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Before the U.S. House of Representatives Committee on Financial Services

"Priorities for the Next Administration: Use of TARP Funds under EESA"

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Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. Thank you for inviting me to testify on the use of TARP funds under the Emergency Economic Stabilization Act of 2008 and on H.R. 384, the TARP Reform and Accountability Act of 2009.

I serve as President of the Center for Responsible Lending (CRL), a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund. For close to thirty years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get affordable home loans. In total, Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America. Self-Help's lending record includes an extensive secondary market program, which encourages other lenders to make sustainable loans to borrowers with blemished credit.

With the constant barrage of statistics and staggering dollar figures that have become commonplace during this financial crisis, it is easy to become numb to the depth and scope of the financial pain American families are experiencing today. However, the numbers paint a picture we cannot ignore. Our most recent report on subprime mortgages shows that over 1.5 million homes have already been lost to foreclosure, and another two million families with subprime loans are currently delinquent and in danger of losing their homes in the near future.[1] Projected foreclosures on all types of mortgages during the next five years are 8.1 million at a minimum, which equates to 1 in 9 households or 1 in 6 households with mortgages.[2] On subprime mortgages alone, the spillover costs are massive. At least 40 million homes—households where, for the most part, people have paid their mortgages on time every month—are suffering a decrease in their property values that amounts to $352 billion.[3] These losses, in turn, are impacting nearly every aspect of American communities, from police and fire protection to community resources for education.

While the causes of this crisis are many,[4] so far solutions are few. Voluntary efforts by servicers and lenders have not been able to get ahead of the curve, and many of the modifications made so far have not resulted in sustainable loans for a variety of reasons discussed below. To date, the federal government has not created a systematic, large-scale way to stop those foreclosures that can reasonably be prevented.

We believe that the Troubled Asset Relief Program (TARP) is the key to leveraging systematic approaches to modifying mortgages to sustainable levels. H.R. 384 takes this approach as well. Whether through legislation or agency action, we strongly encourage the Treasury Department to move in the direction that the legislation suggests. Using TARP to promote modifications and changing the law to permit judicial modification of primary residence mortgages are the two most important ways to help families stay in their homes and reduce their debt burden.

Helping families will stop the decline in neighborhood property values and will have a stimulative effect on the economy: we need consumer spending power we need to pull us out of this downward economic cycle. What's more, foreclosure prevention will strengthen the financial system as a whole. Financial institutions will not survive if their loan-related portfolios continue to fail, given that many banks have leveraged bets on the performance of these loans beyond investments in the securities backed by the loans themselves through credit default swap commitments or collateralized debt obligation investments.

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

I. Voluntary, loan-by-loan modification efforts are not effectively stemming the tide of foreclosures. Modifications being made are unsustainable and many structural, legal, and financial obstacles exist to making modifications at all.

II. Streamlined, broad-based modification efforts are necessary to get ahead of the foreclosure curve. The Treasury can and should facilitate such an effort through TARP.

III. Treasury and Congress can also deploy other powerful tools to remove the current obstacles that block desirable loan modifications.

IV. Judicial loan modifications are needed to provide a crucial backstop in situations where servicers cannot modify a loan through the streamlined system and will provide a strong incentive for servicers and investors to make these programs work.

V. Vigilant oversight of the TARP program is crucial to provide accountability and to ensure that the program t is meeting its objectives.

I. Current voluntary modification efforts have failed to stem the tide of foreclosures.

Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, voluntary efforts undertaken thus far by lenders, servicers and investors have not been sufficient to stem the tide of foreclosures. Moreover, servicers still face significant obstacles in making modifications.

A. The number of modifications is inadequate to stem the tide of foreclosures and the type of modifications being made is unsustainable.

Seriously delinquent loans are at a record high for both subprime and prime loans.[5] All available data consistently indicate that continuing foreclosures far outpace total loss mitigation efforts and that only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.

