carolina.

Foreclosure Impact at the Local and State Level

At the state level, we see the impact of foreclosures at every level of daily life. Our citizens contact our offices for assistance in avoiding foreclosure. Our court systems are clogged with foreclosure proceedings. We see the "for sale" and "auction" signs in our neighborhoods. From an economic perspective, borrowers who lose their homes to foreclosure no longer pay property taxes and many local communities may suffer a fiscal strain as a result. Any subsequent owner is likely to be paying lower property taxes, as the property's value declines, and the values of homes around a house in foreclosure often decline as well, further depressing tax revenues. A recent report by Global Insight for the U.S. Conference of Mayors looked at the fiscal impact of the mortgage crisis on ten states, and estimated an aggregate loss in tax revenue of $6.6 billion. A November 2007 report by the Center for Responsible Lending found that each foreclosure lowers the value of other neighboring homes by 0.9 percent. The CRL estimates a total decline in house values and tax base from nearby foreclosures to be $223 *billion.*

Traditionally, foreclosures occurred because of a weak economy or a major life event, such as job loss, divorce, or illness. While life events have not disappeared and unemployment and economic weakness might be rising, these factors are still at historically low levels. The differences in today's mortgage market are the types of mortgage products being used, the lower standards for loan underwriting, and unprecedented levels of origination fraud. A recent report from Fitch found that "poor underwriting quality and fraud may account for as much as one-quarter of the underperformance of recent vintage subprime residential mortgage-backed securities." This 25% estimate by Fitch may well be conservative, based on the states' experience. According to the latest findings of the Mortgage Asset Research Institute (MARI), mortgage fraud reports increased 30% from 2005 to 2006 alone, and estimated losses due to mortgage fraud last year approached $1 billion dollars.

While lending practices are not the topic of today's hearing, it is critical to understand that today's foreclosure crisis is the fruit of the poor underwriting and lending practices in prior years. For instance, many of the hybrid adjustable rate mortgages facing resets in the next year were made to borrowers based on limited or no documentation. If those borrowers had been offered fixed rate loans with fully documented incomes, many of these borrowers would have paid a *lower* rate than the initial "teaser" rate of the hybrid

ARMs. We would not have a rate reset problem at all; in fact, we would have *fewer* borrowers facing foreclosure.

As a result of systemic weakness in underwriting of these loans, we need systemic solutions to preventing foreclosure. These systemic solutions are made difficult by the very design of mortgage servicing operations.

Servicing for Good Times

This Committee has thoroughly discussed the fragmentation of the mortgage origination system and the moral hazard created throughout the chain from loan broker to investor and addressed these issues in H.R. 3915. In addition, the fragmented system extends into the servicing operation, as specialized mortgage servicers developed to manage prime, subprime, and "scratch and dent" mortgage loans.

For the most part, these servicers' essential function is to collect monthly payments from borrowers and to remit them in a timely manner to investors. Servicers compete for the opportunity to service mortgage portfolios and have developed highly automated and efficient systems to collect these payments quickly and accurately. When borrowers fall behind on mortgage loans, servicers perform their other primary function, that of a debt collector. Like other debt collections, this process is highly scripted and intended to maximize the likelihood of getting the borrower to catch up on the mortgage or, in the alternative, to regain control of the property as quickly as possible to enable the property to be resold.

Over the past few years, with rising property values nationwide, most subprime loans would refinance prior to any rate reset event. Many servicers have reported that upwards of 70% of subprime loans historically repaid prior to the reset, as borrowers either refinanced the loan or sold the property. Loss mitigation efforts focused on short-term repayment plans, which were directed to those borrowers who had a temporary problem. If collections didn't work and short-term repayment plans didn't work, servicers would typically move forward to foreclosure. Servicers rarely, if ever, offered a loan modification. This "waterfall" approach from collections to loan modification meant that modification was the last resort.

Now that property values are declining in many markets, these options have dried up, and servicers report that the percentage of loans that refinance prior to the reset have plummeted to 20-30%. The rest of the loans continue to move toward reset and many of those face likely default as their payment increases. Instead of traditional life events, these homeowners face a long-term problem in that their mortgage payment will increase by 20-30%, assuming interest rates stay steady. Given the turmoil in the credit markets, even this assumption is dubious. Other homeowners have such a high debt-to-income ratio or such little equity in their homes that even the slightest change in their financial situation can lead to ruin.

As the root causes of foreclosure change, servicers have struggled to adapt their approach to solve systemic and large-scale problems created by weak origination practices. Servicers have made significant efforts, but in part, they have failed for two reasons: first, because the legal infrastructure to conduct scalable solutions has evolved in incremental steps; and second, servicer efforts have not adapted systemically to new drivers of foreclosures.

First, we should celebrate the creative legal solutions to enhancing servicer ability to engage in loan modifications. From interpretations of FAS 140, to REMIC rules on passive investments, to guidance to servicers on their duty to the aggregate investment trust, to revisions in pooling and servicing agreements (PSAs), investors and regulators have made tremendous progress in removing legal obstacles to increasing the availability of loan modifications. This is an incredibly complex area, and talented people have made a difference.

Problems remain, however, in that traditional notions of "case-by-case" assessment of individual borrowers capacity to repay have hampered the implementation of scalable loan modifications. Most servicers have been reluctant to offer a loan modification without a full and detailed financial assessment of the individual borrower's current financial condition – such as cellphone and cable bills, how much the homeowner spends on food -- a much more rigorous review than would occur in the underwriting of loans on the front end. While subprime lenders may have engaged in weak underwriting, servicers have traditionally over-underwritten loan modifications to ensure they comply with legal obligations to investors to maximize the value of each loan individually.

Hesitant to make major changes in approach for fear of investor lawsuits or loss of business, servicers have attempted to meet the demand for loan modifications simply by adding additional staff in the loss mitigation area. While these efforts are beneficial, they have not been able to keep up with the increasing volume of homeowners in distress. In addition, the highly individualized assessment needed in the current system requires a higher level of training than do front-line collections. Modifying a loan means spending a great deal of time with a borrower, money not recoverable from investors. In fact, intensive loss mitigation efforts can lose money for a servicer if the benefit from keeping the payment stream of future servicing fees outweighs the cost of the staff time needed to modify a loan successfully.

Based on our reports from our consumer assistance departments, local and national non-profit counselors, and the media, homeowners are still having tremendous difficulty in accessing loss mitigation solutions. Homeowners are having difficulty reaching someone with the authority to make a loss mitigation decision, paperwork gets lost, processing takes weeks or months to finalize a modification. Even state officials have had difficulty in navigating various servicers to find the right person to assist a homeowner. While it is possible that no one benefits from foreclosure, the current system still produces them unnecessarily and sometimes simply as the result of poor customer service.

Another strong servicer effort – increased outreach to borrowers -- has run into similar problems. As has been frequently cited, up to 50% of borrowers who are foreclosed on report that they never talked to their servicers. Servicers identify contacting borrowers as the primary obstacle to foreclosure prevention. As a result, servicers have implemented an array of innovative techniques to reach borrowers, such as mailing cellphones to borrowers, sending letters that look like wedding invitations, contracting with local non-profits to deliver letters personally, and holding "open houses" in local areas hard-hit by foreclosures. These creative techniques are coupled with persistent and frequent phone calls to try to reach borrowers, and this has undoubtedly prevented foreclosures.

In this area, servicers have struggled to combat the negative impression that servicers are simply uncaring debt collectors who do not have options other than foreclosure. In fact, the research on borrower contact identifies that perception as the primary reason that borrowers did not contact their servicers. As a result, many homeowners ignore or avoid contact with servicers. It will take more than creative outreach to combat this problem. Recent efforts to partner with non-profits are critical in this area, and state and local officials are partnering with servicers in some areas to contact hard-to-reach homeowners.

Ultimately, the proof is in the pudding. A recent report by Credit Suisse developed a scale to determine how many loan modifications were being made as compared to the number that should have been made, based on loans that went delinquent within a few months after the rate reset. Even the issuer with the highest percentage modified only approximately one-third of the loans needing modification. Simply put, the energetic efforts of servicers have not translated into meaningful success in preventing large numbers of foreclosure.

Freezing Rates to Avoid Payment Shock is an Important Step Forward

Chairman Bair of the FDIC should be given great credit for her leadership in proposing that servicers develop a systemic approach to dealing with hybrid ARMs before they have rates reset. In California, Governor Schwartzenegger and the California Department of Corporations have announced an agreement with four major servicers to extend the rate on hybrid ARMs for a sustainable period.

The Treasury Department's HOPE NOW initiative, and the proposed freezing of rate resets for certain borrowers reported last week, are efforts toward goals similar to those of our State Foreclosure Prevention Working Group. While the details of this agreement are not yet available, we believe that this approach is the type of scalable solution that will prevent unnecessary foreclosures. In particular we hope this proposal includes the following components:

1. Servicers should take steps to identify owner-occupied hybrid adjustable-rate subprime loans that will face a payment reset within the next six months.

2. For those loans, the servicer should take steps, using available data, to determine whether the homeowner is reasonably likely to default on the loan if the homeowner has to make the monthly payment post-reset. This calculation should be based on a traditional net present value analysis of the modified loan vs. the value of the loan in foreclosure. This assessment should be done without the need to collect specific financial information from borrowers in advance, as most servicers have access to sufficient financial information (e.g. original loan information, payment history and credit reporting) to make this assessment prior to borrower contact.

3. For loans that are *current* at the time of the assessment, and where an increased payment makes it reasonably foreseeable that a default will occur, the servicer should develop a "pre-qualified" loan modification offer. This loan modification offer should be one where the interest rate of the loan is frozen at the current level for the remaining life of the loan or for at least five years, if not for the life of the loan. Given the high volume of delinquent subprime portfolios nationwide, longer-term changes to rate for these loans will enable servicers to focus limited loss mitigation resources on delinquent loans, rather than cycling back through performing loans.

