

**PRESERVING HOME OWNERSHIP: PROGRESS
NEEDED TO PREVENT FORECLOSURES**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED ELEVENTH CONGRESS
FIRST SESSION
ON
EXAMINING THE STATE OF THE HOUSING MARKET AND THE FEDERAL
GOVERNMENT'S EFFORTS TO PREVENT FORECLOSURES

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JULY 16, 2009
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THURSDAY, JULY 16, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee convened, pursuant to notice, at 9:34 a.m., in room 538, Dirksen Senate Office Building, Senator Christopher J. Dodd, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. We gather here this morning to have a hearing on “Preserving Home Ownership: Progress Needed to Prevent Foreclosures.”

It is almost like Groundhog Day. One of the very first hearings I held 2 years ago with my friend Richard Shelby was on this very subject matter, back in February of 2007—

Senator SHELBY. Two-and-a-half years.

Chairman DODD.—two-and-a-half years ago now, and we had, I don’t know the exact number, something like 30 hearings and so forth, a whole series of meetings we conducted over that period of time to try and convince people how serious the foreclosure issue would be. And here we are, two-and-a-half years later, back at the subject matter.

So I am glad all of us could be here today. I am particularly thankful for our witnesses. But I have to be honest with everyone who is here this morning. I am frustrated—that is a mild word to use—that we even have to hold this hearing at all. This is disgraceful, where we are two-and-a-half years later.

For over 2 years, this Committee has worked to stem the tide of foreclosures in America, Democrats and Republicans, both in the Committee, other committees have obviously been involved in it, as well. We have heard plans and proposals from the administration. We have passed legislation. Many changes have been asked of us and we have passed even more legislation. We have received assurance after assurance from the industry. Everyone agrees that the crisis in our mortgage market was the catalyst for the broader economic crisis. There were other factors, obviously, but it was the major catalyst, and everyone understands that getting out of this broader crisis requires that we stabilize our housing market and stem the tide of foreclosures in our country.

So I am hoping that with the stakes this high, somebody can begin to explain to us why nothing has changed over the last two-and-a-half years.

Today, the Associated Press is reporting, I quote, “The number of U.S. households on the verge of losing their homes soared by nearly 15 percent in the first half of the year as more people lost their jobs and were unable to pay their monthly mortgage bills. Over 336,000 households received at least one foreclosure notice in June.”

Why am I still reading about lost files, understaffed and under-trained services and hours spent on hold on the telephone? Why does the National Foreclosure Mitigation Program tell us that homeowners are waiting an average of 6 to 8 weeks—6 to 8 weeks—for a response? Why are we still reading stories about homeowners, community advocates, even our own staffs acting on behalf of constituents, shuffled from voice mail to voice mail to voice mail to voice mail as they attempt to help people stay in their homes? Why are servicers and lenders refusing to accept principal reduction so that homeowners can start building equity and get the housing market moving again?

Two years ago, I brought together in this very room banks, lenders, mortgage firms, regulators, consumer groups for a home owner or home ownership preservation gathering summit. We all agreed upon a statement of principles, which were the following.

First—and these were everyone agreeing to this. This wasn’t something being opposed. There were a number of days meeting to determine what these principles ought to be. First, that services should attempt to contact subprime borrowers before loans reset in order to identify likely defaults early enough for the loan to be modified. Second, modifications should be made affordable for the long term. And third, servicers should have dedicated teams of professionals to implement these modifications. And finally, we agreed that we needed real accountability, a system for measuring the progress.

We were able to come to this agreement because all of us understood that nobody wins, obviously, when a home is foreclosed. Nobody wins, obviously, when a bank has to sell a house at auction for less than it would get it if simply were refinanced. And, of course, no one wins when a home loses at least \$5,000 in value for every foreclosure on that city block or street block. And, of course, no one wins when foreclosure rates are the single biggest threat to economic recovery.

So what has happened over this period of time and what are we doing differently? Today, I want some answers. Foreclosure is not an abstract concept. It is a very real pain for American families. It is not just the loss of a house, it is the loss of a home. It is the anguish of having to uproot your family. It is the sadness of feeling that you have let them down, that you no longer have that place that they can live in. And it is the terrible heartache caused by the violation of the sacred promise that has long defined the American middle class in our country, that if you work hard and play by the rules, that together we can build something better for you and your family.

Most people in foreclosures work hard and play by the rules. They budgeted, they saved, they relied on brokers and lenders, professionals who are supposed to be experts, to help them achieve their dream of home ownership. But then someone lost a job. Some-

one got sick. Fifty percent of the foreclosures are caused by health care crisis in that family—50 percent of them. So in far too many cases, they discover they simply have been cheated, unfortunately.

Last year, I met a woman named Donna Pierce, a grandmother from Bridgeport, Connecticut. By the way, in Bridgeport, Connecticut, there are 5,000 families in that city with subprime mortgages in danger of foreclosure. Donna was assured by her lender that she could refinance in 6 months. But he didn't mention the thousands of dollars in penalties that refinancing would cost, penalties she could not afford.

People like Donna Pierce didn't deserve to lose their homes. Neither did the 10,000 families that before today ends will receive a foreclosure notice in our nation, or the 60,000 families in my home State of Connecticut who find themselves in foreclosure over the next 4 years.

So I know I speak for all of us here in this Committee, our colleagues, not just those on the Committee but others in the Senate and the House, people all across the country, when I say that I am glad to have the support of the administration and the industry in our effort to stem this dangerous tide, but a lot more needs to be done. What we don't have is results. So today, we sit here again and the American people are demanding to know why. So this morning, I hope we are going to get some answers.

I happen to be one that believes that the idea of principal reduction makes a lot more sense than interest rate reduction. It is all about equity—all about equity. If people can increase their equity in a home or have an equity and a chance to regain their footing in equity, then it seems to me we can do a lot better in this than just sitting here monkeying around with interest rates. But that is my point of view. I know others have a different point of view on that. But nonetheless, that is where I believe we should be going with this, rather than the course we are on.

With that, let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Today, the Committee will examine the state of our housing market and the Federal Government's efforts to prevent foreclosures in the midst of what is now the most severe recession in a generation.

Problems in our housing market have been center stage since the start of this crisis, as Senator Dodd just reminded us. Rising default rates on subprime mortgages appear to have triggered the financial crisis nearly 2 years ago. Since then, default rates on all classes of mortgages have risen sharply and the precipitous declines in the value of mortgage-backed securities have crippled banks and led to the insolvency of Fannie and Freddie. As the economy has continued to worsen, millions of Americans have seen the value of their homes fall and many have lost or may lose their homes to foreclosure.

In an effort to forestall unnecessary foreclosures, Congress and the Obama administration initially devised several programs. Nearly 1 year ago, Congress enacted the Hope for Homeowners program. This program aimed to keep homeowners in their homes by encouraging lenders and servicers to modify mortgages. Unfortu-

nately, this program has only modified a handful of mortgages. While recently enacted changes to the program may help improve Hope for Homeowners, it is clear that the program needs a thorough reexamination.

In many ways, I believe that this hearing could begin to put the horse back in front of the cart by undertaking some of the investigative work necessary to properly address the issues surrounding the housing market in this country. We have heard many theories about the causes of our difficulties. However, my hope is that with this hearing, we can bring together verifiable facts which will allow us to do our own analysis here. Homeowners in need will be better served if we actually identify the root causes of foreclosures and craft effective solutions rather than simply implementing policies to counteract what we think is the problem.

As the Committee considers how to prevent foreclosures, I think we should begin by determining the following. First, and probably most important, is the degree to which escalating default rates can be attributed to unscrupulous lenders. If true predatory lending was as pervasive as some have argued, we should be able to easily document that fact. I must say, however, aside from anecdotal evidence, I don't think we have yet to see such data. I look forward to hearing what the administration believes is the reason for the rising default rates and what evidence they cite in support of their position.

The second question we need to ask, I believe, is what is working? Unfortunately, existing modification programs have not been very effective. It is important to understand why they have not been working as expected and if there is anything we can or should do in response here.

Finally, we should determine whether our policies are building the foundations for a stable and sustainable housing market or if they are merely delaying the inevitable. I have long criticized our housing policy for willfully ignoring long-term financial consequences, especially with respect to the GSEs. Sustainable policies must be based on economic realities and facts, not wishful thinking.

I hope today, as the Chairman has indicated, that we can begin to establish some of those facts by examining the research and experiences of our panelists. To the extent that we can clearly determine what caused this crisis, we will then be able to address it more effectively and also implement policies to avoid future crises.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

We have got a rather large second panel, so with my colleagues' indulgence, all of your opening statements will be included in the record and the like, and if you want to use your time to engage in that, that will be available to you, but let me get right to our witnesses, the two first witnesses.