In October, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008.[6] Similarly, the most recent report from the State Foreclosure Working Group of Attorneys General and Banking Commissioners, which covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans, confirms that progress in stopping foreclosures is "profoundly disappointing."[7] Their data indicate that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report.[8] Even the homeowners who receive some kind of loss mitigation are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.[9]

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners and financial institutions in an even worse economic position than when they started. According to an analysis by Valparaiso Professor of Law Alan White, a national expert on foreclosure policy, of more than 3.5 million subprime and alt-A mortgages (all securitized), only 35% of modifications in the November 2008 report reduced monthly payments below the initial payment, while 20% left the payment the same and 45% increased the monthly payment.[10] Similarly, data through September 2008 indicate that the large majority of HOPE NOW efforts rely on repayment plans,[11] which typically require financially burdened households to add previously unpaid debt to their current mortgage payments.

In view of the foregoing, the recent report by the Office of the Comptroller of the Currency (OCC) regarding high loan modification redefault rates is unsurprising.[12] What is surprising is that the OCC seems to suggest that these redefault rates prove that loan modifications are useless in preventing foreclosures. To the contrary, what this report demonstrates is what we already suspected, which is that the modifications being made are not sustainable, affordable modifications. It does not take a statistician to predict that if a homeowner in default is given a higher rather than a lower monthly payment, there is a high probability of redefault.

Studies tracking the results obtained by different types of modifications show that certain types of modifications are much more successful than other types. According to a recent Lehman Brothers analysis, rate reduction modifications result in a more significant improvement in performance than principal and interest capitalizations that add past-due amounts onto the balance of the loan.[13] Credit Suisse reports that when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.[14] And the OCC report suggests that modifications of mortgages held by a lender, rather than ones pooled into a mortgage-backed security, have been defaulting at lower rates, and this data further supports the notion that sustainable modifications can be made if obstacles to doing so can be overcome.[15]

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

A recent Federal Reserve Staff Working Paper identifies a number of obstacles that limit the scale of modifications.[16] These obstacles help explain why voluntary loss mitigation cannot keep up with demand.

- *Investor Concerns:* Servicers may shy away from modifications for fear of investor lawsuits.[17] While some Pooling and Servicing Agreements (PSAs) provide adequate authority to modify loans, these modifications may cause disproportionate harm to certain tranches of securities over other classes. Other PSAs include serious impediments to modifying securitized loans. For example, some limit the number or percentage of loans in a pool that can be modified.[18]

- *Second Liens:* Additional liens on a property pose a structural obstacle that is often impossible for servicers of the first lien to overcome. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,[19] and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, "it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications," thereby dooming the effort.[20]

- *Servicer Incentives:* The way servicers are compensated by lenders creates a market-distorting bias for moving forward with foreclosure rather than engaging in foreclosure prevention. Servicers are often not paid for modifications, but are reimbursed for foreclosure costs.[21] The Federal Reserve concludes, "Loan loss mitigation is labor intensive and thus raises servicing costs, which in turn make it more likely that a servicer would forego loss mitigation and pursue foreclosure even if the investor would be better off if foreclosure were avoided."[22]

- *Limited Servicer Staff and Technology:* With few but welcome recent exceptions, servicers have continued to process loan modifications in a labor-intensive, case-by-case review. While they have added staff and enhanced systems, the lack of transparent, standardized formulas has limited the number of modifications that have been produced.[23] Even when a servicer has a uniform methodology, that lack of transparency in the inputs to its net present value analysis, such as its selection of an appropriate discount rate, prevents borrowers and the public from properly evaluating modification decisions.

II. The Treasury should use the Troubled Asset Relief Program (TARP) to leverage a systematic modification approach that will result in much larger numbers of sustainable modifications.

As noted above, the most pressing public policy goal today is to help homeowners to stay in their homes and, by extension, to support their neighbors' property values and the financial system as a whole. Yet as administered by Treasury, TARP has to date utterly ignored the problem of excessive foreclosures, in the face of clear Congressional intent otherwise. We believe it is crucial for the Treasury to use its TARP authority to prevent many of these foreclosures and thereby to restore stability to the housing market and to ease access to credit.