4. This pre-qualified loan modification offer should be clearly communicated to the borrower. The offer should be contingent on the homeowner providing a reasonable confirmation of the homeowner's existing financial condition.

5. The pre-qualified loan modification offer should include a direct contact number to the loss mitigation department of the servicer, in the event the homeowner has questions or individual financial conditions that might impact the option.

Recent press has mistakenly characterized this type of scalable solution as a "bailout." We believe this is wrong for three critical reasons. First, this proposal best serves the interests of investors and homeowners. Investors' financial returns will improve as a result of a systemic approach to this issue, rather than allowing 80-90% of the loans to enter default before getting serious attention from loss mitigation staff at the servicer.

Second, no government money is involved in this proposal. Investors who made poor financial investments will bear the brunt of those choices. Many borrowers who receive this type of modification will be those who could have obtained a fixed rate loan at a similar price two years ago, if they had provided full documentation of income.

Finally, as high foreclosures accelerate home price declines, slowing down foreclosures not only benefits individual homeowners, but also protects aggregate property values and the health of our communities and economy. The serious negative externalities associated with foreclosures, such as reduced property values, increased crime, deterioration of properties, etc., make foreclosure levels of this magnitude a public policy issue. Given that we are experiencing the first nationwide home price decline in our

lifetimes, mitigating foreclosures gives our markets a chance to recover rather than spiral further downward.

Challenges Ahead

While it would be tempting to think that the proposed freezing of rates for some hybrid ARMs would solve the foreclosure problem, we have much more work to do. Given that many subprime loans originated in 2006 are already showing historic levels of default, continued efforts are necessary to find ways to promote long-term affordable solutions to prevent foreclosures. Some areas that need additional work are:

- Finding creative loss mitigation techniques to deal with struggling homeowners who are "under water" due to home price declines. The use of balloon modifications may maximize homeownership preservation for those willing to stay in the home, while creating an opportunity for investors to recover their principal if the market rebounds.
- Solving the problem of piggyback second mortgages. Many subprime loans in recent years were 80/20 loans, where the first and second mortgages were securitized into different instruments, serviced by different servicers. Struggling homeowners may face competing servicers contacting them to seek payment for different mortgages. This creates incredible pressure and confusion for the homeowner. In addition, the investors (and servicers as agents) have competing interests and may struggle to find a mutually acceptable loss mitigation outcome to preserve homeownership.
- Reducing paperwork necessary to consummate a loan modification. Traditional servicing techniques have required extensive documentation to justify a loan modification. Servicers need to develop and implement processes that require less paperwork.
- Improved customer service to provide homeowners with the right solution on the first phone call. If homeowners have to talk to five different people at a servicer before accessing the appropriate solution, many will fall through the cracks.
- Providing meaningful data to the public through state and federal officials to demonstrate progress of loss mitigation efforts.
- H.R. 4178 offers the basis for enhanced protection for servicers making best efforts to prevent unnecessary foreclosures. While broad immunity shouldn't be necessary given that these loan modification efforts are in the interests of investors, the reality is that every servicer we have talked to believes they will be sued by investors; the question is not if, but when. Congress can mitigate this problem, assuming the bill does not violate contracts and the Constitution. Any legislative immunity, however, should be limited strictly to investor lawsuits.
- Investors should be willing to reimburse servicers for work with independent third-party counselors. It is in investors' interest to pay servicers or housing counselors an additional fee for modifications that result in performing loans. The American Securitization Forum's recent paper on this topic will hopefully lead to broader investor acceptance of this reimbursement of independent counselors assisting in foreclosure prevention.

- A close look at pay-option ARM products, as a potential "second wave" of resets may occur as these loans reach their negative amortization caps. We should get out ahead of these resets.

Next Steps for State Foreclosure Prevention Work Group

The State Foreclosure Prevention Working Group's meetings with the top 20 subprime servicers highlighted the need for meaningful data on the extent and type of modifications actually being offered, and on progress in preventing foreclosures. Servicers need information about each other's practices and procedures in order to develop industry-wide best practices, and a consistent approach to these modifications.

Therefore, the Working Group has developed and sent out a "call report" for servicers, in an attempt to collect essential information. The Consolidated State Report for Mortgage Servicers asks servicers for data on their total loans serviced; the characteristics of these loans; the number and amounts of prime, subprime and Alt-A loans that will reset and when; the past-due and default rates on each of these categories; and what steps the servicer has taken to prevent foreclosures, ranging from deed in lieu of foreclosure to loan modification. The Working Group has shared the call report format with a number of state and federal regulators, including members of the HOPE NOW initiative. We anticipate receiving data from servicers in this format within the next couple weeks.

Collecting this information will give us a better understanding of the scope of the problem and the current state of loss mitigation efforts by the servicers. It should allow both regulators and the industry to track our progress and to move past anecdotal stories of success or failure.

We will continue to work with these servicers in a collaborative and cooperative fashion to identify ways to prevent needless foreclosures. Where appropriate, there are opportunities for collaboration between state and federal regulators. In fact, CSBS has briefed all the federal banking regulators and OFHEO about the progress of the State Foreclosure Prevention Working Group, and hope to work with federal agencies as they continue their efforts. There is great opportunity for partnership and innovation, as we need our collective efforts to mitigate the national foreclosure crisis.

Conclusion

States have a critical stake in preventing foreclosures and keeping committed homeowners in their houses. What is a macroeconomic issue for the nation's economy is, at our level, a question of reduced tax revenues, blighted neighborhoods, increased crime and demands on social services, and even civic instability.

We are spending our time and resources on this issue because it is so important to our citizens and our neighborhoods, and we ask Congress to recognize and include our efforts in any comprehensive approach to foreclosure prevention.

We intend to continue our work with you, the industry and with our counterparts nationwide to minimize the impact of this surging disaster in communities across the nation. Thank you for your time and attention, and I would be happy to answer any questions you may have.

Statement of Larry Platt
Kirkpatrick & Lockhart Preston Gates Ellis LLP

On behalf of
Securities Industry and Financial Markets Association

Before the
Committee on Financial Services
United States House of Representatives

December 6, 2007

Chairman Frank and Ranking Member Bachus thank you for the privilege of testifying here today on behalf of the Securities Industry and Financial Markets Association (SIFMA[1]) on a proposal that would allow regulators to impose significant monetary penalties on creditors and assignees that exhibit a pattern and practice of certain violations of H.R. 3915, the "Mortgage Reform and Anti-Predatory Lending Act of 2007." While we appreciate the efforts of the Committee to strive to find ways to protect borrowers who are victims of unlawful lending practices, we oppose this measure as offered during floor consideration of H.R. 3915. We believe it will have the unintended effect of prohibiting residential mortgage loans that do not qualify for the safe harbors provided in Title II of H.R. 3915, much like HOEPA effectively outlaws "high cost mortgages." We believe the remedies provided in Title II should be given a chance to work before declaring them to be ineffective.

At the outset, we believe that there are certain principles that guide the willingness of the industry to participate in the primary and secondary mortgage markets. First, lenders, assignees and securitizers all need to know what reasonably is expected of them before being subjected to the risk of significant penalties for errors in judgment made in good faith. Second, lenders, assignees and securitizers all desire carefully crafted laws that provide a reasonable balance between the legitimate interests of consumers and industry participants. Third, lender, assignees and creditors should not be subject to penalties that bear no rational economic relationship to actual harm, and impose the potential for "bet your company" liability. We are concerned that this proposal would upset the balance of the base legislation and cause parties to leave the market.

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

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BACKGROUND

As you know, Title II of H.R. 3915 obligates a creditor to make a reasonable and good faith determination of (i) a consumer's ability to repay a residential mortgage loan and (ii) the provision of a net tangible benefit to the consumer of a refinancing residential mortgage loan (the "Law"). Generally speaking, a consumer has a right to obtain a rescission of a loan that is made in violation of this provision although creditors and assignees may cure the violation in lieu of rescission. The proposed amendment also would impose civil money penalties of $1 million plus not less than $25,000 per loan on any creditor, assignee or securitizer that engaged in a pattern or practice of originating, assigning or securitizing residential mortgage loans in violation of the Law (the "Proposal").

The Proposal would apply only to residential mortgage loans that are not "qualified mortgages, "qualified safe harbor mortgages" or "high cost mortgages." The first two types of loans are presumed to satisfy the Law and thus could not raise the possibility of pattern and practice violations. The third type of loan, high cost mortgages, are subject to a separate set of statutory requirements; the mortgage finance industry generally does not make, finance, buy, sell, or securitize these loans because of the draconian remedies that may be asserted against assignees.

The remaining residential mortgage loans to which the Proposal would apply truly are caught between two worlds. On the one hand, they do not benefit from a presumption of compliance. On the other hand, they are not illegal, and remedies for violations do not include enhanced damages and assignees are not subject to any and all claims that consumers could assert under other laws as HOEPA now permits. Of course, the risk of rescission awaits a creditor or, in some cases, an assignee or securitizer who makes or buys a loan that violates the Law. But presumably a lender can price the risk of uncertainty and not withdraw entirely from this segment of the market for fear of immeasurable liability.

Underlying this amendment is the belief that enabling a borrower to get out of a loan that should not have been made is not enough. While it may make the individual borrower "whole," the limited remedy is perceived to be insufficient to discourage creditors, assignees and securitizers from routinely taking the risk to violate the Law. Imposing the risk of multi-million dollar liability, without regard to the actual harm suffered by individual borrowers whose loans were rescinded or cured, is thought to motivate the market to comply with the Law. We disagree and believe that the remedy of rescission should be given the chance to succeed.