We are joined here first by two witnesses. Herb Allison is the Assistant Secretary for Financial Stability at the U.S. Treasury. Assistant Secretary Allison has been a leader in the U.S. financial markets, both in the public and private sectors, having served in top positions at Freddie Mac, TIAA-CREF, and Merrill Lynch.

William Apgar is the Senior Advisor to the Secretary for Mortgage Finance of the Department of Housing and Urban Development. Previously, he was the Assistant Secretary for Housing. He has served in various positions as a lecturer and scholar at the Harvard Kennedy School of Government.

We appreciate both of you being here this morning and we will accept your testimony here. Try and keep it down to five or 8 minutes if you can so we can get to the questions.

Mr. Allison, you are up first.

STATEMENT OF HERBERT M. ALLISON, JR., ASSISTANT SECRETARY FOR FINANCIAL STABILITY, DEPARTMENT OF THE TREASURY

Mr. ALLISON. Thank you very much, Mr. Chairman. Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for this opportunity to testify about the Treasury Department's comprehensive initiatives to stabilize the U.S. housing market and to support homeowners. I will keep my remarks brief, as I have provided a more detailed review of the program's progress and challenges in my written testimony.

A strong housing market is crucial to our economic recovery. The recent crisis in the housing sector has devastated families and communities across the country and is at the center of our financial crisis and economic downturn. Today, I want to outline the steps that Treasury and the administration have taken to address this crisis, help millions of homeowners, and lay the foundations for economic recovery and financial stability.

This crisis was years in the making, and as a result, millions of homeowners have mortgage payments that they are unable to afford. Rising unemployment and recessionary pressures have impaired the ability of many otherwise responsible families to stay current on their mortgage payments. The result is that responsible homeowners across America are grappling with the possibility of foreclosure and displacement. Many analysts project that more than six million families could face foreclosure in the next 3 years if effective actions are not taken.

This administration has moved with great speed to aggressively confront the economic challenges facing our economy and housing market by announcing and implementing an unprecedented mortgage modification program.

Chairman DODD. Mr. Allison, would you mind moving your microphone a little closer to you so we can hear you better? Thank you.

Mr. ALLISON. Thank you. An initiative of this scale has never been previously attempted. On March 4, just 2 weeks after the President announced the program, the administration, working with the banking regulators, Fannie Mae and Freddie Mac, HUD, and the Federal Housing Finance Agency, published detailed program guidelines for MHA's Home Affordable Modification Program, or HAMP.

On April 6, we issued detailed servicer guidance. Today, we have 27 servicers lined up to participate in MHA. Between loans covered by those servicers, as well as Fannie Mae and Freddie Mac, more

than 85 percent of all mortgage loans in the country are now covered by the program.

The initiatives include three key components. First, support for the Government Sponsored Enterprises, or GSEs. We have committed an additional \$200 billion of capital to Fannie Mae and Freddie Mac to encourage low mortgage rates and help maintain mortgage affordability.

Second, the Home Affordable Refinance Program, or HARP, expands access to refinancing for families whose homes have lost value and whose mortgage payments can be reduced at today's low interest rates. It helps homeowners who are unable to benefit from the low interest rates available today because price declines have left them with insufficient equity in their homes. We have recently expanded the program to help homeowners with mortgages up to 125 percent of current home value.

Third, the Home Affordable Modification Program, or HAMP, which will provide up to \$75 billion to encourage loan modifications that will provide sustainable, affordable mortgage payments for borrowers. Importantly, HAMP offers incentives to investors, lenders, servicers, and homeowners to encourage mortgage modifications.

We have recently announced details of additional HAMP program features, including a second lien program, that can provide a more affordable solution for borrowers by addressing their total mortgage debt; measures to strengthen the Hope for Homeowners Program, which provides additional relief for borrowers with mortgage balances greater than the current value of their homes; a foreclosure alternatives program that will provide incentives for short sales and deeds in lieu of foreclosure, where borrowers are unable to complete the modification process; home price decline protection incentives that will encourage more modifications where home price declines have been severe.

Today, I want to highlight some key points of success. Three-hundred-twenty-five thousand trial modifications have been offered under HAMP. Approximately 160 trial modifications are now underway, and that number is growing every week. While this number is not yet audited, we believe it is reasonably accurate, based on our discussions with the GSEs who administer the program. As servicers adjust their systems and new reporting capabilities become operational, we will continue to improve the accuracy and robustness of the data that we provide to you.

At this early data, MHA has already been more successful than any previous similar program in modifying mortgages for at-risk borrowers to sustainably affordable levels and helping to avoid preventable foreclosures. Nonetheless, we recognize that challenges remain in implementing and scaling up the program. We are committed to overcoming those challenges and reaching as many borrowers as possible.

In particular, we are focused on addressing challenges in three key areas: Capacity, transparency, and borrower outreach. We are taking a number of steps and working with servicers to expand nationwide capacity to accommodate the number of eligible borrowers who can receive assistance through MHA.

Just last week as part of the Administration's efforts to expedite implementation of HAMP, Secretaries Geithner and Donovan wrote to the CEOs of all the servicers currently participating in the program. In this joint letter, they call on the servicers to devote substantially more resources to the program in order for it to fully succeed. They ask that all servicers move rapidly to expand servicing capacity and improve the quality of loan modifications.

Specifically, this will require that servicers add more staff than previously planned, expand call center capacities, bolster training of representatives, enhance online offerings, send additional mailings to potentially eligible borrowers, and provide a process for borrowers to escalate their concerns about servicers' performance. The joint letter also requested that each CEO designate a senior liaison to attend a program implementation meeting with senior HUD and Treasury officials on July 28 to work directly with us in all aspects of MHA.

As Secretary Geithner has noted, we are committed to transparency and better communications in all of Treasury's programs. Accordingly, we are planning to take three additional concrete steps in conjunction with the servicer liaison meeting to enhance transparency in the program.

First, by August 4, we will begin publicly reporting servicers' specific results on a monthly basis. These reports will provide a transparent and public accounting of individual servicer performance by detailing the number of trial modification offers extended, the number of trial modifications underway, the number of official modifications offered, and the long-term success of modifications.

Second, we will work to establish specific operational metrics to measure the performance of each servicer.

Third, in order to minimize the likelihood that borrower applications are overlooked or that applications are inadvertently denied a modification, Treasury has also asked Freddie Mac in its role as compliant agent to develop a second look process for auditing a sample of MHA modification applications that have been denied.

These additional measures will complement the steps we have already taken to increase transparency, such as expanding the efforts of the Federal Government to combat mortgage rescue fraud and put scammers on notice that we will not stand by if they prey on homeowners seeking help under the program.

The third challenge we are tackling aggressively is borrower outreach. We are committing significant resources, in partnership with the servicers, to reach and inform as many borrowers as possible. We have already launched a consumer-focused website, www.makinghomeaffordable.gov, with self-assessment tools for borrowers to determine their potential eligibility for the MHA program. This website is in both English and Spanish and has already received over 22 million page views.

We have established a call center where borrowers can reach HUD for approved housing counselors who can provide information and assistance in applying for the MHA program.

And working closely with Fannie Mae, we have also launched foreclosure prevention workshops and borrower education events in areas of the country facing high foreclosure rates. The first out-

reach event was held in Miami and another is taking place today in Sacramento.

Much more must be done. We will continue to work with other agencies and the private sector to reach as many families as possible.

Finally, we recognize that any program seeking to avoid preventable foreclosures has limits, HAMP included. As President Obama noted when he launched the program in February, this program will not save every home. Even before the current crisis, when home prices were declining, there were hundreds of thousands of foreclosures a year. Therefore, even if HAMP meets our ambitious goals, we should still expect millions of foreclosures over the next several years. Some of those foreclosures will affect borrowers who, as investors, do not qualify for the program. Others will be borrowers who did not respond to our outreach, and others will be borrowers who bought homes well beyond what they could afford and would be unable to make their monthly payment even on a modified loan.

Nevertheless, for millions of homeowners, HAMP will provide a crucial opportunity to stay in their homes. It will bring relief to the communities hardest hit by foreclosures. It will provide peace of mind to families who have barely managed to stay current in their mortgages, who have recently fallen behind in their payments. It will help stabilize home prices for all American homeowners, and in doing so aid the recovery of the U.S. economy.

In less than 5 months, including the initial start-up phase, the Making Home Affordable Plan has accomplished a great deal and helped homeowners across the country. But we know that more is required to help American families during this crisis, so we will work tirelessly to build on these efforts.

Sustained recovery of our housing market is vital to achieving financial stability and promoting a broad economic recovery. We look forward to working with you to help Americans stay in their homes, to restore stability in the U.S. housing market and grow the U.S. economy.

Thank you very much, and I look forward to your questions.