The core approach of H.R. 384 is modeled on the streamlined and systematic approach to loan modifications that the FDIC has been using for restructuring IndyMac Federal Bank's mortgage loans and that will continue after the FDIC sells IndyMac. Similar approaches have now been adopted as part of a recent settlement between Bank of America and state Attorney Generals regarding unfair and deceptive lending practices by Countrywide, by Citigroup, and by JP Morgan Chase/Washington Mutual. While these modification programs face some obstacles, including difficulty getting all homeowners to respond and the inability so far to modify sufficient numbers of loans held in private label securities, they represent a step in the right direction and can serve as a basis for modifying loans through the TARP program.

As we see it, the Treasury will need to adopt different strategies for three different categories of loans:

- **Loans in Private Label Securities:** Treasury should adopt FDIC's proposed loan modification guarantee program and provide guarantees to modifications from servicers with streamlined affordable modification protocols based on the FDIC/IndyMac model. An appropriately structured model that subsidized borrower interest payments could also be considered.

- **Loans Held By Fannie Mae and Freddie Mac:** As the conservator for the GSEs, the Federal Housing Finance Agency should direct them to facilitate modifications to the greatest extent possible. The recent November 11 announcement is a positive step for these loans.

- **Loans Held in Portfolio by Banks and Thrifts:** Treasury should require banks and thrifts that participate in Treasury's equity investment or asset purchase program to adopt these streamlined loan modification protocols.

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

As noted above, FDIC has pioneered a promising approach to streamlined modifications in its operations at IndyMac Bank, which it is applying to IndyMac loans held in portfolio and to those it services for private mortgage-backed securities investors, where possible. As H.R. 384 proposes, TARP could substantially expand this promising approach and effectively address the existing obstacles to modifications, particularly the obstacles posed by private securitization.

The FDIC/IndyMac model compares the net present value of modifying the loan to foreclosing and losing money reselling the house. As long the modification provides a greater return than foreclosing, the loan can be modified. All loans are converted to fixed rate loans at the Freddie Mac Survey interest rate at the time of the modification, which is currently 5 percent. The model establishes a clear affordability target: a 38 percent debt-to-income ratio (DTI) for total housing payments for the IndyMac first mortgage (including mortgage principal, interest, taxes and insurance).

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

- Servicers first reduce interest rates for five years, potentially to as low as 3%, to meet the DTI target. Thereafter the rate rises by 1% per year until it reaches a market rate, which is defined as the Freddie Mac survey rate.

- If this rate reduction is not enough to reach the target DTI, the servicer would increase the loan term to a maximum of 40 years from date of origination.

- If the loan still isn't affordable, then a portion of principal would be deferred until the loan becomes due or pays off early, with no interest accruing, or forgiven entirely. Monthly payments would be calculated on the lower balance, which would make the loan more affordable.

The FDIC has also introduced some important procedural initiatives to try to increase response rates. Where they have income information, they establish a pre-approved modification offer which they send to the borrower via certified mail. To accept, the borrower can return the offer in an enclosed pre-paid envelope, with a signature, a lower payment and current income verification documentation. Where FDIC does not have borrower income information, they have used mail, phone calls and payments to counselors to try to contact borrowers. Although there is still limited data available, the FDIC /IndyMac model is increasing modifications substantially for homeowners who take advantage of the program.

Implementing the new loan modification guarantee program modeled on the FDIC IndyMac modification program as outlined in H.R. 384 would act as a strong financial incentive for servicers and investors to agree to modify loans to newly established affordability standards. Under such a program, servicers who modified loans to meet certain standards would share the losses that result from future re-defaults of these modified loans.