ANALYSIS

Any evaluation of the merits of the Proposal must begin with a straight forward question—namely, should residential mortgage loans falling outside of the safe harbor be encouraged or discouraged? As a preliminary matter, by reducing the financial triggers that cause a residential mortgage loan to become a "high cost mortgage," the House already has sought to remove from the marketplace a large segment of loans to which the new Law otherwise would apply. For the remaining residential mortgage loans that do not qualify for the presumption of compliance, the amendment will effectively do the same thing.

H.R. 3915 does not conclusively define how a creditor determines a consumer's ability to repay a loan or a loan's net tangible benefit to a consumer. This means that the proposal would impose a minimum

penalty of $1 million on a creditor for engaging in a pattern or practice of violating a law that is inherently subjective in nature. H.R. 3915 also does not impose any substantive legal obligation on assignees or securitizers to make independent determinations of either a borrower's ability to repay a loan or a loan's net tangible benefit to a borrower or the correctness of the creditor's determination. And, even if it did impose a direct obligation, it does not precisely define what is illegal. This means that the Proposal would impose a minimum penalty of $1 million on an assignee for engaging in a pattern or practice of an act that is itself not illegal—the simple act of purchasing loans. Either way, the practical application of the Proposal is to impose substantial economic penalties on parties to discourage behavior that is ambiguous at best.

In the face of the inherent ambiguity of the law, what should a creditor do? A lender that reasonably and in good faith believes it has developed an alternative underwriting tool to predict default would be at material risk to use it. If it implements the widespread usage of the tool—shall we say a pattern and practice of usage—it could subject itself to multi-million dollar claims. Moreover, the underwriting tool that gave rise to the pattern and practice claim most likely would be the subject of class action litigation against creditors. Indeed, the available remedies presumably will provide a rich incentive to assert class action claims. And the absence of any meaningful definitions of what constitutes compliance with the Law means that long drawn out court battles will ensue with a judge or jury ultimately having to decide the meaning of phrases that Congress chose not to define. Continuing efforts to develop flexible underwriting tools for underserved borrowers, for example, would be undermined.

Assignees and securitizers acting in good faith are further challenged. They will have to evaluate the reasonableness of a creditor's determination of legal compliance and will be unable to diligence compliance in advance in a definitive way. As noted before, the simple act of repeatedly buying loans made by others creates a pattern and practice that could result in multi-million dollar liability. This Proposal would go beyond making assignees liable for the legal violations of creditors, and would seek to impose direct liability on the assignees and securitizer, thereby setting themselves up for piggy back claims under other laws.

As evident from market reaction to HOEPA and certain state experience in extending HOEPA-like liability to other sectors of the mortgage market, we know that excessive penalties that bear no rational relationship to actual harm will cause the mortgage finance industry to withdraw from the market. We believe the remedies in Title II are more than sufficient to discourage the behavior this Proposal seeks to curtail.

We appreciate the opportunity to testify, and would be happy to answer any questions.

Embargoed until
December 6, 2007, at 10:00 am

Statement of

Scott M. Polakoff
Senior Deputy Director and Chief Operating Officer
Office of Thrift Supervision

concerning

Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement

before the

The Committee on Financial Services
United States House of Representatives

December 6, 2007

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement
before the
Committee on Financial Services
United States House of Representatives

December 6, 2007

Scott M. Polakoff, Senior Deputy Director and COO
Office of Thrift Supervision

I. Introduction

Good morning, Chairman Frank, Ranking Member Bachus, and Members of the Committee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on loan modifications, foreclosure prevention and several amendments considered during House deliberations and passage of H.R. 3915, the Mortgage Reform and Anti-Predatory Lending Act.

In your invitation letter, Mr. Chairman, you ask us to address ways to improve the pace and volume of mortgage loan modifications to help troubled borrowers remain in their homes. In particular, you ask us to address how to accomplish loan modifications on a wholesale basis, the barriers to doing so, and the need for policy changes to facilitate a more broad-based approach to reach more borrowers more rapidly to modify troubled loans.

You also ask us to address the following issues in this testimony:

- The need for more broadly-based loan modifications, steps mortgage servicers and other industry participants should be taking to achieve this goal, and any legislative or regulatory changes that may be needed to facilitate this process.
- The extent to which the threat of lawsuits has become, or is in our view likely to become, a barrier to more widespread modification of troubled loans.
- Who we think could be likely the target of any lawsuits and what would be the likely legal basis for such suits?
- What approaches, including the approach taken in H.R. 4178, is appropriate to address this potential problem?
- Whether, and to what extent, the Frank-Miller-Watt amendment would enhance the capacity provided to the regulators under H.R. 3915 to combat "patterns" of behavior violating its ability-to-repay and tangible net benefit standards for mortgage loans.
- Other measures that should be considered to improve regulatory enforcement of the proposed new rules under H.R. 3915.

In addressing these issues, I will first discuss the current state of the subprime mortgage markets and include context on the overall mortgage and housing markets. Next, I will discuss the issues in structuring a viable loan modification program and the experience, albeit brief, of several lenders' efforts to structure such a program. I will also discuss the views of the OTS on the necessary elements of an effective program and ways that these can be achieved. I will conclude my testimony with observations on the Castle bill, H.R. 4178, the Emergency Mortgage Loan Modification Act, and the Frank-Miller-Watt Pattern or Practice Liability amendment.

Before proceeding, Mr. Chairman, I want to note that many of the issues we are discussing today were debated earlier this week at the OTS National Housing Forum. In addition to remarks from Treasury Secretary Paulson, HUD Secretary Jackson and former FDIC Chairman William Seidman, we had four panels of distinguished speakers from the industry, community organizations, financial firms, media and the government. The entire proceedings of the day's events are available at the OTS website. If you have the opportunity to do so, I encourage you to view it.

II. Current State of the Subprime Mortgage Loan Market

Based on recent data, total outstanding mortgage loans in the U.S. are approximately $10.4 trillion. Of this total, subprime loans account for $1.2 trillion, or 11.5 percent of the U.S. mortgage market. Subprime 2/28 and 3/27 mortgage loans account for a total of $496 billion, or roughly 4.8 percent of aggregate outstanding U.S. mortgage debt and 41 percent of outstanding subprime mortgage loans.

In 2005, subprime originations were approximately $625 billion, representing roughly 20 percent of the $3 trillion mortgage origination market that year. In 2006, subprime loans of $600 billion again accounted for approximately 20 percent of originations of $3 trillion. These two years accounted for the majority of subprime 2/28 and 3/27 loans currently outstanding. The vast majority of these subprime mortgages were 2/28 or 3/27 loan products. Most of these 2/28 and 3/27 loans were underwritten to pretax debt-to-income ratios of 45 percent and higher. Typically, these borrowers paid initial "starter rates" for their loans that were between 7 percent and 9 percent. Many of these loans are now due to reset upward by as much as 300 basis points. Several additional points regarding subprime 2/28 and 3/27 are worth stating:

- Subprime 2/28 and 3/27 mortgage loans have significantly higher delinquency rates than other subprime loan products.
- Based on recent data, 24 percent of subprime 2/28 and 3/27 mortgage loans were more than 90 days past due, compared to a 19 percent 90-day past due rate for all subprime loans.

- 30 percent of all subprime 2/28 and 3/27 loans experience delinquency prior to a rate reset.
- More than 27 percent of subprime 2/28 and 3/27 loans made in connection with a home purchase with no money down become delinquent.
- 41 percent of subprime borrowers that experience a rate reset become delinquent.

Clearly, these are troubling numbers. Of particular relevance to the current discussion is the fact that while a rate reset can be a significant event triggering delinquency, many subprime 2/28 and 3/27 loans experience delinquency (although many are cured) even before a rate reset. A loan modification that extends the starter rate will not help borrowers who ultimately will be unable to pay under their current starter rate. Generally, an effective loan modification program will focus on reaching borrowers who make it to their rate reset relatively free of serious past payment problems.

The other useful data that we have from the subprime market is that, as referenced previously, hybrid ARMS are the predominant mortgage product. In fact, 2/28 and 3/27 hybrid ARMs are almost exclusively underwritten to the subprime market. Currently available data indicate that 43 percent of outstanding 2/28 and 3/27 hybrid ARMs were purchase money loans (with 25 percent to first time buyers); 49 percent of these ARMs were cash out refinances; and 8 percent were no-cash out refinances. This split of purchase money and cash out loans underscores a critical fact about the subprime market given the depreciation in housing values that has occurred in many areas of the country – many subprime borrowers now have little, if any, equity in their homes in today's market. This is a significant factor, and perhaps the paramount challenge, in structuring loan modifications that are meaningful to the borrower as well as prudential to the lender.

III. Structuring a Viable Loan Modification Program

As highlighted in the Committee's invitation letter, one of the most important considerations in structuring a viable loan modification program is reaching as many borrowers as possible as quickly as possible. In our view, this translates into conducting an expeditious and systematic review of outstanding loans approaching reset – or for which a rate reset has already occurred – in order to identify broad categories of borrowers eligible for loan modifications. As simple as this concept sounds, in application it has many challenges. I believe it is critical in this effort to provide servicers with as much guidance and flexibility as practicable to conduct meaningful reviews to identify borrowers in need of assistance.

In structuring a viable loan modification program, three goals should be recognized and incorporated. First, and most fundamental, the program should preserve and sustain homeownership. Second, of course, the program should protect homeowners from avoidable foreclosures due to interest rate resets. Finally, it is extremely important that the program be structured to preserve and maintain market integrity, as well as

ensuring the continued safety and soundness of depository institutions and the broader financial services industry.