Chairman DODD. Thank you.

Mr. Apgar, go ahead.

**STATEMENT OF WILLIAM APGAR, SENIOR ADVISOR TO THE
SECRETARY FOR MORTGAGE FINANCE, DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT**

Mr. APGAR. Chairman Dodd, Ranking Member Shelby, members of the Committee, thank you for the opportunity to testify.

Secretary Allison has already provided you with a summary of the Making Home Affordable Program. I will focus my comments on the implementation of the Hope for Homeowners Program and others administration efforts to provide relief to homeowners and neighborhoods suffering from the effects of the foreclosure crisis.

First of all, I want to commend Chairman Dodd and the other members of the Committee for your leadership in passing the Helping Families Save their Homes Act of 2009, signed into law by President Obama on May 20 of this year. This legislation makes

important and much needed improvements to the Hope for Homeowners Program that we are now implementing.

Due to several obstacles to participation, including steep borrower fees, costs, complex program requirements, and lack of operational flexibility in program design, the original Hope for Homeowners Program only served a handful of distressed owners. These legislative improvements that were enacted this year, combined with the integration of Hope for Homeowners into the Administration's Making Home Affordable Program, will help the program, Hope for Homeowners, become a less burdensome option for underwater borrowers who are seeking to refinance their home and regain equity in their home.

Services participating in the Making Home Affordable Program will be required to offer the option for Hope for Homeowners refinancing in tandem with a Making Home Affordable modification. To ensure proper alignment of incentives, servicers and lenders will receive payments in the Hope for Homeowners refinancing option similar to those offered to the modification option. Though the Hope for Homeowners Program offers substantial benefits to underwater borrowers best served by an increase in equity position in their homes, treatment of second liens poses significant challenges to the implementation of the program.

First, the presence of a second lien complicates the execution of a mortgage refinance program even under the best of circumstances. Since second liens tend to be held in the portfolio by several of the Nation's largest banking institutions while first liens are owned by a wider range of investors, coordinated communication and decisionmaking between these two separate financial interests can be logistically complex.

Equally challenging is the determination of a fair allocation of payments to each of these two distinct investment interests. As you know, the basic program requires first lien investors to take a significant write-down in order to restore the borrower to an affordable mortgage with a meaningful level of equity in their home. Though initially resistant to the program, many first lien investors under the concept of one loss, one time, appear increasingly willing to accept the required haircut and execute a clean exit from the transaction.

Unfortunately, the calculation of second lien-holders is more complex. Even in situations where the combined LTVs of the first and second liens exceed the market value of the home, second liens may have some value. In particular, representatives of banking institutions that hold sizable numbers of second liens on their portfolios report that in some situations, borrowers who are delinquent on their first lien continue to make payments on their second lien, providing some measure of benefit to second lien holders. Of course, where the first lien is underwater, once the property moves to foreclosure, the second lien is worthless.

In light of these complex and often conflicting interests, determining the fair compensation system for holders of second liens is difficult. In this regard, the July 10 letter to the heads of five bank regulators jointly signed by you, Chairman Dodd, and House Financial Services Committee Chairman Frank, is illustrative. In assessing methods used to estimate the value of second liens held on

the balance sheet of the Nation's largest bank, the letter expressed concern that loss allowance associated with these subordinated liens may be insufficient to realistically and accurately reflect their value, especially in light of the historically poor performance of first lien mortgages and the seriously diminished value of the underlying collateral. The letter goes on to observe that in situations where banks are allowed to carry these loans at potentially inflated value, they may be reluctant to negotiate the disposition of these liens and thus stand in the way of an increasing participation in Hope for Homeowners.

To better understand these issues, HUD and Treasury are now working with the OCC and other regulators that supervise the activities of large national banking institutions that hold in portfolio the largest share of second liens. We hope these conversations will draw on the considerable expertise of the OCC and other regulators to help HUD craft an extinguishment schedule that will provide fair compensation to the holders of these second liens.

Finally, HUD and the Administration are also working to implement several other initiatives to expand the reach of foreclosures throughout the country. These efforts are described in my written testimony and I would be happy to discuss them more at length during the question and answer period.

In conclusion, once again, I would like to thank you for the opportunity to participate in the hearing and I am happy to answer any questions that you may have. Thank you.

Chairman DODD. Thank you very much, both of you. I appreciate your being here.

Obviously, there is a lot of frustration in these numbers we hear this morning. We add to it, despite all of the efforts we have all made up here trying to put together something that works for people, and obviously we understand that not everyone you are going to be able to keep in their homes. I want to raise the issue with you about the principal reduction versus the payment reduction approach.

But I think it is also important to point out that at some point, we need to come to conclusions about these. There are people we can help. There are people we cannot help. And when those issues arise, when you can't solve that problem, it seems to me then it is better to get that property up, get it auctioned off, and get it moving.

I was listening to some people in my State not long ago who are in the real estate business who when they have had—they are not selling a lot of new homes, and in fact, some of the sales are foreclosure sales. And when there is a foreclosure sale, people show up to acquire the property. So striking that balance between trying to help out people we can, and as you point out in your testimony, Mr. Allison, there are some situations where we just cannot work it out despite the efforts, but you ought to make the effort, it seems to me, and then make that conclusion, and if that conclusion is the one that something can't be done, then to move the property along, as well.

But let me get to the first issue, because—
[Telephone ringing.]

Chairman DODD. I suspect that is my 7-year-old daughter. I will put that down. Hold on. I apologize for that.

Let me ask you the question about the principal reduction versus the payment affordability approach which the Administration is taking. Others, including the Federal Reserve and others, have argued for the principal reduction approach. Now, you point out, Mr. Apgar, that the second mortgage issue raises issues, and I want to get to that in a minute. But which of those two approaches do you believe, Mr. Allison, is a better approach in terms of achieving the kind of outcomes we are looking for here and why are we not then moving on the principal reduction idea if, in fact, there is a better outcome there?

Mr. ALLISON. Well, we actually are now offering—

Chairman DODD. You have got to get your microphone on and speak right into it.

Mr. ALLISON. We actually, Senator, now are offering the Hope for Homeowners, which is a principal reduction program—

Chairman DODD. Right.

Mr. ALLISON.—alongside the modifications, and it is important, first of all, to make home ownership affordable. And in solving for affordability, we are looking at each homeowner, that is the servicers are, and what they can afford to pay. There are incentives for both the servicer to modify a loan to an affordable level and for the homeowner then to make the payments on that modified mortgage loan.

Chairman DODD. So you agree that the principal reduction is the better way to go now?

Mr. ALLISON. I believe that both ought to be looked at and both can be important. What is most important is to make the home affordable now. So the servicer is going to be looking at whatever method seems to work best for each individual homeowner.

Chairman DODD. How do you feel about this, Mr. Apgar? What do you think is the better approach?

Mr. APGAR. I think that the evidence suggests that affordability is the key problem that homeowners face, that if you are able to get their mortgage payments down to some appropriate share of their income—31 percent of DTI is what we use in the program—that is the best way to help them maintain—

Chairman DODD. Well, I want them to get a better equity position in that home. If their equity position isn't going to improve, how are you going to convince that person to sort of stay, in effect?

Mr. APGAR. I also understand that folks are deeply underwater, or underwater at all and need some additional help, and that is where the Hope for Homeowners feature comes in. So again, getting affordability, I think that is the lesson that the FDIC experience demonstrated, that by achieving that 31 percent DTI, they could stabilize the family, avoid re-default, and help a large number of people, while at the same time we work on working to extinguish the overhang for people that are underwater. That is the Hope for Homeowners promise.

Chairman DODD. Do you also believe that if there is nothing that can be done for people, that we ought to then try to move that property? I mean, that is what I mentioned earlier, reaching a deci-

sion—some system in place where you arrive at a conclusion here. It seems to me we are sort of drifting.

Mr. APGAR. Well—

Chairman DODD. Weeks go by and there is no resolution. There is no conclusion as to whether or not that situation can be resolved and the other one cannot, and then deciding on a course of action.

Mr. ALLISON. Senator, we are going to be beginning to disclose on a servicer-by-servicer basis their performance, both how rapidly they are resolving issues on behalf of homeowners and how many modifications they are making. And we think that that type of disclosure, servicer by servicer, will be important to spurring greater activity on their part.

Chairman DODD. Let me get to the second mortgage issue. A witness on the second panel, an economist from the Federal Reserve in Boston, acknowledges that lenders have not been doing modifications over the past months and the modifications they have done have more often resulted in increased monthly payments. No surprise, then, that the re-default rates in those cases are very high. That is not a terribly enlightening statement, for obvious reasons.

The homeowner can't afford the original payment. It is hard to see how they would be able to afford an even higher payment. This is consistent with findings by many other researchers, by the way, not just the Federal Reserve in Boston, including those at the Federal regulatory agencies.