The program would result in sustainable and affordable home loans for families facing foreclosure because it focuses on debt-to-income ratios and caps final interest rates at a pre-determined, prime rate. In addition, the FDIC model aligns incentives among investors and homeowners to the benefit of stabilizing home values: investors want to see modifications succeed because they share in future losses and the loan must perform for a minimum period before the guarantee kicks in. Further, since the guarantee can cover the cost of a re-modification or disposition short of foreclosure, there are substantial incentives for servicers to forego foreclosure.

Affordability Standards: Because federal resources would be insuring future performance risk, it would be important to establish strong affordability standards for the initial modifications. Although IndyMac is using a 38% housing DTI standard without any federal guarantee, when the taxpayers are funding guarantees, we believe that the initial affordability should be set at 31% of income for total housing costs.

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

Efficient Use of Taxpayer Resources: One of the most important aspects of this proposal is that the return on the government's investment would be substantial. For example, an investment of $24.4 billion would enable this program to assist up to 2.2 million borrowers at risk of foreclosures.[24] Structured as a guarantee program, federal costs would only be incurred when modified loans default. These losses would be shared equally with the investors. By using government funds as risk capital rather than liquidity, and leaving the loans within private securities, the government can leverage its funding significantly.

Loan Modifications Even When a Second Lien Exists. The best outcome for loans that have second liens – often with no value based on current market prices – is to have them paid off with very sharp discounts.[25] However, FDIC's IndyMac and model allows modifications to go forward even with second liens attached in the event that FDIC is unable to negotiate with the holders of the second mortgage to give up its lien interest, and the new loan guarantee program should also take this approach. Leaving the second liens in place is not optimal, but may be a necessary evil since 50% of subprime and Alt A loans currently have piggyback seconds, and these borrowers should not face certain foreclosure just because their out-of-the-money second mortgage investors refuse to release their interests. Many second mortgages will not foreclose, because after the house is sold in foreclosure and foreclosure expenses are taken into account, there would be no funds left to pay the second.

Incentive payments to servicers would increase the number of loans modified. As a counterweight to the reality that most servicing contracts compensate servicers more for foreclosure than modification, a payment to servicers of approximately $1,000 for each modification that meets the identified affordability standards would tilt the playing field toward modification. Just as Treasury pays investment advisors and other contractors under TARP to structure its equity investments or asset purchases, this program would pay the servicers who will do the work necessary to modify the mortgages under this program.

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

- *Investor Concerns:* A government guarantee to share the costs of future re-defaults has significant implications for the basic decision about whether a modification generates better returns for investors than foreclosing. Servicers would accept the government guarantee when the net present value to investors is greater to modify under the program than to foreclose, and the guarantee against re-default is likely to tip the scales strongly toward modifying. When the net present value (NPV) comparison results in this clear positive outcome, the fears about investor lawsuits would be substantially alleviated.

- *Second Liens:* As described above, permitting modifications even if second liens existed will maximize the number of loans that can be modified in a streamlined fashion**.** When the ban on judicial modifications is legislatively lifted, as is discussed in Section V below, the ability to settle or write off second liens will be increased. It would work best in combination with a Treasury program to purchase second mortgages cheaply, as described below.

- *Servicer Incentives:* Paying servicers directly for delivering affordable and sustainable modifications would address the servicer incentive problem. A direct payment should mitigate current incentives for them to opt for foreclosures rather than modifications.

- *Servicer Staffing and Technology**:*** Adopting a systematic approach based on the FDIC model simplifies and streamlines the work of servicers, limiting staff time per case. The modification analysis can be performed by a simple model and requires much less staff time or expertise than the current labor-intensive process, which requires subjective scrutiny of family debts and budgets. The FDIC was able to implement its new approach to modifications within weeks of taking over IndyMac Bank. Further, the use of a worksheet like the FDIC's makes the NPV calculation transparent.