Currently, about two million American families have subprime 2/28 and 3/27 mortgages that are scheduled to reset by the end of 2008. As I mentioned earlier, the initial "starter rate" for these loans typically ranged from 7 percent to 9 percent; and about 30 percent of delinquent 2/28 and 3/27 loans were past due before the rate reset. Between 1980 and 2000, the national foreclosure rate was below 0.5 percent of aggregate mortgage loans. In fact, as recently as 2005, the national foreclosure rate stood at 0.38 percent. Since then, the foreclosure rate has risen 55 percent to almost 0.6 percent of outstanding mortgage loans. Far more troubling is that, among subprime borrowers holding a 2/28 or 3/27 loan product, foreclosures are projected to rise from about 6 percent currently to about 10 percent by 2009.

There are several important factors in structuring a viable loan modification program that can influence these projections downward. First, as I note at the outset, expediency is critical. Servicers should quickly review their loan portfolios to identify characteristics of groups of borrowers eligible for loan modifications. Eligibility standards will determine the likelihood of achieving meaningful impact under a loan modification program. Generally, borrowers should qualify if, due to rate resets, they are either in default, or there is a reasonable foreseeability of default.

A program's success will also hinge on providing adequate time for troubled borrowers to work out of their current economic problems. We believe servicers should be prepared to extend the starter rate for a minimum of 36 months, but a good argument can be made for a minimum of five years. And it may also make sense to include a trial period, such as six months, for certain borrowers to be able to demonstrate that they can continue to pay under the starter rate before the starter rate is locked in under a loan modification. Generally, a trial period will serve to protect the interests of the lenders, avoid including in a modification program loans that are destined to fail, and provide resolution to borrowers rather than delaying the inevitable for an additional 36 months or longer.

We are aware of a number of loan modification programs that have already been established. While these programs have been in place for generally short periods of time, i.e., several months, it is our understanding that strategies similar to those articulated above have been successfully deployed to modify significant numbers and dollar amounts of subprime 2/28 and 3/27 loans held in securitizations. For example, several programs have employed broad-based borrower identification criteria to identify groups or classes of loans at risk, and then applied established eligibility requirements to hone in on individual loans and borrowers at risk of default. Other programs have opted for more comprehensive fixes by identifying borrowers and re-underwriting with full documentation for a 30 year term. We are supportive of all of these programs and efforts

to address the problem and encourage that any standards or guidelines provide maximum flexibility to servicers and lenders to address troubled subprime loans in a manner that protects both the borrowers and the underlying economic interests of investors.

It is also critical in exploring viable solutions that our actions preserve the integrity of the broader mortgage markets, including capital market participation in the continued funding of the mortgage markets. While there have been some who have suggested that solutions from the capital markets have fueled speculative and unsafe mortgage lending activities, there remain many U.S. consumers who are homeowners solely because of favorable mortgage rates and terms that they received as a result of the efficiency of the U.S. capital markets. In other words, we must take great care that our efforts on behalf of some consumers who entered into bad deals do not compromise the greater, collective interests of all consumers. It would be a policy failure to produce a result that alters mortgage funding so that the future cost or availability of mortgage credit is adversely affected for all U.S. consumers.

We are currently at what can best be described as a crossroads to addressing the wave of rate resets for subprime 2/28 and 3/27 mortgage loans. There are a number of programs that have been reasonably successful in structuring viable loan modification approaches, but more needs to be done – and soon.

As recently reported, there have been significant industry efforts to identify practices and approaches to structure guidelines for viable loan modification programs that can be implemented quickly, efficiently and effectively in the marketplace. Our understanding is that many of the issues previously identified as significant obstacles to broad-scale loan modifications may, in fact, be issues that can be addressed within the terms of the pooling and servicing agreements that dictate the rights of servicers and impact on investors under terms of the trusts that hold the securitized assets. Given this, we believe that legislative and/or regulatory actions could hinder rather than help at this point in the process. Instead, we encourage the industry to identify and implement solutions that work, with the full understanding that regulatory intervention will occur quickly if it becomes clear that any proposed solution(s) will not be effective.

IV. The Emergency Mortgage Loan Modification Act – H.R.4178

H.R. 4178, the Emergency Mortgage Loan Modification Act, would provide a safe harbor from liability for creditors, assignees, servicers, securitizers and other holders of residential mortgage loans in connection with loan modifications they conduct during the six month period after enactment of the legislation. Based on our review of the bill, it is intended to cover troubled debt restructurings of residential mortgage loans (other than prime loans and other qualified mortgages under H.R. 3915) in or facing default. In addition, in order to be protected under the bill, it provides that a workout would have to

maximize the net present value of the loan in the pooling and servicing agreement under which it is held.

While we understand and appreciate the intent of this legislation, there are several issues that should be considered in connection with any action on the bill by the Committee. First, it is unclear whether the intent of the bill is to override pooling and servicing agreement contract terms. If so, then the bill raises potentially larger issues that would have to be carefully considered and would likely be challenged in court. It has also been suggested that many servicers already have adequate flexibility to address issues covered by the bill. In the end, the costs and benefits of H.R. 4178 come down to three points. Will it be effective in helping securitizers keep borrowers in their homes? Will it unduly interfere with or override contract rights? And will it do anything to keep future investors from continuing to fund the housing market?

In addition to a big picture cost-benefit analysis, the bill raises a number of issues. First, it does not distinguish between rate reset delinquencies and those where other issues were a problem. Borrowers in default for other than a rate reset appear to be covered by the terms of the legislation. Similarly, the bill lacks sufficient criteria for narrowly focusing coverage on loan modifications for borrowers who are current in their payments (or in default only due to a rate reset). We urge the Committee to explore the necessity and utility of these broad and comprehensive approaches within the bill. More narrowly focusing the scope and coverage of loans covered by a litigation safe harbor would enable servicers to dedicate their resources to the class of borrowers and loans that most agree deserve attention – mortgages securing owner-occupied properties at risk due to a rate reset (or already in default due to a rate reset).

We also question whether the bill could create liability against a servicer that opts not to engage in loan modifications. And, conversely, whether the bill could permit securitizers and others to "game the system" by conducting loan modifications that are not in good faith or the best interests of the borrower simply to inoculate themselves from litigation.

Finally, the bill does not extend the safe harbor protection to loan modifications that occurred before its effective date. This disadvantages those who acted first to implement loan modifications – arguably the class of servicers most deserving of protection from a policy standpoint because of their proactive and aggressive efforts to address the problem in the first place. In a similar vein, if a safe harbor approach is implemented, the Committee may wish to consider extending the safe harbor beyond six months since significant loan modification activity may extend beyond a six month window.

In sum, there are numerous unanswered questions regarding the extent of litigation that may result from large-scale loan modifications. It is unclear, however,

whether legislation such as H.R. 4178 will be able to alter such actions, particularly if the terms of existing pooling and servicing agreements clearly spell out the terms that bind the parties to the agreement. To the extent that H.R. 4178 may be beneficial in areas where either the terms of the agreement are silent or unclear, we believe that the parameters of the bill should be altered to focus on mortgages secured by owner-occupied properties at risk from a rate reset (or in default due to a rate reset). And the Committee should consider extending coverage to loan modifications occurring before the effective date of the legislation if enacted, and perhaps longer than six months after enactment.

V. The Miller-Watt-Frank Amendment

The Miller-Watt-Frank amendment would impose a civil penalty of $1 million and not less than $25,000 per loan on a creditor, assignee, or securitizer for engaging in a pattern or practice of originating, assigning, or securitizing residential mortgage loans that violate the duties of care established under H.R. 3915. These duties of care include assuring the ability to repay requirement for certain mortgage loans under H.R. 3915 and the net tangible benefit requirements for certain mortgage loan refinancings under the bill.

As structured, the amendment would impose a strict liability penalty for engaging in a pattern or practice as described above. The penalty would not be discretionary and would be in addition to any enforcement action or penalty that an agency may impose. Penalties paid under the amendment would be deposited in a trust fund (administered by the Treasury Department) for consumers who hold loans eligible for rescission or cure due to violation of a duty of care, but have no party against whom to assert such remedies.

The bill further provides that any person with information regarding a pattern or practice violation could report it to a TILA enforcement agency. That agency would then bring the complaint to the attention of any other TILA enforcement agency with jurisdiction over the violation.

The amendment would require the Treasury Department to issue regulations to establish a consumer claims process, administrative procedures for handling claims, and a payment process for consumers eligible for relief. The amendment also provides that any claim determination made by the Treasury Department under these provisions will be final, and not subject to judicial review.

Based on our review of the proposed amendment, there is uncertainty regarding the scope and application of the proposed amendment. Coupled with its strict liability requirement, the amendment could have a significant impact on mortgage lending to certain market sectors. We urge the Committee to explore this issue. In particular, we note the following:

- The federal banking agencies already have authority, which includes a significantly lower threshold than the "pattern or practice" standard, to pursue actions against an insured depository institution and its subsidiaries, holding company parents, affiliates and service providers. As such, we urge the Committee to consider an approach excluding insured depository institutions entirely from coverage under the amendment. Insured institutions are currently subject to extensive prudential supervision, regulation and oversight by the federal banking agencies. The banking agencies have pursued actions against lenders (including their subsidiaries, affiliates, holding companies and service providers) subject to their jurisdiction for programmatic lending violations on a wide range of issues and matters, including predatory lending activities.

- A mandatory monetary penalty not only removes regulatory discretion raising policy concerns, it eliminates discretion for a court or agency to alter a civil penalty for a violation or the amount of the civil penalty. Federal banking agency discretion is important to address programmatic lending violations and impose penalties and remedies tailored to the nature and extent of a violation. Administrative discretion is also necessary for reasons of safety and soundness, particularly since the amount of the penalty is so high. The provision holds a creditor, assignee, or securitizer strictly liable for the full civil penalty in any pattern or practice case without regard to the circumstances or financial impact. TILA currently permits even statutorily mandated remedies to take into account the circumstances of the violation and potential impact of the remedy.