Mr. Willen, the witness I am talking about, goes on to argue that the reason that lenders aren't doing more modifications is because it is—his quote, "it is simply unprofitable for them to do so." What is your view of this conclusion? Do you agree with Mr. Willen? Mr. Allison?

Mr. ALLISON. Chairman Dodd, that information—I believe that study was based on past modification efforts. This one is substantially different. This one is geared to major reductions in the payments that homeowners are making. As you correctly pointed out, many of those prior modifications actually resulted in higher payments because the foregone previous payments were built into the future mortgage payments.

This approach is the first large-scale modification effort where homeowners will see their monthly payments in many cases dramatically reduced. So I would submit that the past data, while accurate for those past efforts, does not really apply to the program that we are undertaking today.

Chairman DODD. Well, I hope so. That just doesn't make any sense at all.

Mr. ALLISON. Right.

Chairman DODD. My staff has been briefed regarding the errors in the Home Affordability Mortgage Program, the so-called HAMP program, situations where people have been turned away, where upon a second look it turns out that they have been offered a modification. These errors are not uncommon, I am told. Why don't you make the elements that go into the modification decision, all the software, the net present value test, and the like public so that the foreclosure counselors can make sure people are treated fairly across the spectrum?

That would make people like Joan Carty, by the way, who we are going to hear from on the second panel, who I would hope—by the way, she is here in town for the day. She is a professional. She does an incredible job in Bridgeport, Connecticut, for us, really knows these issues. And I asked Joan. She says, “I need a system. I need a reliable, predictable system.” This is someone on the ground dealing with a massive amount of problems, and the sense is there is no system. There is nothing predictable and reliable about it.

And when you have got people like Joan Carty out there who are feeling frustrated, who are dealing with these issues every day, not feeling confident about a system in place where you get answers, and so why don't we make this stuff public so we have more transparency?

Mr. ALLISON. Mr. Chairman, let me address that in several ways. First of all, we will be working with the servicers to develop escalation procedures so that when homeowners believe that there is an unnecessary delay or they have a complaint about the way that their mortgage is being addressed, they can escalate that complaint to higher levels within the servicer. We also have the Hope Now website which has escalation procedures. Or they can go on the Fannie Mae or Freddie Mac websites.

Also, as part of this program, Freddie Mac will audit the mortgage modifications to make sure, first of all, that people who are qualified for a modification are able to get one, and second, to make sure that we aren't producing modifications for those who are not qualified and also looking at people who have been foreclosed on to see whether they would have qualified for this and some redress should be made.

Chairman DODD. I would hope, Mr. Allison, it might even today at some point—I haven't asked her to do this, or you, but people like Joan and others, that you might spend a little time and hear what they are going through on the ground. It isn't just this woman in my State, there are people like her all across the country—and listen to them as to what they need, because they are the ones literally struggling every day to try and come to conclusions on some of these issues. So I think it would be really worthwhile to listen to people every day who are struggling with these systems and have to make them work.

Last and very quickly, because I want to turn to my colleagues, is the issue on the second mortgage. Many of the big servicers agree to take some reasonable payouts for the second mortgage. They hold as the primary obstacle the use of the Hope for Homeowners program. You point out, as has been mentioned here already, the value of the home isn't even sufficient to cover the first mortgage, much less the second. Mr. Glovier in his testimony later this morning will point out that only 3 percent of second mortgages are current where the first mortgage is in a delinquency.

Shouldn't such loans be sold for pennies on the dollar, in many ways it seems to me? What has been your experience with this? Are the lenders being reasonable? And if so, what can we do to extinguish these loans? That is the major blocking point in a lot of these areas, as you point out, Mr. Apgar. What, if anything, can be done? Can we do anything? Is there anything that Congress needs to do to try and deal with this problem of the second mort-

gage issue, if that is the major obstacle? Can you give me a quick answer on this?

Mr. APGAR. Well, the key is offering fair loans and sorting out—fair offers and sorting out the instance where there is some value to the second liens and recognizing that and paying fair compensation, while not overpaying by not recognizing as a fact that many of these loans are deeply in distress and have limited economic value. As I mentioned, we are working with OCC and others with the Treasury team to come up with a fair compensation system. We have received maybe the initial Hope for Homeowners Program maybe didn't offer enough, especially in those cases where there was economic value, and got in the way of us moving forward on a wide range, recognizing the fact that in many instances it is pennies on the dollar is the right answer of what to pay for these second liens.

Mr. ALLISON. Mr. Chairman, to add to Mr. Apgar's answer, as part of the new second lien program that we are rolling out, we have already signed up the five banks that together account for over 80 percent of the second liens. So they are pledging to work to solve for affordability of the second lien alongside the modification of the first lien, and we think this will go a long way to assure greater affordability for many more homeowners.

Chairman DODD. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Steps to combat fraud—it is my understanding that the Special Inspector General for the Troubled Asset Relief Program made a number of recommendations to Treasury to address concerns about vulnerabilities in the Home Affordable Modification Program Senator Dodd was talking about, the HAMP. Among these recommendations were requiring third-party verified evidence that the applicant is residing in the subject property, requiring notarized signatures and a thumbprint of each participant, and mandatory collection, copying, and retention of copies of identification documents of all participants in the transaction at closing.

Secretary Allison, what actions has the Department taken to address these specific recommendations? Additionally, describe broader efforts that Treasury is taking to prevent fraud in this program.

Mr. ALLISON. Yes, sir. Senator, thank you for your question. It is a very important issue, making sure that in this program, where we are going to be spending a sizable amount of taxpayers' dollars, we are protecting the taxpayer, as well.

That is one reason why we have been taking quite a bit of time and effort to make sure that we have fraud prevention built into this program by requiring appropriate verification and also why we have appointed Freddie Mac to audit this program, to look for signs of mortgage fraud. We have also been working with agencies across the government to assure enforcement. Where we find fraud, we are going to enforce the laws and the rules of the mortgages to the greatest extent possible.

Senator SHELBY. Mr. Apgar, since Hope for Homeowners was created last year by the Congress, the program, it is my understanding, has only refinanced one mortgage—one. Clearly, this is a regrettable policy failure. While recently enacted changes to the program will hopefully improve its success rate, it appears that the

Hope for Homeowners will help far fewer borrowers than the hundreds of thousands that the program sought to help. Why has Hope for Homeowners not been more effective? In other words, why the failure?

Mr. APGAR. Well, as I mentioned, the original formulation had complex servicer requirements that weren't standard to the industry and many servicers did not feel it was appropriate to—

Senator SHELBY. Explain what you mean.

Mr. APGAR. Requiring additional borrower certifications. A particular instance was the servicer was required to verify that the borrower had not committed mortgage fraud for the last 10 years. Many servicers said that they didn't have the capacity to verify that, and so in reform of the program, that particular feature was removed.

In addition, I also believe that at the time, the industry was not ready to begin to recognize the depth of the crisis that we are encountering and many first lien investors were not prepared at that stage to take the necessary haircuts in order to make the program a go. As you know from the discussions of the revitalized Hope for Homeowners, that many of the first lien investors are now saying we prefer to take a haircut on the mortgage in the context of Hope for Homeowners refinancing in order to get a clean exit. What that does is give them cash now, minimizes any re-default risk they might encounter if they continue to work with that borrower, and avoid any further loss in property value should property values continue to decline.

So we think that the Hope for Homeowners now is a program that will be embraced by first lien owners and will be more widely utilized.

Senator SHELBY. Without a huge haircut—Senator Dodd was talking about reducing it down to something people can pay, realistically afford—aren't we wasting our time here? In other words, as we continue to lose more jobs, the expectations of people making higher mortgage payments, that is an illusion, isn't it?

Mr. APGAR. I think that any holder of these mortgages that believes that hanging on is a better strategy is a false promise. The program isn't demanding the haircut, the market is demanding the haircut. The values of these homes are discounted. The question is, what is the best that the investor can realize in terms of, as I said, getting a clean exit. Hope for Homeowners for many is the preferred exit strategy because it gets the borrower in a good situation and it gets them out of the loan at hopefully a fair approximation of the current market value and reduces the foreclosure cost of getting to it.

Senator SHELBY. But whatever we say or do policywise, or you implement the policy, if the market doesn't respond to it favorably, it is not going to work, is it?

Mr. APGAR. You have to pay attention to the market interest. There is no doubt that we have seen a significant decline in housing prices. The housing prices then have made it difficult for the owners of these securities, and that is the reality that any program has to address.

Senator SHELBY. Secretary Allison, Treasury earlier this year released information stating that the Home Affordability Mortgage

Program—I will just call it HAMP—will use \$50 billion in TARP funds to modify mortgages. It is also my understanding that Fannie and Freddie will provide additional money to assist homeowners with loans on their portfolios.