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

In November, the GSEs announced a program to provide streamlined modifications for loans they own or that have been placed in Fannie Mae or Freddie Mac mortgage-backed securities that they guarantee. While the program is still new, this announcement is an important step forward for conforming loans, which represent over half of all mortgages in the country.[26]

While they were private companies, Fannie and Freddie hesitated to purchase out of securities loans that they had guaranteed because accounting standards required the GSEs to mark the loan down to its current market value.[27] While it is understandable that a private company under financial stress would hesitate in this manner, accounting-only losses should not drive substantive policy, particularly when modifying loans will result in lower final losses, which are now backed directly by U.S. taxpayers. We therefore commend FHFA and the GSEs for no longer making the distinction between loans on their portfolio and securitized loans for modifications.

However, we understand that the streamlined refinance program is not available for borrowers unless they are in default, which continues to serve as an obstacle to modification. Such stipulations have prevented many servicers from initiating timely and cost-effective modifications for borrowers who are likely to default in the future, and they create the perverse incentive of having borrowers miss payments and enter default to qualify for modifications. However, we also understand that the Trust Agreement has been modified to permit early workouts outside of the streamlined process even before a borrower becomes delinquent. We urge widespread usage of this option for borrowers for whom default is reasonably foreseeable, without requiring them to actually default first. In addition, Fannie Mae's streamlined modification program applies for loans sold to the GSE without recourse by the seller. In order to induce lenders to modify loans that do not fit into this category, Fannie Mae should implement policies to allow the purchase of performing mortgages after they have been modified.

Finally, since the loans held or guaranteed by the GSEs produce at most just 20% of current foreclosures, our other recommendations are critical to address the other 80% of at risk loans, particularly those subprime and Alt A loans that are held in private label securities.

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

The remaining at-risk loans, approximately 10%, are held directly by banks and thrifts in their portfolios. There are fewer obstacles from banks modifying these loans than if they were sold, but some obstacles remain from having these loans modified to avoid foreclosures. Most notably, banks may be reluctant to do so because such modifications will require marking down their balance sheets and weakening their capital positions, the same problem faced by Fannie and Freddie.

TARP's equity injection program provides a significant lever for requiring participating banks and thrifts to adopt a systematic loan modification program for their loans held in portfolio. Since the banks would just be recognizing losses they would soon bear anyway, and minimizing losses at that, Treasury should make receipt of equity from the TARP program contingent upon the adoption of a similar loan modification program. The fact that the government is providing equity that can absorb accounting losses should remove this objection. The Treasury Department conditioned Citigroup's second injection of funding on the implementation of a streamlined loan modification program along the lines of the FDIC program, and this requirement should be extended to all participants. When an institution has been required to create a streamlined loan modification program of this nature, foreclosure will only be permitted in those situations where the protocol does not produce a loan modification or where the homeowner has defaulted on such a loan modification.

III. <u>There are also other powerful tools that can increase modifications by removing the current obstacles that block desirable modifications.</u>

In addition to creating a streamlined modification program, there are several supplemental approaches that can be taken to maximize sustainable loan modifications.

A. Use TARP to purchase second mortgages so that they can be consolidated with the first mortgages and restructured.

As noted above, second mortgages are one of the greatest obstacles to modifications because a first mortgage holder will not generally voluntarily reduce interest or principal only to increase return for a second mortgage holder or cure its loan if the borrower is still in default on a second. Yet because most second liens are underwater, Treasury could likely purchase them very inexpensively.

To be most effective, purchases should be concentrated on second mortgages where the owner of the first mortgage is known and a modification effort is already being made, and/or Treasury could establish a fund to purchase second mortgages that can then be accessed by servicers who run into the problem of a second mortgage when trying to modify a first mortgage whose owner is already known. (For securitized second mortgages, there would need to be a change in REMIC rules, as discussed below, to enable their purchase.)

Although H.R. 384 contemplates a program under which the government could loan homeowners the money to pay off second liens, direct purchases may be the best outcome for homeowners if they can be made cheaply enough.