- An open-ended pattern or practice standard could infuse significant uncertainty into the mortgage markets, particularly given the strict liability penalties under the amendment. For example, "pattern of practice" could be more clearly defined to cover only willful and blatant violations. In addition, the bill could delegate authority to define a "pattern of practice" by joint regulation to the federal banking agencies and the other TILA enforcement agencies. This would permit the agencies to set clear standards on what would or would not constitute a "pattern or practice."

- It is unclear if a private right of action is intended under the amendment. While it may make sense from a policy standpoint to impose a strict liability standard and penalty on unregulated originators, creditors, assignees and securitizers, if a private right of action is intended, it may make it more difficult for the federal banking agencies to pursue actions against insured depository institutions since agency actions could lay the groundwork for private actions.

- Similarly, a statutory provision barring judicial review of a claim determined by the Treasury Department may raise a significant issue of law. We defer to the

Committee with respect to the merits of a statutory provision barring judicial review of a final agency action.

For all of these reasons, we encourage the Committee to explore a carve-out from coverage of the amendment to insured depository institutions.

VII. Conclusion

The OTS shares the concerns of the Committee regarding the expediency of structuring and implementing programs that produce viable loan modifications. Foreclosure prevention is a critical issue that requires our attention, efforts and actions. However, we must ensure that our actions are appropriately tailored to assist those legitimately in need of assistance. There are four categories of subprime borrowers: (1) those who can afford the interest rate in their mortgage loan; (2) those who cannot afford to pay even at the starter rate on their loan; (3) those who can refinance their mortgage; and (4) those with steady incomes and relatively clean payment histories who can afford to continue to pay at their starter rate, but not the reset rate.

The bulk of our efforts should be directed at the latter two categories of subprime borrowers. This is where we can make a difference to preserve and sustain homeownership, and protect existing homeowners from avoidable foreclosures due to interest rate resets. Again, the focus of all of these efforts should be on keeping existing homeowners (i.e., owner-occupiers) in their homes, not assisting speculative buyers who are now at risk of foreclosure.

Thank you, Mr. Chairman, Ranking Member Bachus, and Members of the Committee for the opportunity to present the views of the OTS on these issues. We look forward to working with the Committee to structure and implement standards or guidelines supporting viable loan modifications.

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TESTIMONY OF

FAITH SCHWARTZ

ON BEHALF OF

THE HOPE NOW ALLIANCE

HOUSE COMMITTEE ON FINANCIAL SERVICES

HEARING ON

Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement

December 6, 2007

Mr. Chairman and Ranking Member Bachus, thank you for the opportunity to testify today on efforts to assist at-risk homeowners through expanded outreach efforts and solutions, such as accelerating loan modifications and other methods to prevent foreclosures. My name is Faith Schwartz and I am pleased to be here on behalf of the HOPE NOW Alliance to talk about the latest steps in this unprecedented joint industry and non-profit national initiative to reach out to at risk borrowers and find solutions to prevent foreclosures. I serve as Executive Director of HOPE NOW and am coordinating the efforts of all our industry and non-profit partners.

As you know from your hearing on November 2, the HOPE NOW Alliance is collaboration between credit and homeownership counselors, lenders, investors, mortgage market participants, and trade associations. It was formed with the encouragement of the Department of the Treasury and HUD and builds on the efforts that you and other Members of Congress have encouraged us to undertake. HOPE NOW is establishing a coordinated, national approach among servicers, investors and counselors to enhance our ability to communicate with borrowers who may have or expect to have difficulty making their mortgage payments and to offer them workable options to avoid foreclosure.

The members of the HOPE NOW Alliance recognize the urgency of this issue, and we are working to reach new milestones on a weekly basis. I will update you on these efforts which are intended to meet the goals you have stated as part of this hearing.

On November 13, loan servicers who are HOPE NOW Alliance members agreed to a Statement of Principles on reaching out and helping distressed homeowners remain in their homes. These principles were established to ensure that all borrowers can expect quality service and assistance when they contact their lender/servicer in the Alliance.

These principles are consistent with your call for the industry to expedite solutions for borrowers. The principles are:

- HOPE NOW members agree to attempt to contact at-risk borrowers 120 days, at a minimum, prior to the initial ARM reset on all 2/28 and 3/27 ARM loan products.
- HOPE NOW members agree to inform borrowers of the potential increase in payment and terms of the loan, in an effort to determine if the borrower may face financial difficulty in keeping their mortgage current.
- HOPE NOW members agree to establish a single port of entry for all participating counselors to use by January 2008.
- HOPE NOW members agree to make available dedicated e-mail and fax connections to support counselor and consumer contacts by January 2008.

By establishing these principles, HOPE NOW members are improving the infrastructure needed to help more borrowers on a much larger scale. In addition to improving lender/servicer systems for working with counselors and borrowers, we must redouble efforts to reach out to at-risk borrowers.

You have heard it before, but it can't be emphasized too much: borrowers in trouble are reluctant to ask for help. It has been found that 50 percent of borrowers who go into foreclosure never contacted their servicer for help. We are working to drastically reduce that number and help as many troubled homeowners as possible avoid foreclosure.

On November 30, we completed the first in a series of direct mail outreach to at-risk borrowers. From November 19-30 HOPE NOW members sent more than 300,000 letters to borrowers who are behind on their mortgage payments and provided a dedicated number to their

servicer to call for help. We are asking all Members of Congress to help publicize that letter campaign and urge their constituents who receive a HOPE NOW letter to respond to it. We are gathering data on the response rate to that mail campaign.

On December 19, we will begin another direct mail campaign to at-risk borrowers and this letter will include the 888-995-HOPE Hotline, provided by the Homeownership Preservation Foundation, which directly connects the homeowners with a counselor at HUD-certified non-profit counseling agency. Those counselors will have direct access to the lender/servicers through improved single points of entry that all HOPE NOW Alliance members have agreed to create.

The Homeowner's HOPE Hotline, 888-995-HOPE, is having a dramatic and positive impact for at-risk homeowners. The HOPE NOW Alliance will continue to expand the Hotline's capacity and promote it to reach more at-risk borrowers.

- Since the Homeowner's HOPE Hotline's inception in 2003, it has received over 304,015 calls which led to counseling for 134,889 homeowners.
- Calls are increasing monthly. In October, there were 22,461 calls to the Hotline that produced 10,660 counseling sessions.
- Through October 26, 2007, more than half of all homeowners counseled have been connected with their lender for assistance, and about one quarter of all homeowners counseled in the third quarter of 2007 were referred to their lender for a recommended workout.
- As of November 30, the Homeowner's HOPE Hotline has received over 149,725 calls in 2007.
- Those calls have led to 67,516 homeowners being counseled in 2007.

- That compares to 25,364 calls and 10,321 counseling sessions in all of 2006.
- In November, the HOPE Homeowner's Hotline received 26,966 calls which led to 11,185 unique counseling sessions for homeowners. In the last week of November alone, there were 9,408 calls and 3,247 counseling sessions.
- Counseling sessions are rapidly increasing. Call volume increased 104% from first Quarter to second quarter and 89% from second quarter to third quarter.
- Lender/servicers are urging borrowers to call for counseling. Homeowners primarily hear about the Homeowner's HOPE hotline from their lender – up to 33% in third quarter.
- More homeowners with ARMS are calling – 44% of callers in third quarter of 2007, up from 34% in first quarter.
- On December 4, the hotline received 5,800 calls

In the coming weeks, publicity for the Homeowner's HOPE hotline, 888-995 HOPE will continue to increase. When Secretary Paulson mentioned the Homeowner's HOPE Hotline in his remarks on Monday, calls to the hotline increased dramatically. The Homeownership Preservation Foundation, a HOPE NOW Alliance member, is operating the hotline. The Foundation is working to add trained, experienced counselors to the program to handle the increasing call volume from concerned homeowners. In November, a sixth counseling agency was added, Money Management International. The National Foundation for Credit Counseling (NFCC) is also in talks with HPF to add its broad network of trained counselors to the Homeowner's HOPE hotline effort. The addition of the NFCC's counselors could potentially double the telephone counseling capacity of the Homeowner's HOPE hotline provided today by

the following agencies: Auriton Solutions; CCCS Atlanta; CCCS San Francisco; Novadebt; and Springboard.

As you know, NeighborWorks America, a national network of more than 240 community-based organizations in 50 states, is part of the HOPE NOW Alliance, and actively providing in-person counseling services to consumers today, as are many other counseling groups. NeighborWorks has also taken the lead in working with the Advertising Council on the national advertising campaign for the Homeowners' HOPE hotline.

In addition, on Friday December 7, NeighborWorks and other HOPE NOW Alliance members will meet with HUD and other HUD counseling intermediaries to review ways to include additional grass roots counseling groups. We are working to broaden the HOPE NOW effort to ensure it is a model that works broadly for industry and non-profits to maximize the ability to reach troubled borrowers.

Reaching borrowers to work with them on a workable solution is the key to helping them stay in their homes. The solutions will vary with the circumstances of the borrower. Prudent and responsible loan modifications and other types of workout options are solutions that can both help borrowers keep their homes and minimize losses to investors. The HOPE NOW Alliance is committed to pursuing all viable solutions to help people stay in their homes.

Accelerating Loan Modifications

You have asked what can be done to accelerate loan modifications. Loan modifications are a solution for borrowers who have an ability to repay a loan, and the desire to do so and keep their home, but may need some help in meeting this goal. Loan modifications are not the only

solution – in many cases, refinancing, forbearance, and repayment plans provide borrowers a more appropriate option than loan modifications.