My question is this. How did Treasury determine the amount of funding it would allocate through TARP to drive HAMP initiatives and incentives, and to what extent do you think more money may be needed than was originally allocated? Second, will you provide this Committee with the data and analysis that was used to determine the appropriate levels of funding that might help us understand what road we are going down?

Mr. ALLISON. Senator, in answer to your last point, we will be glad to provide you with the underlying information. I think it is important to point out at the outset that this is a pay-for-performance approach. We will pay servicers—most of their payments depend on their performance over time. Also, the incentives for individuals depend on their continuing to pay their new reduced mortgage rates going forward.

We currently have set aside about \$18.6 billion for the first loan modifications. We will be setting aside some additional amounts for the other programs that we are rolling out toward the end of this summer. We have based this on projections about what success might mean over time and the goals that have been set for this overall 3-year program. But again, I want to point out, this is a pay-as-you-go program.

Senator SHELBY. Mr. Apgar, will you share your data with this Committee?

Mr. APGAR. For sure.

Senator SHELBY. OK. Last question. Mr. Chairman, thanks for your indulgence here. Mr. Apgar, given your role at HUD, you must spend a considerable amount of time analyzing what happened in our housing market over the last few years. Could you please discuss what you view as the primary reasons for the dramatic uptick in foreclosures as well as the broader cause for the escalation then subsequent deflation of home values? What is your view? You are into the depth of this.

Mr. APGAR. Thank you. Prior to coming to HUD, of course, I worked for the Joint Center for Housing Studies and did extensive research on the housing foreclosure crisis and so I do have a view, both educated by that work and also from my experience now at HUD. My sense is that at the core of the problem was aggressive mortgage lending fueled by a strong demand for mortgage-backed securities on the part of Wall Street investors and others, and that in the rush to do these mortgage loans, some of the cautionary tales that are common in the mortgage lending business were put aside.

People were placed into mortgages they neither understood nor could afford to pay. Prime mortgages, if they didn't reach the goal, were topped off with very risky second liens that took a prime loan that looked like it could be secured and turned it into a loan combination with a hundred or plus LTV at the beginning.

Once those loans began to go bad, of course, the problem just radiated out, and it was the downward pressure on prices that came

from the foreclosure and delinquencies of these difficult mortgages that was the seed that set off the financial crisis.

Senator SHELBY. It is going to be difficult to deal with, isn't it?

Mr. APGAR. Putting Humpty Dumpty back together is a very difficult situation, there is no doubt about that.

Chairman DODD. Thank you, Senator Shelby.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Mr. Apgar, your testimony suggests that the Administration is exploring a series of programmatic options that can help unemployed workers get the mortgage assistance they need, which suggests perhaps direct assistance to homeowners. There have been a couple of proposals. One is simply to avoid going through the servicer route and just subsidize individuals so they can pay their mortgages—

Mr. APGAR. Mm-hmm.

Senator REED.—or some folks have proposed creating a mechanism where title might pass formally but the individual can stay indefinitely as a renter, paying a suitable rental fee.

Two questions. One, what types of assistance are you thinking about, and second, given the record of the difficulty of getting these programs going, can we jump start any of these types of programs that you are contemplating?

Mr. APGAR. Well, thank you for your question. We are, in fact, exploring other options relative to both unemployment and other elements to help keep folks in their home, as you suggest. Of course, one of the primary focuses on the unemployment thing is to make sure the economy returns to growth and that people don't experience unemployment because we have a growing job sector. Extending unemployment benefits can be a direct way of helping people tide over and not force the difficulties faced when folks have loss of income and therefore can't pay their mortgages and can't in some instances even qualify for a modification program because they don't have even sufficient income to support a drastically written-down mortgage.

We are also exploring other options related to how to provide assistance to unemployed folks. Those are in the formative stage. I have nothing to report on that. But it is safe to say that unemployment is making the job of doing modifications more difficult and we recognize the importance of exploring those issues.

On keeping people in their homes, there have been a lot of proposals of these so-called fast foreclosures, where the foreclosure happens but the homeowner stays in, and we know there are some proposals like that, that are being circulated. I get them on a regular basis. And so I just say on that that all proposals that will help provide relief to borrowers in their home and deal with the negative effects of foreclosures on communities are being explored. I wouldn't say that that set is particularly at the top of the list, but that all options are under review because we have to get a program that works.

Senator REED. Well, thank you very much. I think, as a comment, what is most frustrating, and indeed infuriating to people is that we did unprecedented things to help support the largest financial institutions in the country in order to sort of stem what we,

I think reasonably believed could be a global financial meltdown. My perception today is this mortgage crisis is of the same scale in terms of threatening our economy and perhaps world recovery, and if we don't take such aggressive action, if we don't urge all the participants to take such aggressive action, we are not going to be able to stabilize the economy and foreclosures and unemployment back home are interrelated. We have got to move aggressively on both fronts.

Mr. Allison, again, you indicated that these new programs, revised programs, have resulted in about 325,000 modifications. But unfortunately, it seems that the number of foreclosures are accelerating and that even with this improved performance, we are not catching up. What is your sense of that?

Mr. ALLISON. Senator, first of all, let me correct the numbers. I was reporting that about 325,000 offers of modifications have been issued. The actual number of modifications now in a trial phase is about 160,000. It is growing very rapidly. And so as you point out, it seems likely that the foreclosure rate will increase, the numbers of foreclosures will increase. This program is also ramping up very quickly. It is actually only about 10 weeks since the servicers began offering this program and we already have 160,000 mortgage modifications in the trial phase and we expect this number to continue growing rapidly for some time.

We are not even stopping there. A number of these servicers are just starting to ramp up. We are meeting with them, as I mentioned, late next week, bringing them into Washington to talk about how they can further accelerate their programs and how we might help them. We are urging them to hire more people, to expand their call centers, to improve their systems. We are also creating—we are working with an outside systems firm that services most of the servicers, provides service platforms, so we can get streamlined input and keep closer track on the progress that the banks are making.

So even though we are making rapid progress, we think we can do even more to accelerate and try to get out in front of this foreclosure problem, to the extent possible.

Senator REED. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Reed.

Senator Bunning.

Senator BUNNING. Thank you. Gentlemen, your reports are stunning, to say the least. Most of us who sit at this desk up here have watched this crisis from the very beginning. I don't know how long you have been in your jobs, but if you expect me to believe that Fannie and Freddie are watching the store when they are 100 percent kind of owned by the Federal Government, you are asking the impossible.

Most of the problems with the economy stem from a law that was passed in 1994 when we, the Congress, gave the power to watch over mortgages, both banks and mortgage brokers, to the Federal Reserve, and for 14 years, not one regulation was written—14 years. Now, that is a pretty good time. They didn't do anything, zero. And you are sitting here and telling me all these wonderful things that you are doing, and I am like Jack Reed. The mortgage crisis is escalating, not rescinding. It is escalating.

We had some numbers today, and Senator Dodd brought them out, about foreclosures, but they have projected an additional 1.5 million foreclosures for just this year, in addition to the ones that we already have. So we are not even making a dent.

So what does that mean? That means for our economy to recover, we have got to stop the spiral down and we have got to get credit. You can't get credit if you don't have a job. I mean, give me a break. You are telling me about the programs that you are having for people that don't have jobs. They can't pay anything unless they have saved a lot of money, and then they wouldn't have a problem with their mortgage if they saved a lot of money. We are talking about people who live from paycheck to paycheck, and when they don't have a paycheck, they can't pay a mortgage. So they are going to do the best they can to get in and out of a house with the least pain to that family. Now, there is going to be pain for everybody concerned, including the kids.

So all those wonderful programs that you are talking about mean absolutely nothing to the American people that are still losing their houses. You may be stopping, as Mr. Allison said, you have 150,000 people that you are trying to service out of 300,000-and-some, but that doesn't mean anything because we are losing 350,000 more foreclosures this month.

So give me a break and tell me when you think you can stop the bleeding. When? When are these programs that this whole Committee put together and handed you and said, with your help, with your input, that these could help the people that were in stress, when are you going to stop the bleeding?

Mr. ALLISON. Senator, we share your sense of urgency. This entire Administration is working very hard to deal with this crisis. And as you know, President Obama and the Administration announced and the Congress approved an \$800 billion package aimed at economic recovery. That money will be expended over the next—

Senator BUNNING. So you used TARP money instead of the stimulus money?

Mr. ALLISON. Sir, we are actually using the economic recovery package that the government has enacted, and also on top of that there is the—

Senator BUNNING. Will you please answer my question?

Mr. ALLISON.—mortgage and homeowner affordability.