B. Provide servicers with a safe harbor from investor lawsuits when they modify loans.

One obstacle to servicers in modifying loans is that they fear lawsuits by investors harmed by their decision; any modification will favor some investors and disfavor others. H.R. 384 addresses this obstacle by creating a safe harbor for servicers attempting to do the right thing. The legislation provides that servicers can modify mortgages regardless of any limitations contained in a PSA and also that servicers are not required to repurchase loans out of pools to make such modifications. We support this approach and agree that fee-shifting provisions will support the goals of this legislation.

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

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

Congress should pass legislation clarifying that participation in a government-sponsored whole loan purchase program would be permitted under Real Estate Mortgage Investment Conduit (REMIC) tax rules in order to provide Treasury with a further option to address the foreclosure crisis if the other suggestions are not sufficient. Congress should provide that continued REMIC status (and future tax benefits) is contingent on PSAs being modified to permit (but not require) participation in the loan sale process. Finally, Congress, the SEC or Financial Accounting Standards Board would need to ensure that accounting standards change to permit these sales. Clearly, having whole loans that servicers for whatever reason are unable to modify, that will cause needless foreclosures, and that Treasury cannot purchase even though it could restructure the loans to make them affordable to the borrowers and maximize the return to the government, is not socially optimal. There should be no objection to freeing servicers to modify or sell these assets at the direction of a Treasury program.[28] These changes should also permit private parties to purchase whole loans out of securities under a program that Treasury describes to increase modifications, which would increase the value of mortgage related securities and decrease the leveraged losses to financial institutions.

Once Treasury purchased loans at a substantial discount and modified them to an affordable level, it could resecuritize the mortgages into pools guaranteed by the government. This guarantee would make the securities marketable and allow the government to revolve its funding into new purchases, increasing its impact. In addition, this change should be implemented to provide Treasury the ability to cheaply buy second mortgages, which are proving a significant obstacle to modifications.

D. *Buy servicing rights of existing loans to facilitate modifications.*

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

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

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

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

Right now, because loan servicers have no obligation to provide specific information on their servicing activities, it is difficult to monitor progress and assess servicing performance. For example, the data from HOPE NOW are aggregate data and not identified either by servicer or loan. This lack of data creates difficulty in ascertaining what is and is not working.

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

In addition, Treasury should require servicers to make public their modification protocols, as well as the inputs to the NPV analyses that they undertake when deciding whether to modify versus whether to foreclose. Because of falling house values, proper use of these models should be leading to orders of magnitude more voluntary modifications than are occurring. Transparency should address this issue and prevent servicers from skewing the results by using unrealistically high discount rates or other inaccurate inputs.

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

When a servicer provides a homeowner with a loan modification containing a principal writedown or, in certain circumstances, a significant interest rate reduction, the IRS considers the homeowner to have received taxable cancellation of indebtedness income unless the mortgage debt is "qualified" under the terms of the Mortgage Forgiveness Debt Relief Act of 2007 or the homeowner is insolvent. In many instances, especially where the difference between the original loan amount and the current value of the house is large, the prospect of tax liability could discourage homeowners from seeking a modification, or, if such a modification is obtained, the resulting tax liability could cause the homeowner to redefault on the loan. To prevent this perverse result, Congress should amend the Mortgage Forgiveness Debt Relief Act of 2007 in two ways: (1) lenders should not be required to file a Form 1099 with the IRS when cancelling any mortgage-related debt; and (2) the definition of "qualified mortgage debt" should be extended to include all home equity debt.

IV. TARP must have effective oversight to ensure accountability and to check that it is meeting its objectives.

Although the passage of TARP was necessary to protect the U.S. financial system, the fact remains that this legislation gives the Treasury Department unprecedented authority to use enormous sums of taxpayer money with very few strings attached. More disturbingly, Treasury has provided only a bare minimum of detail to Congress and to the nation regarding how the TARP money has been spent so far. The lack of transparency is mystifying and suggests at best a disregard for the very taxpayers funding the program, let alone for the members of Congress who voted for the program.