HOPE NOW members recognize that an enhanced process for indentifying borrowers who may benefit from a loan modification and establishing a process for advancing those is an essential part of this effort.

Servicers that are members of HOPE NOW have been working closely with the American Securitization Forum and their investor members with the strong encouragement of the Department of the Treasury, HUD and the federal banking agencies.

The focus of the effort has been to identify categories of subprime hybrid ARM borrowers who can benefit from workout solutions that can help as many homeowners as possible remain in their homes. We believe such a framework can be put in place with the cooperation of investors and servicers and the support of policymakers and Congress.

As you know, the key is to find solutions which help borrowers but do not violate the agreements with investors who now own the securities containing these loans.

Building on our members' continuing and increasing efforts to contact borrowers, servicers and HOPE NOW have been working with ASF and their investor members to develop a triage system to identify in advance of a reset solutions for borrowers who would qualify for refinancing, loan modifications, and other workout options. The key is to allow servicers to have a system to offer options to borrowers in a manner that does not violate the pooling and servicing agreements with investors. Servicers need to be confident that investors will accept and support more far-reaching loan modification and other workout solutions, and will not engage in a series of law suits which can only slow down the effort to assist targeted borrowers. It is important that markets recognize that this approach is needed to avoid unnecessary

foreclosures that could exacerbate the housing market downturn and further erode the value of existing mortgage securities.

The framework that is being established will help provide solutions for homeowners with subprime hybrid ARMs who fall into three categories.

Refinancing:

The first category or segment of borrowers are those who are current, likely to remain current even after reset, or likely to be able to refinance into available mortgage products, including FHA, FHA Secure or industry products. Generally, the servicer will determine whether loans may be eligible for refinancing into various available products based on readily available data such as LTV, loan amount, FICO, and payment history. The servicer will facilitate a refinance in a manner that avoids the imposition of prepayment penalties whenever feasible.

Loan Modifications:

This second category or segment of borrowers includes those with good payment records but who will not qualify for refinancing; these borrowers will be targeted for streamlined loan modifications. These are borrowers who are unlikely to be able to refinance into any available product. These borrowers will be eligible for a fast track loan modification if the loan is secured as a primary residence and meets additional criteria regarding their upcoming reset and their ability to pay at the reset amount, using evaluating factors such as a comparison of their original and current FICO score and a Loan to Value test. Borrowers in this category will be offered a loan modification for 5 years under which the interest rate will be kept at the existing rate of the loan.

This fast track option does not in any way preclude a servicer from conducting a more individual in-depth review, analysis, and unique modification for a borrower to determine if a longer term modification would be appropriate.

The fast track framework allows the servicer to make these decisions:

- The borrower is able to pay under the loan modification based on his current payment history prior to the reset date.
- The borrower is willing to pay under the loan modification by agreeing to it after being contacted.
- The borrower is unable to pay (and default is reasonably foreseeable) after the upcoming reset under the original loan terms, based on the size of the payment increase that would otherwise apply, and based on current income if the borrower did not pass the FICO improvement test.
- The modification maximizes the net present value of recoveries to the securitization trust and is in the best interests of investors in the aggregate, because refinancing opportunities are not available and the borrower is able and willing to pay under the modified terms.

Loss Mitigation:

This third category includes loans where the borrower is not current and is not able to refinance into any available product. These are borrowers who are significantly behind in their payments and their situations need to be evaluated individually. It is especially important for us to reach this group of borrowers through efforts such as the HOPE NOW direct mail campaign and through the national advertising campaign for the Homeowner's HOPE hotline. For loans in this category, the servicer will determine the appropriate workout and loss mitigation approach on a loan-by-loan basis. Referrals from counselors if the borrowers contact the Homeowners' HOPE hotline will also be important. The approaches for these borrowers may include loan modification (including rate reduction and/or principal forgiveness), forbearance, short sale,

short payoff, or foreclosure. Because these borrowers are already behind in their payments, and may face challenges such as loss of income or other issues, they require a more intensive analysis, including current debt and income analysis, to determine the appropriate loss mitigation approach.

Mr. Chairman, it is important to note that a streamlined, scaleable solution for current borrowers facing a reset will allow for more detailed attention to at risk, hard to reach, delinquent borrowers. Servicers will be able to work closely with credit counselor and or homeowner to ensure all options are explored to avoid foreclosures. The scaleable outreach, streamlined modification effort in no way precludes on going workout solutions for the highest risk, delinquent borrowers

Mr. Chairman, we are committed to an aggressive system of finding solutions for borrowers. As part of that system HOPE NOW will track and measure outcomes. We will develop measures of trends in delinquencies and resolution outcomes, e.g. reinstatement, workout (repayment plans, modifications, short sales, deed in lieu, partial claims) and foreclosure. The intent is to develop consistent and informative data reports based on common definitions and to develop information that provides insights into the nature and extent of the current mortgage crisis and helps in the development of workable solutions that avoids foreclosure whenever possible.

H.R 4178, legislation by Representative Castle to create a safe harbor for Loan Modifications

H.R. 4178 seeks to promote loan modifications through additional protection for servicers from litigation by third parties for loan modifications for individuals who are in default or immediate danger of default and the result maximizes the return to the pool.

Litigation is a serious concern for servicers in making decisions about modifying loans which have been securitized and are now held in the private secondary market. Since there always seem to be plaintiffs available to aggressive lawyers, protection from litigation would help promote loan modifications.

At the same time, servicers recognize that confidence in contracts are essential to appropriately sort out rights and responsibilities of the parties, and impartial dispute resolution facilities, be it courts or arbitration, have been a necessary ingredient to assure that the rule of law works well and smoothly. Absolute confidence in the integrity and immutability of that procedure and system is the foundation of the ability to conduct business confidently.

The importance of confidence in the system goes directly to price and availability of credit for consumers. If business people are unable to say with certainty that the rules under which they make binding agreements will persist for the life of the agreements, they must make some allowance for the possibility that any changes in the rules will be to their disadvantage. They must assume that the costs to the lender will increase, and if that is the case the lender will have to either charge more for the credit or choose to use the capital allotted for that business, in this case lending to subprime mortgage customers, to another business in which the risk-adjusted return on capital is better and uncertainty is perceived to be lower.

Just as there is no requirement that borrowers take out mortgage loans, there is no requirement that lenders make mortgage loans, or that investors invest in them. Lenders make them only because doing so is good business, and they receive a return on capital that is adequate to warrant using their capital in that way. If uncertainty becomes too big a part of the circumstances that must be considered, the attraction of making mortgage loans diminishes.

H.R. 4178 would provide protection for servicers as they try to modify an unusual number of mortgage loans in a short period of time, particularly from lawsuits brought by investors who might try to challenge whether such modifications maximized the return to the pool. That protection could come at a steep price if investors believe that it establishes a precedent, albeit only for a short period of time, of abrogating contracts and calling into question the certainty surrounding the dispute resolution system into which the parties believed they had subjected interpretations of their agreement.

The present voluntary plan discussed today is being developed by servicers, investors, securitizers and has been strongly encouraged by the Administration and federal banking regulators. This plan is best practice for industry participants to follow. Those who modify loans consistent with that plan will be adhering to what the pooling and servicing agreements refer to as the industry standard, and therefore will be doing what is in the best interests of not only the borrower but also of the pool of mortgages.

We believe that a servicer who performs its responsibilities consistent with this plan will have a very reasonable and strong defense against aggressive plaintiff's attorneys. Nevertheless, there may well be a few who will take a chance on suing a servicer who has performed appropriately if for no other reason than to try to get a nuisance settlement from the servicer. If the investor community does not broadly endorse the plan, legislation like that proposed by Congressman Castle may have to be revisited as an option.

The servicer has an obligation to maximize the return for the pool in practices it pursues in modifying loans. There are an unprecedented number of borrowers who currently face the possibility of being unable to make payments under loans into which they entered when the housing market was much better. While individually reviewing each file and discussing with

borrowers the options which are available has been the method followed previously, because of the great number of borrowers in certain situations in the present circumstances, doing so one by one would be expensive and time consuming, meaning that a number of loans would go into the process of foreclosure before servicers had a chance to review them for modifications. Those expenses, of course, would all have to be deducted from the revenues of the pool, and this could seriously raise questions whether such an approach would maximize the return to the pool. Using the approach articulated in the plan would do so.

In addition, the lenders and servicers supporting the HOPE NOW Alliance are pleased to see the best standards of industry practice being articulated in this plan, because absent it, it is difficult to sort out the best industry standards from among the many ways servicers approach loan modifications. It can be done, but with this plan, it is much easier to do and is less susceptible to challenge. As you know, industry standards are important in the interpretation of actions taken by the servicer.

We would urge the regulators to issue interpretations and guidance which support servicers in modifying loans consistent with this plan, further defining the plan as the industry standards for modifying loans.

Taking all of this into consideration, it may be best to defer action on H.R. 4178 at this time. We support the goal of Congressman Castle's legislation to promote loan modifications by providing more assurances against litigation, but we hope that the plan developed by the industry at this time helps provide additional solutions that will assist more borrowers in an expedited fashion.

Conclusion

Mr. Chairman, the HOPE NOW Alliance and those working with it are committed to enhanced and on-going efforts to contact at-risk homeowners and to offer workable solutions. Out top priority is to keep people in their homes and to avoid foreclosures whenever possible.

We want to again express our appreciation for your statement of support for the HOPE NOW effort when it was announced in October and we appreciate the efforts you and Congressman Bachus have made to inform your colleagues of the 1-888-995 HOPE hotline number. Active involvement of Members of Congress to alert constituents that help is available when they contact either their lender/servicers or a non-profit counselor through the HOPE hotline will continue to be essential in helping as many homeowners as possible in the coming months.