Senator BUNNING. When are you going to stop the bleeding?

Mr. ALLISON. We are working very hard to accelerate this program. This program has actually been—

Senator BUNNING. When do you see the bleeding stop?

Mr. ALLISON. We are moving as fast as we can to get out in front of the problem. We are well aware that there are about 360,000 foreclosures a month and we expect this program to reduce that number—

Senator BUNNING. My last question. We just had a meeting with Sheila Bair, who is the head of the FDIC. She is a pretty honest lady and tells us like it is. She told us that unless something dramatic happens, that we could lose up to 500 more banks—up to. She didn't say that that was the exact number. But that means that those people that make mortgages in local places, local com-

munity bankers, bankers who are closest to the people that really could help in a foreclosure, will not be there.

So 500 additional, besides this morning we learned that CIT is going to go financially bankrupt and that Citicorp is not far behind. Well, Citicorp is part of the solution, according to some of the documents that I have. If they are not there to help, where do we go? Where do we go for help?

Mr. ALLISON. Senator, if I may, we recently, several months ago, reopened the capital purchase program for smaller banks in local communities. We are also concerned about making sure that lending is available to small companies throughout America.

Senator BUNNING. Well, it has been a failure.

Mr. ALLISON. Well, it has actually—we have helped over 600 banks that were viable banks—

Senator BUNNING. But there are 8,000-plus banks, so what about the rest of them?

Mr. ALLISON. We have offered this program to all banks who are viable, and so far—and many are already well capitalized. I think that one of the issues you are talking about—

Senator BUNNING. Thank you for your patience, Mr. Chairman.

Mr. ALLISON. Yes, sir.

Chairman DODD. Thank you, Senator.

Senator TESTER.

Senator TESTER. Thank you, Mr. Chairman.

I want to express my appreciation for both of you being here today. I thank you for that.

I want to start out by going back to what Senator Shelby had talked about in his opening statement and that is about policies that result in a stable and sustainable marketplace. I think that is ultimately what we all want in the end. I know you could spend my entire 5 minutes talking about it, Mr. Allison, but I hope you could be as succinct as possible. Do the policies that we have in place right now, from your perspective, are they enough? Are they adequate to result in a stable and sustainable marketplace in the housing industry?

Mr. ALLISON. Senator, we believe that the actions that we are taking can make a material difference, especially for working Americans. We are going to be reducing one of their largest monthly expenditures, those who are qualified, by reducing their mortgage payments. We are also offering refinancing approaches to many Americans, as well.

Senator TESTER. I understand that. The question is, have we done enough or are we kind of like a mole on an elephant at this point?

Mr. ALLISON. Well, this, as I mentioned in my testimony, Senator, was a problem years in the making.

Senator TESTER. Yes.

Mr. ALLISON. It is a huge crisis.

Senator TESTER. There is no doubt about it.

Mr. ALLISON. We all appreciate that. We are taking what we think are well thought through, deliberate, and aggressive actions. This is already—we should point out again—the most successful modification program ever run and it is just beginning and we are

intent on expanding this program dramatically, as fast as we can. This Administration inherited a huge problem—

Senator TESTER. You are right.

Mr. ALLISON.—and it is doing its best to deal with it as rapidly as possible.

Senator TESTER. And I appreciate it, and it is not an easy task. I guess the question that I need to know from a policy standpoint, do you have enough tools in your toolbox at this point in time to adequately address the problem?

Mr. ALLISON. Senator, I think we have enough tools. The challenge is to roll them out. We have got to reach as many Americans as possible, educate them about this program so that they understand what help is available, and we have to have the capacity to handle the demand. And we have been building capacity, working with the services as rapidly as possible. We are not satisfied.

Do we have adequate tools? We think if we can roll this program out at the pace we expect, we will make this program available to all qualified homeowners who wish to avail themselves of it.

Senator TESTER. And the program you speak of is all three of them, or is there one in particular?

Mr. ALLISON. Yes, sir.

Senator TESTER. All three of them?

Mr. ALLISON. Yes, sir.

Senator TESTER. OK, which brings me to my next question. Can you give me a timeline for when they will be fully operational?

Mr. ALLISON. Well, again, I want to be very careful about this, because one reason why we are bringing the servicers in at the end of this month is to ask those very same questions of them. How fast can they ramp up to serve the American public, and what can we do to help them further? We want to work with them as closely as possible. We are monitoring them every day. We are in continuous contact with the servicers. And I know that we are going to have much greater capacity every month for the next several months.

Senator TESTER. OK. In your opening statement, you talked about a myriad of outreach things that you were doing. I assume it is not only to homeowners, but also to servicers and maybe others.

Mr. ALLISON. Yes, sir.

Senator TESTER. Are those outreach—number one, is it adequate? Do people that need help know that there is help available and know how to get through the myriad of, as with anything, the myriad of forms and people to get hold of and all that? And what is the best way, in your opinion, to reach out to the homeowners that have problems so that they know that there is help out there?

Mr. ALLISON. Senator, I think that is a very important question and we have to reach homeowners in multiple ways. We are going out and holding events. At the event in Miami, we had several thousand people come and we were helping them to fill out the forms on the spot. We are doing the same, as I mentioned, in Sacramento today. We are going to other communities around the country. But that is just one measure. We have to work with local counseling agencies. We are using the Internet to get the word out, as well. We have to be on television. We have got to be doing as

much as we can, many different approaches, and we have to reach people many times.

Senator TESTER. Can you tell me at this point in time what the rate of turn-down is in participation?

Mr. ALLISON. I can't give you yet a really good estimate of that, and the reason is, as I mentioned, for instance, right now, we have, as I said, 325,000 offers right there. The number of trial modifications will lag the number of offers, as you can understand. So right now, we have about 160,000 trial modifications. We haven't yet completed any significant modifications because that takes 3 months in the trial period. So in August, we are going to start to see actual modifications. So this is still early and I think it is premature for me to give you a definitive answer to your very good question.

Senator TESTER. We would love to have it at some point in time.

I am sorry, Mr. Apgar, I didn't fire more questions at you.

I appreciate—these are difficult times and there is a level of frustration here that is high. We appreciate your work and we look forward to working with you to try to get this problem solved into the future. Thank you.

Mr. ALLISON. Thank you.

Chairman DODD. That question that Senator Tester has raised with you about the tools in the toolbox, we need to know from you. There is no lack of willingness up here to step up if you give us some idea of what additional tools are needed. Our frustration is, we see these numbers continue to go up. We think we are trying to address the issue. We turn around and we watch the numbers get worse. And, of course, we are being asked every single day by our constituents and others, what is going on? You have got money you put into this. You crafted designs and programs to get things done and the numbers continue to rise.

So you are getting a sense of the frustration we are feeling, and you feel it at the local level. As I say, you are going to hear from some people later today if you hang around who are out there at the street level that are as frustrated as we are, and they reflect those frustrations to us.

So we need to know. You are not going to find unwilling members here to want to respond, and quickly, if there are things that we can do to assist you to get this done. But you need some clarity in the system. It needs clarity so that people know what the rules are and how to apply them and make it work, and that is going to be critical.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and I thank both of you for your service and for being here and for being involved in this really complex issue.

I am going to take a little different tack. No doubt, I wouldn't be in this body, I don't think, if I had not been involved in trying to make sure that people had affordable housing as a young man, and that civic and nonprofit activity led me to this place, no question. So I want you to know I have tremendous empathy for people who especially have children and living in a home that have to vacate it because of foreclosure and loss of jobs, and I understand that is a tragedy for many people across the country.

But I am going to take, again, a little different tack, because I am not under any illusion that you will ever really catch up with this. I know that you are trying hard. I talked to a lender yesterday who said one of the biggest problems is the program continues to change. So every time they get set up and ready to execute, there is a whole new set of rules, and that is because we are chasing this thing from behind, and I know this. It is very unlikely we are going to catch up, and I am under no illusion you are going to solve it. I think your efforts will improve. But I think the only thing that is going to resolve it is a turn-around in the economy and things stabilizing. But I thank you for your efforts, OK.

The tack I want to take is this. I know that \$50 billion is coming out of TARP for this. I know that most of us thought that the TARP money all was going to be repaid because we were going to invest in things that had value. And I realize there were clauses in here that allowed this to occur and I am not debating that. And I realize both Administrations have invested money out of TARP that is not going to come back, so I am not—but the fact is, this \$50 billion is gone once it is spent. I mean, it is not invested in something the taxpayers will get back.

It seems to me that there are numbers of different classifications of borrowers. I mean, Mr. Apgar, you alluded to the fact, I think—I was daydreaming, I apologize, for a second—but you alluded to the fact that I think one of the biggest problems was 100 percent loan-to-value, and that is why we are having this problem. And so we had so many people in this country that put down 3 percent, and some of that was loaned to them or given to them by the seller. And so we had people that, in essence, were really renting houses. I mean, they didn't really own a home. They did in document, but they put no equity down. I think the staff have shown us, those people who put equity down, candidly, have not been foreclosed on in large.