Under those circumstances, it is crucial that Congress provide effective oversight of the TARP program. Oversight provides accountability for the use of the funds, which protects both the taxpayers and the Treasury Department. What's more, proper oversight can ensure that the program is meeting its stated goals, and if those goals are not being met, Congress can work with the Treasury Department to make any needed changes. The changes in size and authority of the Financial Stability Oversight Board proposed by H.R. 384 are the types of tools which are required.

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

It is important also to provide a backstop to protect those homeowners whose lenders cannot or will not agree to voluntarily modify their loans, either through the TARP initiative or otherwise.

The best and only solution in these cases – provided the homeowner could sustain a market rate mortgage – is to lift the ban on judicial modifications, and allow a bankruptcy court to implement an economically rational solution that otherwise would be lost.

Right now, judicial modification of loans in bankruptcy court is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century and investment banks like Lehman Bros., yet it is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence *the only debt* that bankruptcy courts are *not* permitted to modify in Chapter 13 payment plans. Eliminating this exception would immediately help stem the tide of foreclosures *at zero cost to the U.S. taxpayer*.[29] Mark Zandi, founder and chief economist of Moody's Economy.com, testified last week in support of this measure, estimating that it could save 800,000 homes from foreclosure.[30]

The urgent need for a solution, and the manifest failure of the many proposed solutions attempted to date, have led several prominent industry leaders to reverse their former opposition and now urge that Congress lift the ban on judicial modification of primary residence mortgages. Just last week, Citigroup reached an agreement with Congressional leaders to support court supervised loan modifications in bankruptcy as set out in S 61 and HR 200, provide that the legislation is amended to accomplish three things: (1) to limit relief to cover only existing loans (not loans made in the future); (2) to require borrowers to certify that they have attempted to work out an acceptable solution with the lender or servicer; and (3) to provide for the forfeiture of lender claims only where the lender has violated certain provisions of the Truth in Lending Act.

There are already a number of other limitations in the bill. Relief is available only to homeowners who would otherwise lose the home in foreclosure and who have sufficient means to sustain a market rate mortgage. The downside to lenders is circumscribed: interest rates must be set at commercially reasonable, market rates; the loan term may not exceed 40 years; and the principal balance may not be reduced below the value of the property. The judge must be satisfied of the homeowner's good faith in seeking relief. Finally, as with all Chapter 13 bankruptcy cases, the homeowner must subject herself to the supervision of the bankruptcy court for a three to five year period, during which time she can make no expenditures beyond limited allowable living expenses, and incur no credit card or other debt, without court supervision.

These provisions will ensure adequate protection for lenders, servicers and investors, while providing the forceful solution needed to lift the housing market out of its present crisis. Making this change will have the further benefit of encouraging servicers to participate in the TARP and other voluntary modification initiatives. To be clear, CRL does not want to see hundreds of thousands of homeowners actually file for bankruptcy. It is far preferable for most of these homeowners to receive a sustainable loan modification through a streamlined or individualized program. But if bankruptcy judges could make these modifications, it will help encourage additional voluntary modifications as everyone in the system would know the alternative.[31] Investors would have no reason to sue over a modification if the same or more costly modification could be made by a judge. Bankruptcy judges, who are extremely skilled at debt workouts, could help develop modification templates that could be used by servicers outside of the bankruptcy court context.[32]

Finally, there is clear precedent for this relief. Congress implemented a similar measure in response to the farm crisis of the 1980s when an economic downturn and depressed land values were pushing family farmers into foreclosure. Congress enacted the Family Farmer Bankruptcy Act of 1986, for the specific and express purpose of permitting bankruptcy judges to modify mortgages on family farms, permitting adjustment of interest rates and the reduction of principal to fair market value, in order to help distressed farmers avoid foreclosure, including on their primary residence. Chapter 12 proved effective in helping farmers through the crisis. In fact, after being extended several times, the Act was made a permanent part of the Bankruptcy Code, with bipartisan support, in 2005.