The HOPE NOW Alliance is a serious and committed effort that will continue as long as necessary until problems in the housing and mortgage markets abate. We will provide updates on our progress to you in the coming weeks.

Thank you for inviting us to testify today.

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STATEMENT OF MR. HILARY O. SHELTON
DIRECTOR, WASHINGTON BUREAU OF THE
NATIONAL ASSOCIATION FOR THE
ADVANCEMENT OF COLORED PEOPLE
ON "ACCELERATING LOAN MODIFICATIONS, IMPROVING FORECLOSURE
PREVENTION AND ENHANCING ENFORCEMENT"
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES

December 6, 2007

Thank you, Chairman Frank, for once again inviting me here today to talk about predatory lending and some of the initiatives your committee is undertaking to help alleviate the problems associated with predatory lending and ensure that we are never again faced with a foreclosure crisis similar to what we are looking at today.

I would also like to take this opportunity to once again thank you, Mr. Chairman, as well as Congressman Miller, Congressman Watt and the other members of this committee who have worked so hard and for so long to address this problem. Your drive, your initiative and your commitment are deeply appreciated.

As many of you know, my name is Hilary Shelton and I am the Director of the NAACP Washington Bureau. We are the public policy and advocacy arm of our Nation's oldest, largest and most widely-recognized grassroots civil rights organization.

As I have said before, predatory lending is unequivocally a major civil rights issue.

As study after study has conclusively demonstrated, predatory lenders target African Americans, Latinos, Asians and Pacific Islanders, Native Americans the elderly and women at such a disproportionate rate that the effect is devastating to not only individuals and families, but entire communities as well. Predatory lending stymies families' attempts at wealth building, ruins people's lives and, given the disproportionate number of minority homeowners who are targeted by predatory lenders, decimates whole communities.

Because predatory lending is so important to the NAACP, our members and the communities we serve, we have been actively involved in the predatory lending debate here on Capitol Hill and throughout our country. As such we worked closely with you, Chairman Frank and Congressman Miller and Congressman Watt among others in the development of H.R. 3915, the *Mortgage Reform and Anti-Predatory Lending Act of 2007*. And while we supported the bill with amendment throughout the process, we were, like most people, disappointed with the final product that passed the full House.

Specifically, we had hoped that the bill would have been improved through the amendment process to provide stronger penalties for lenders who break the law and remedies for the victims of predatory lending. We also need to ensure that any final federal product is the minimum standard, allowing states to continue to be even more aggressive in eliminating predatory lending and protecting home owners.

Thus, we strongly supported amendments offered during floor consideration that would have increased the penalties on individuals or businesses which practice predatory lending. We also opposed amendments that would have weakened key provisions, including the very important anti-steering provisions, the renters' protections, the prohibition on prepayment penalties in the subprime market, and the prohibition on the use of yield spread premiums in the subprime market.

We also ardently opposed, and shall continue to work against any federal preemption of state laws which limits individual state's ability to respond to local or regional anomalies which may adversely affect their residents, as well as new predatory practices which may threaten legitimate homeownership after enactment of the federal law.

We were dismayed to see that many of the amendments we supported were defeated, and hope to work with the Senate to ensure that if and when strong anti-predatory lending legislation becomes law that breaking the law does not become a cost of doing business.

Which brings us to the pattern or practice amendment. As Chairman Frank stated on the House floor during consideration of H.R. 3915, the amendment as offered was developed in a hurry and needed more consideration. We applaud the Chairman for his efforts to bring more accountability to the securitizers and we also appreciate his foresight in withdrawing the amendment and holding this subsequent hearing to look more thoroughly into the issue.

While we support the goals and the premise of the amendment, we do have some concerns about the implementation of any resulting law. First of all, and perhaps most importantly, we do not support allowing this pattern and practice provision to be preemptive. We believe that every individual should be able to

bring a private right of action against anyone and everyone involved in predatory lending.

Secondly, the NAACP has expressed concerns over the last few years about the inaction of several federal agencies to launch investigative or prosecutorial efforts involving civil rights violations. Our concern about a tough pattern and practice provision would be that it must be followed up with action by the regulators, or it is really of little use.

Finally, Mr. Chairman and members of the committee, the NAACP has some concerns about the amount prescribed in the amendment for fining companies found to be in violation of a pattern or practice of predatory lending. To the NAACP, as well as most Americans, I believe that one million dollars plus $25,000 for each bad loan would be enough to stop us from even considering breaking the law. Yet as we all know, one of the biggest subprime lenders paid $425 million in a settlement and didn't blink. Thus, we must ask how much will make the industry sit up and take notice. We don't know the answer to that question, but I suspect it is larger than any of us can fathom.

So I want to thank you again, Chairman Frank, Congressman Miller, Congressman Watt and other members of this committee, for your aggressive response to the predatory lending problems facing our Nation and for your continued diligence on this issue. I look forward to continuing to work with you to ensure that more homes are not lost to foreclosure, either in the near future or in years to come.

The attack by subprime lenders on communities of color across this Nation is not only a moral disgrace and ethical shame, but it should clearly be illegal. With your help, we will ensure that it is.

Thank you, and I welcome your questions at this time.

TESTIMONY OF
DAMON SILVERS, ASSOCIATE GENERAL COUNSEL,
AMERICAN FEDERATION OF LABOR-CONGRESS OF INDUSTRIAL ORGANIZATIONS
AFL-CIO
ON BEHALF OF EXECUTIVE VICE PRESIDENT ARLENE HOLT BAKER

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

House Committee on Financial Services
December 6, 2007

Good morning, Chairman Frank, Ranking Member Baucus and members of the Committee. My name is Damon Silvers, and I am Associate General Counsel for the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). I am here on behalf of our newly elected Executive Vice President, Arlene Holt Baker, who could not be here due to the death of her mother. The AFL-CIO represents more than ten million Americans and their fifty-five national unions.

Arlene, AFL-CIO President John Sweeney and Secretary Treasurer Richard Trumka have been all across our country in recent weeks talking to working people in their communities. Everywhere they have been, working men and women are panicked. They ask: What is going to happen to our health care, our pensions, and more and more often we hear, our homes? How am I going to make it when my health insurance premiums go up, my mortgage payments rise, gas prices have skyrocketed and I have to put more money into my pension? What is going to happen to my community and my family members when my neighbors lose their homes? Is my job in danger? What is happening to the American Dream?

In the last week, we have heard from hundreds of AFL-CIO members suffering from the credit crisis and in fear of losing their homes. One example is Kimberly Somsel of Westland Michigan, an unemployed single mother of two battling breast cancer and facing foreclosure due to a ballooning "2 and 28" loan payment. She is selling the family car and her furniture just to get by. Five houses on her block are threatened with foreclosure.

Whether you look at data from economists or talk to the ordinary people of this country you will get the same message—our country faces an urgent housing financial crisis that is threatening to spread into a full-blown recession, carrying the most serious consequences for the living standards of working families. These inter-related crises demand bold government action. Unless the government acts with urgency, hundreds of thousands of workers will lose their homes, millions of workers will suffer pension losses and further millions more will lose their jobs. We hope that responsible business

leadership will join government, but government must act in any case and sooner rather than later.

While recently the Treasury Department has moved in the right direction in looking to the mortgage servicers to restructure subprime loans, merely asking lenders to restructure loans will not be enough. We believe this crisis needs a much more aggressive approach that will be clearly understandable to the millions of Americans fearing the loss of their homes as teaser rates reset.

The U.S. mortgage market is the financial market most closely linked to the lives of American working families. The lack of effective regulation of mortgage markets has allowed these markets to be flooded with products that are misleading and exploitative, products marketed to tens of millions of Americans who work at low wage jobs or who have inadequate retirement income, so they are desperate for a financial short cut to either home ownership or adequate income.

The AFL-CIO supports this Committees' work to give homeowners more protections through H.R. 3915. The AFL-CIO urges H.R. 3915 be swiftly passed by Congress. However, we strongly urge Congress to ensure that on final passage H.R. 3915 provides for meaningful multiple avenues for enforcing consumer protection standards, including at a minimum the right for state attorney general's to enforce its standards.

The result was millions of mortgages structured with teaser rates, and more than a trillion dollars lent out on the assumption that housing prices would rise forever[1]. Of course, when housing prices fell, millions of Americans were stuck with mortgages they could not afford. The banks that put this all together are looking at the financial abyss. Mutual funds, money market funds and pension funds are facing major losses in bonds that were sold to them as investment grade[2]. And throughout our economy, credit is drying up.

The consequences of inaction will be foreclosure rates that have already doubled going higher still, with particularly devastating effects in Florida, California, the Southwest and the upper Midwest[3]. Falling real estate values will undermine the debt-financed consumer spending that has been powering economic growth over the past seven years and the tightening of credit markets will constrain business investment spending. The result is the looming prospect of recession with the most serious consequences for the living standards of working families. And there is no question there is a risk of a downward spiral as weakening economic conditions contribute to further housing defaults.

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[1] Edmund L. Andrews, "Democrats prepare bill to tighten loan rules," *NY Times*, September 9, 2007.

[2] See for example, Michael M. Grynbaum, "Fund Crisis in Florida Worrisome to State," *NY Times*, December 5, 2007.

[3] "Spreading the Misery," *NY Times*, November 29, 2007.