I am wondering if we should treat homeowners that were in essence renting their houses—they basically got somebody to give them a nonrecourse loan and nothing down—if we should focus on them the same way that we focus on those people who actually—and I know there are far less of these—actually had equity in their homes.

And then I love—actually, just answer that briefly, if you would. I have one more question. I will stop.

Mr. APGAR. Well, I will take it, Senator. I will take a shot at that. It is true that folks who have limited equity in their home or no equity, as you suggest, are more likely to quickly get in trouble in economic instability times and more likely to lose their home to foreclosure. We can't pick and choose which side of the line we work on because when a house goes to foreclosure, it provides such blighting influence on a neighborhood that the neighbors are harmed, as well. And as house prices go down, it is indiscriminate in terms of folks that once had good equity in their home are now underwater just along with the folks who had limited equity are underwater. So we have to work with both groups.

I do believe that we need to think real hard about the role of low downpayment lending in whether or not that is a helpful path to home ownership.

Senator CORKER. And I hope that, at some point—I realize in the middle of a crisis, maybe that is not the time, but I think we should look at that, and I think that most of us realize that in a push to create affordable housing for everybody in America, we actually have created a big part of this problem because there was no equity. And then we have done away with the recourse side of loans, which has made it even worse, and I would like for us to focus on that at some point. I think that is a huge issue.

But I want to ask my one last question. The reason I brought up the \$50 billion and the reason I brought up the fact that so many of these people are basically renting a home, because they put no equity in it, OK, we are expending huge amounts of taxpayer monies in other ways, too. It is not just this \$50 billion. And I wondered, Herb, if you might talk to us a little bit about the liabilities that you believe we are creating at the GSEs, Fannie and Freddie, because there potentially, the way I see it, is going to be a large trailing liability that we may be creating at those organizations by continuing to sort of chase this mortgage problem the way we are. If you would give us some insights into that. And I hope at some point—I think we will—we will look into that as a Committee, but if you could share that with us today, I would appreciate it.

Mr. ALLISON. Thank you very much, Senator Corker. First of all, you have mentioned correctly that we may spend \$50 billion on the homeowner affordability programs. These expenditures can be also viewed as investments that will have returns in the form of housing prices higher than they would have been had we had more foreclosures. So that is a type of return to the American public. And also, we are making payments to individual homeowners for successfully continuing to pay on their modified mortgage, which is also money they can be spending and putting back into the economy. So I think there is a kind of multiplier effect.

Senator CORKER. What I meant for the taxpayers, I am talking about like a return on investment—

Mr. ALLISON. Yes, sir.

Senator CORKER.—which you are very familiar with in your previous life, so—

Mr. ALLISON. Yes, and you are absolutely correct, Senator. Those are, from that standpoint, expenditures. We are not going to get a direct return back on those, but I think we will get an indirect return.

As to the liabilities of the GSEs, I would answer it the same way. I want to point out, I think that the GSEs are performing an extremely vital role in this program and I think they are off to a very good start. They have—they account for about half the mortgages in the United States. They have great professionals there with great knowledge and a lot of capability.

We are, as you know, the government has provided an additional \$200 billion to the GSEs to assure that they can play an active role in the mortgage modification programs going forward. Again, I think that their ability to be actively involved in the modification program is going to provide returns to the American public.

Senator CORKER. I know my time is up, but it is further digging a hole for the GSEs to play the role they are playing in these mortgage modifications, isn't that correct?

Mr. ALLISON. That is correct, sir, that there are additional expenses that they will be incurring as a result of this, but we have also provided about \$25 billion available to the GSEs for their expenses in this program.

Senator CORKER. But that is, again, taxpayer money.

Mr. Chairman, I do hope at some point we will look at the collateral damage that we are creating, just to sort of be able to tally up the true cost so that we ourselves will know, and I apologize for going beyond my time.

Chairman DODD. No, that is all right, and it goes to the point, I think, to speak for myself, I am prepared to make some of these investments provided we get some results. My frustration here is not so much that you are making these investments, that in fact we are getting the indirect return on the investment because we are keeping people in homes, the economy is stabilizing, the institutions are, I think that is a tradeoff I can make a case for. What is frustrating is that we make the investments and we see the problems continue to escalate. That is the frustration I feel in all of this to some degree. But obviously, it is an important question, and we need to look at it, and I have told Senator Corker that we will, in fact, have a public hearing on that issue, as well.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman, and thank you for your testimony.

I wanted to get an overview here. Under Hope for Homeowners, I believe the testimony is that only a handful of new mortgages have been written. A handful is one, or is a handful a dozen, or is a handful a thousand?

Mr. APGAR. I think it is safe to say that a handful is very few. The technical answer is that there were over 50 mortgages actually closed, but because of the processing delays and problems with the way in which the program was done, only one actually moved to actual insurance. So 50 homeowners got the benefit of the refinancing, but FHA only insured one mortgage.

Senator MERKLEY. OK, so 1 to 50?

Mr. APGAR. Yes. Not enough to talk about.

Senator MERKLEY. All right. And under the HAMP program, the Home Affordability Mortgage Program, I believe the testimony was 160,000 modifications?

Mr. APGAR. One hundred and sixty thousand completed trial modifications, yes.

Senator MERKLEY. Why do you say trial modifications? What is that meant to signify?

Mr. APGAR. Well, I will take a shot and I will turn it back to my colleague, but—

Senator MERKLEY. Very brief, because I have lots of questions.

Mr. APGAR. It takes 3 months to prove that the borrower can handle the new modification program, and then they go to a permanent modification.

Senator MERKLEY. I see. OK, great. Then under the HARP program, the Home Affordable Refinance Program, how many refinancings have taken place under that?

Mr. ALLISON. The total number of refinancings, this year, number at least two million. However, if you look at the modifications

of loans with a loan-to-value ratio above 80 percent, the program, that is about 43,000 so far. And the pace of refinancings depends heavily on interest rates. Recently, interest rates have risen somewhat on mortgages, which tends to slow the number of refinancings.

Senator MERKLEY. So refinancing is about 43,000?

Mr. ALLISON. With loan-to-value ratios above 80 percent, yes.

Senator MERKLEY. OK. Let me lay out my frustration. If you take the roughly 200,000 families that have been assisted through this—and another question I have, and you may not know the answer but if you do I would like to know it—is kind of the cost that goes into each one of those, on average. Is it \$10,000 per family? Is it \$20,000 per family? But let us say it was \$10,000 per mortgage in terms of costs to the citizen. We would be looking at roughly \$2 billion that have been spent to assist homeowners.

Now, \$2 billion is a significant number, but the contrast is stark between an extraordinary, enthusiastic, eager, generous effort to assist our major financial institutions, which was extremely important in order to stabilize our economy, and what has just been a dragging through the mud, slow, difficult, we will try this, we will try this, and here we are at one mortgage under Hope for Homeowners and only about 200,000 with the other two programs. There must—we need the same attitude with which we approached assisting our banks to assist our working families.

I know that as you lay out the details it is complicated, it is difficult, but somehow, it is just hard to explain to the working families in America how it is we could move so fast with extraordinarily complicated deals with the huge financial institutions and we are moving so incredibly slowly, mired in paperwork, in rules. In talking to the banks back home, they are complaining that every couple of weeks, they get a different version of the rules and the citizens can't get through to folks who can make the modifications, and we just don't seem to be applying the same levers of government to move quickly for our families that we have moved on with our major financial institutions.

Just kind of your thought about that contrast and how we can possibly get the same level of energy and effort to help our working families.

Mr. ALLISON. Senator Merkley, thank you, because that is a question on everybody's minds, and we are as frustrated as anybody. This is a crisis that began about 2 years ago. This Administration has been in office now for 5 months or so. This program was announced early in the Administration. This is an all new, very aggressive, dramatic program. It was really launched in terms of actually beginning to work with homeowners about 10 weeks ago.

Already, we have 160,000 modifications underway. I know that in comparison to the damage that has already resulted from this crisis, this seems like a small number. It is growing rapidly. We are doing all we can to grow it as fast as possible.

You correctly point out that this is a complicated business. It has taken some weeks just to set up the program. Mortgages are very complicated. We have to work with many different servicers. We

have to make sure that they are totally involved in this program, they are totally committed to it.

I think as my colleague, Mr. Apgar, said, they are past the stage where they were wondering how much they needed to be involved. I think more and more, they are fully committed to this program and that should result in even faster roll-out.