Conclusion

Today's financial crisis is a monument to destructive lending practices—bad lending that never before had been practiced on such a large scale and with so little oversight. These practices have now undermined not only just the entire US economic, but the world economy as well. There is no single solution to the challenges facing us today, but any effective policies must seek to maximize the number of families who stay in their homes. In particular, Treasury should use its TARP authority to prevent foreclosures and Congress should lift the ban on judicial restructuring of loans on primary residences.

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[1] Center for Responsible Lending, *Continued Decay and Shaky Repairs: The State of Subprime Loans Today* (Jan. 8, 2009) p. 2 [hereinafter "*Continued Decay*"]. http://www.responsiblelending.org/issues/mortgage/research/continued-decay-and-shaky-repairs-the-state-of-subprime-loans-today.html

[2] Credit Suisse Fixed Income Research, *Foreclosure Update: Over 8 Million Foreclosures Expected* (Dec. 4, 2008), p.1.

[3] *Continued Decay* p. 3.

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

[5] *See* HOPE NOW Data for all periods, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf.

[6] Credit Suisse Fixed Income Research, *Subprime Loan Modifications Update*, October 1, 2008, p.2, *available at* http://www.credit-suisse.com/researchandanalytics [hereinafter "Credit Suisse Update"].

[7] State Foreclosure Prevention Working Group, *Analysis of Subprime Servicing Performance*, Sept. 2008, at 2, *available at* http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachment1.pdf.

[8] Id. at 6.

[9] Id. at 7-9.

[10] Alan White, *Deleveraging American Homeowners: December 18, 2008 Update to August 2008 Report*, Valparaiso University School of Law (December 2008), p. 2.

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

[12] *See* OCC and OTS Mortgage Metrics Report (Third Quarter 2008), *available at* http://occ.gov/ftp/release/2008-150a.pdf [hereinafter "OCC Report"]. One of the many concerns about this report is that meaningful, sustainable loan modification efforts did not become active until the third and fourth quarters of 2008, long after the OCC's was collected including the streamlined modification programs being used by the FDIC for IndyMac Federal Bank and by Fannie Mae and Freddie Mac.

[13] Lehman Bros. U.S. Securitized Products Fixed Income Research, *The Loan Modification Story So Far* (Sept. 11, 2008) p. 2.

[14] Credit Suisse Update, p.1.

[15] OCC Report, pp. 5-6. We hope that the OCC will release disaggregated data, which we anticipate would show that when modifications reduce monthly payments and are made in accordance with the homeowner's ability to pay, these modifications are much less likely to redefault than modifications that do not reduce or even raise monthly payments.

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

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

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

[19] Credit Suisse, *Mortgage Liquidity du Jour: Underestimated No More*, March 12, 2007 at 5.

[20] Credit Suisse Update, p. 8.

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

[22] Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf , *The Incentives of Mortgage Servicers: Myths and Realities* (Federal Reserve Staff Working Paper, Finance and Economics Discussion Series, 2008-46), p. 15 [hereinafter "*Myths and Realities*"].

[23] Id. at 3, 9, 23.

[24] These projections can be found at http://www.fdic.gov/consumers/loans/loanmod/

[25] As noted below, the Treasury could also buy second liens at a fraction of their cost.

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

[27] AICPA Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer (SOP 03-3).

[28] See Center For American Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages, April 2008, available at http://www.americanprogress.org/issues/2008/04/reimc_brief.html.

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

[30] Williamson, Elizabeth, and Simon, Ruth, *Plan to Cut Foreclosure Rate Clears Key Hurdle*, Wall Street Journal (Jan. 9, 2009), *available at* http://online.wsj.com/article/SB123144562914865337.html?mod=djemalertNEWS

[31] The same phenomenon *occurred* when Chapter 12 was passed to modify loans on family farms in the late 1980s.

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