The subprime crisis is not just a subprime crisis, and it is not just a housing crisis or a financial crisis. It threatens to become a full-blown economic crisis affecting both growth and employment. This crisis's roots lie (1) in the lack of effective regulation of the mortgage and other financial markets and (2) on our economic policy makers' reliance on asset inflation to power economic growth in recent years. Falling or stagnant real wages, extreme inequality, and the dominance of financial gimmickry over good jobs that create real value have left tens of millions of Americans dependent on borrowing to sustain their standard of living[4]. Mr. Chairman, you have spoken often of the threat economic inequality poses to our nation and its values. Today we are discussing the consequences of our failure to create an economy based on good jobs.

Let us briefly review the data—subprime lending has grown from 5% of mortgage originations in 2001 to 20% in 2006[5]. Subprime loans have gone from predominantly 30-year fixed rates to predominantly exploitative structures with teaser rates, the so-called 2 and 28 structures. As a result, in the next 18 months, over $300 billion in teaser rate mortgages will reset at high cost interest rates. And according to the Federal Reserve Board, in 2005 these high cost mortgages accounted for 55% of purchase mortgages obtained by African Americans, 46% of purchase mortgages obtained by Latinos, and 17% of purchase mortgages obtained by non-Latino whites[6]. And the majority of subprime mortgages are refinancings, where the racial data are even more skewed.

Until this past week, the reaction from government has consisted of 1) the Federal Reserve's cutting interest rates, 2) the Treasury's creation of private liquidity pools in the secondary market, and 3) efforts in Congress to improve the housing market going forward. Each of these efforts is positive, and in particular the AFL-CIO strongly supports Congress moving forward to quickly pass this Committee's bills strengthening consumer protections (H.R. 3915), and improving the regulation of the Government Sponsored Enterprises (GSE's) (H.R. 1427), as well as Senator Durbin's bill giving bankruptcy judges the authority to restructure mortgage loans (S. 2136). The House should also pass H.R. 3609, introduced by Representatives Miller and Sanchez, which would allow borrowers to discharge mortgage debt in bankruptcy beyond the fair market value of the house.

A major contributing factor to the subprime mortgage crisis has been the disappearance of the Federal Housing Administration (FHA). Simply put, FHA is no longer a significant player in the single-family mortgage market and this has led to serious consequences. In the past seven years, FHA has been supplanted by subprime lenders. In 2001, of the $2.2 trillion mortgages originated, FHA/VA originated nearly 8% and the subprime share was 5%. In 2006 by contrast, of the $3 trillion mortgages originated, the

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[4] The personal saving rate fell to negative 1.0 percent in 2006 according to the Economic Report of the President transmitted to the Congress in February of 2007.

[5] Remarks by FDIC Chairman Sheila Bair at the Nikkin 18th Special Seminar on International Finance in Tokyo, Japan, November 14, 2007.

[6] Sue Kirchoff and Judy Keen, "Minorities Hit Hard by Rising Costs of Subprime Loans," *USA Today*, April 26, 2007.

FHA/VA share fell to less than 3%, while the subprime share rose to over 20%. Part of the solution to the subprime crisis must be a revitalization of FHA. That is why the AFL-CIO supports this committee's efforts in H.R. 1852 to reform and revitalize FHA and create a Low Income Housing Trust Fund.

But these steps together will not be enough to prevent massive economic damage and massive injustice. We must actually put the power and influence of the United States government in play to prevent millions of American families from losing their homes.

The reality is that for all the talk of business concern, banks and other mortgage originators are simply not restructuring these mortgages. Moody's reported in September, after this crisis was almost six months old, that only 1% of subprime mortgages were being restructured[7].

The result is that we are facing the certainty of a further dramatic escalation in defaults and foreclosures. While foreclosures are a normal part of economic life, when foreclosure rates escalate, particularly in geographically concentrated areas, they present a real danger to both economies and communities, and ironically, to the investors in whose name the foreclosures are being carried out.

So here is what must be done:

First: A MORATORIUM ON FORECLOSURES
There must be an immediate moratorium on foreclosures on subprime mortgages—any mortgage with a teaser rate structure. We cannot have homes foreclosed and fear stalking our communities while banks and government agencies negotiate over loan restructuring programs. Only a moratorium will create real incentives to restructure loans.

Second: RESTRUCTURE SUBPRIME LOANS FOR 30 YEARS AT TEASER RATES
The mortgage industry and government must create a structured program providing for the replacement of teaser rate loans, 2 and 28 loans, with conventional thirty-year mortgages at the teaser rate. This program will also have to address the consequences of falling property values in some cases, and provide solutions for allocating losses in ways that are fair to working Americans and have the least systemic. Experience both in the last real estate bust and in real estate busts in other countries suggests short-term solutions are unlikely to work.

Third: REWARD RESTRUCTURING—NOT FORECLOSURES
Servicers must renounce those servicing agreements that reward mortgage companies for foreclosing on homes rather than encourage refinancing or other workout strategies.

Fourth: TRANSPARENCY

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[7] Special Report on Structured Finance by Moody's Investors Services, *Moody's Subprime Mortgage Servicer Survey on Loan Modifications*, September 21, 2007.

Mortgage servicers must commit to publicly reporting company by company how many subprime loans they are servicing; how many have reset; how many have been restructured, and how many foreclosures are occurring and where.

Fifth: OUTREACH
There must be massive outreach under federal government auspices to subprime borrowers to let them know how they can keep their homes. The Treasury Department has encouraged this type of outreach by private groups, but in our view this effort should be much more extensive and should be clearly governmental in nature.

These recommendations flow directly from the AFL-CIO's recent successful experience with a very similar, but less severe, crisis.

In the fall of 2005, after Hurricanes Katrina and Rita, the mortgage industry offered hurricane victims 90 days of forbearance. As Christmas approached, the ninety days came to an end. As an atmosphere of panic began to build in the Gulf, the AFL-CIO worked together with the bank regulators, led by the FDIC, and community advocates in the Gulf, most prominently ACORN, to call a series of meetings with the entire community of mortgage lenders and secondary market participants.

In those meetings, we asked for one-year forbearance for mortgages in the Gulf, and a moratorium on foreclosures. Again, for the Gulf region, the stakes were enormous—the certainty that whatever recovery efforts were being made would be crushed by a further collapse of both the real estate market and the labor markets.

Out of those meetings came a short-term industry wide forbearance agreement, followed by a series of informal understandings and working relationships that led to the effective extension of forbearance for tens of thousands of Gulf homeowners for the full year we had originally asked for. Although there have been foreclosures in the Gulf region since hurricanes Katrina and Rita, the wave of mass foreclosures widely feared at the end of 2005 never occurred. The credit for that fact goes to all the participants in the dialogue—the bank regulators and the GSE's, the Mortgage Banking Association and other industry groups, and the advocates.

Although this experience has much to teach us, the current situation is actually far worse. That was a natural disaster—this is a man-made one, in which many homeowners fear their lender or servicer as the institution that is trying to take their home. In the Gulf, the dominant lenders were participants in the conventional market. Here, the lenders are much more fragmented, both vertically and horizontally. And of course, the Gulf was a regional crisis; this is a genuinely national one.

For these reasons, the subprime crisis requires a higher level of government involvement—to convince homeowners that they should come forward and ask for assistance, and to make sure bad actors in the mortgage industry understand there will be consequences for seeking to continue to take advantage of the public.

So these are the steps necessary to stabilize our housing markets, prevent cascading defaults, and safeguard our economy. They are also the steps necessary to protect the financial institutions and the investors, the very people who will likely complain about government interference.

These steps are not outside the possible. Even as the financial services industry as a whole is resisting the FDIC's recommendation for replacing 2 and 28 structures with 30-year fixed loans at teaser rates, the AFL-CIO's Union Plus mortgage program for union members is routinely doing just that for subprime customers. We understand some major banks are doing the same. Like many other non-profit groups, Union Privilege also provides a Hotline that offers counseling and assistance to union members facing financial crisis as a result of being caught in the subprime trap. So far, the program has helped over 600 union members and their families. This kind of help should be available to all Americans.

The Hotline was developed after a survey of union members found that nearly four out of 10 adjustable rate mortgage holders said they would not know where to turn for help if they had difficulty paying their mortgage. The Peter D. Hart Research Associates study also found that a majority – 51 percent – wants the government to help people facing foreclosure, and 77 percent say the government should do more to regulate the mortgage industry[8].

Some complain that there are legal obstacles. But the truth is that the servicing agreements give the power to servicers to modify loans in the face of the "imminent prospect of default." And that is certainly what we are facing. There is no question that the mortgage industry has the power to take each step we recommend voluntarily, and that the government can easily help them with the outreach to borrowers. But if the industry won't cooperate with government on this program, the Treasury, the regulators, and ultimately Congress must act to ensure the nation's interest is protected.

Chairman Frank, you have heard from the regulators, from FDIC Chairman Sheila Bair, who first called for wholesale restructurings, and we know you are working with the Treasury Department, which has now moved in that same direction. But I bring you the desperate pleas of union members and their families facing the loss of the American dream.

Some say, let working people suffer; markets left alone will get it right in the end. Yet somehow there is always help for the well-connected—cheap money for the banks, severance packages for their failed executives, billions in bonuses for the investment bankers who structured the mortgage deals. Workers, single women who are heads of households, people of color, the retired, are just collateral damage. But not this time--this time we must act to help the people who really need the help—the alternative is genuine economic crisis.

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[8] Survey of 500 homeowners with adjustable rate mortgages from September 13-25, 2007 conducted by Peter D. Hart Research Associates.

The AFL-CIO hopes that as you have led so far, Chairman Frank, you will bring business and regulators together to make real the program we have outlined—freezing foreclosures, giving working people mortgages they can live with, telling the public the truth about what Wall Street is doing and working with us to address growing economic insecurity. We stand ready to work with you to ensure the American Dream of home ownership and an economy that works for all. Thank you.