We want this to happen as rapidly as possible. I think even though this crisis is several years in the making already, we have to keep in mind that this program started just weeks ago. We all wish it had started a lot earlier. But here we are and we are trying to make it work as rapidly as we possibly can.

Senator MERKLEY. Do you wish to add anything?

Mr. APGAR. Well, with respect to the Hope for Homeowners Program, there is no doubt that 51 mortgages is not going to help the economy stabilize. That is why immediately in February, we proposed bold new reforms for the Hope for Homeowners Program, including taking this, what once was a stand-alone program and nesting it in the harder Making Home Affordable Program, so that people have the option to both get a modification or, where it made sense, a mortgage write-down under a Hope for Homeowners Program. We worked with the Congress to make sure we got that perfecting legislation. It has now been enacted, and we are busy rolling—putting that in place. We think that the new Hope for Homeowners will perform substantially better than the flawed program that we inherited at the beginning of the year.

Senator MERKLEY. Well, I certainly wish you Godspeed in pursuing this and appreciate your effort to expedite it in every possible way.

I would like to follow up, because my time is out, but follow up with my staff and get details on the 160,000 modifications. One of the things I have been concerned about is that some modifications are better than others, and modifications that we saw early on, where simply a family was told, well, you don't have to pay for 3 months, but then you have got to make it up over the next 12 months, the payments actually went up, really didn't help the situation at all. I want to get a better understanding of what share of those 160,000 modifications actually represent paths to avoid foreclosure and will be a solution.

Mr. APGAR. Well, just a quick answer on that. One hundred percent of the modifications that are being done brings the homeowner to a 31 percent DTI. They are deep, true modifications, not the things that were passing off as modification which actually increased the borrower's payment in some of the earlier reports on modifications.

Senator MERKLEY. That is excellent. Thank you.

Senator Menendez.

[Presiding.] Thank you.

Senator JOHANNIS.

Senator JOHANNIS. Thank you, Mr. Chairman.

Secretary Allison, how many homes would be in foreclosure today? What would the total number be?

Mr. ALLISON. I am not sure of the exact number, but it numbers—the numbers are far too high.

Senator JOHANNIS. And how many go into foreclosure every month?

Mr. ALLISON. I think we are seeing several hundred thousand a month.

Senator JOHANNIS. Is that accelerating or is that declining, that monthly number?

Mr. ALLISON. I think we are seeing that as unemployment has been rising, the rate of foreclosures has risen to an extent.

Senator JOHANNIS. I have an impression that as we have gone through this subprime mess, that part of what we are dealing with now, and I wouldn't know how to quantify it, I haven't even read any statistics about it, but that we are now moving into another phase of foreclosure-related problems related to unemployment rising and people, if they don't have a paycheck, even with unemployment, they are probably in a crisis very quickly. Would that impression be accurate?

Mr. ALLISON. Well, we certainly are seeing that while early on, excessive speculation accounted for a lot of the foreclosures, now certainly unemployment is a major factor. And that is why the Administration has also introduced and the Congress has approved the Economic Recovery Program. That is the \$800 billion of expenditures between now and the end of 2010.

Senator JOHANNIS. Here is what I would suggest to you. I didn't vote for that because as a former mayor and a Governor, I couldn't figure out how there was any possibility that that would be a job creator. I just didn't see it. At least initially, we aren't seeing it. Some have even gone so far as to call it a flop. Whether it is or not, time will tell. But if that doesn't work, if, in fact, the three to four million jobs that were promised by the President don't occur, how much worse does this get?

Mr. ALLISON. Well, I think all of us have to be intent on doing the best we can to ameliorate the problem, and I think that the Administration, with the support of the Congress, has enacted very, very bold programs to deal with this extremely serious crisis.

Mr. ALLISON. Let me come at this from another angle. I look at these huge foreclosure numbers. I look at the really paltry amount of impact that you are having at this point, and it is. It is very, very small. And I understand the situation with the new Administration. But here is my struggle. I see these extravagant promises in just about everything that happens here—and I am new to this, too, myself—and then I see this terrible execution. You know, the stimulus money isn't getting out. You are not getting on top of the foreclosure numbers. And that has nothing to do with what you inherited. Execution is what you do every day.

Tell me when you break through here. Tell me when you are up and running and going and the next hearing—when can we invite you back for a hearing where you say, boy, I know when we were here in July, it was pretty ugly, but now we are hitting on all cylinders and we are doing exactly what you want us to do. Is that a week away? Is that a month away? Is that a year away? When will you be able to assure us that the program is firing?

Mr. ALLISON. Senator, my expectation is that sometime in the fall, we will probably be at the near capacity on this program in terms of scaling. We are working very hard to do that. But we will

not rest even then. There will still be more we can probably do. We are constantly reevaluating the program, even at this very early stage, to see how we can do it better. We have got to be in touch with the American public, the community groups, the banking system, with the Congress, obviously. We have to be reporting to you, and beginning next month—

Senator JOHANNNS. So—

Mr. ALLISON.—you are going to see more complete reporting on how well this program is working so we can all assess its effectiveness together.

Senator JOHANNNS. So if we say fall is October 15 and you are at capacity at that point, what is capacity? What can I write down on a sheet of paper here, and when you are invited back I can remind you that you told me by fall, and I picked the date October 15, that you are at capacity? Tell me what that number is.

Mr. ALLISON. Well, what I mean is we have signed up now servicers representing about 85 percent of the total mortgages in the country. We can still reach more servicers to get at the rest of that 15 percent and we are going to try hard to do that. But with the 85 percent now covered, we want to make sure that these servicers are scaling as rapidly as possible so they can reach all of the eligible homeowners, and that is going to take some time.

I want to point out again, this was intended to be a multi-year program, as is the overall Economic Stimulus Program, and it is going to take time to implement, unfortunately, all of these programs.

Senator JOHANNNS. Here is what I would tell you, though. Those weren't the promises made. You know, the promises made were very vastly different on the economic stimulus package than what you are trying to sell me on today. And I am just saying to you that if you can't tell me how many homes will be impacted monthly by the time you are fully ramped up, I don't know what you are heading toward and I don't know how \$50 billion is therefore going to be effectively spent, and that is my point.

I have started new administrations as a mayor and a Governor. Sir, you always inherit something, and you know what? You are going to leave something behind for the next people. It is just the reality of life. But it is the execution that I think is just desperately worrisome here. And if you can't articulate what the goal is, how do you even rally the troops back in your office to get to whatever?

I walk away from this hearing not better informed about what that is going to be and I think that is a serious flaw in what you are doing.

I am sorry I am out of time, but those are my thoughts. I just think if you can't tell us what you are headed to, what your goal is in terms of number of properties you are going to deal with each month, we will be flailing around with this 2 years from now and it will be regarded as a failed program, a costly failed program. Thank you.

Senator MENENDEZ. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman.

I wanted to, now that we have gotten around the horseshoe here, share a really typical story that I get in my office or when I am traveling the State and I think it is typical of what people on this

Committee hear about every day, and this comes from David Croach of Aurora, Colorado, who is a former Air Force Security Police Officer.

Last year, David was laid off. He found another job, but was laid off again and has been looking for full-time employment since March. From a part-time job, David makes about \$20,000 a year, down from his former salary of \$61,000 per year. In a letter to my office, he wrote:

I have a 14-year-old son and am doing the best to make ends meet. Unfortunately, ends aren't meeting anymore. I have exhausted my savings, had to disburse my 401(k) to pay bills and attempt to save my house.

After calling the Colorado Foreclosure Prevention Hotline, David was referred to a HUD-certified counselor who recommended that he apply for a loan modification. Unfortunately, David was told by his mortgage lender that he made too much money to qualify for a loan modification. Instead, the bank offered to take his overdue balance and put the balance back into the loan, which would have increased his payments. The bank wouldn't consider any other options.

In discussing his situation with my staff, he noted that every time he turned around, the answer from his lender was no. He filed for bankruptcy on May 28 and foreclosure remains a serious threat.

We hear about these stories on a daily basis, and I appreciate your efforts, by the way. Thank you for your service. I am wondering, as this gets ramped up, as people need to hear the information that you are providing, the trips to Florida and to the Northwest you talked about, whether there is some way we can work with lenders to forestall some of these foreclosures as the program gets ramped up, to be able to, where possible, have some sort of moratorium that says we are not going to foreclose paying loans during this period of time.

And I realize there are all kinds of unintended consequences of what I am talking about, but the shame here would be if the inability to be able to get the money out, the inability to be able to have people understand the procedures and processes leaves us in a situation where foreclosures that could have been avoided aren't. And as you were saying earlier, the effect of a foreclosure or a fire sale on an entire neighborhood, on the home equity value of tens and hundreds and thousands of other homeowners in the country are affected, potentially by foreclosures that never should have happened to begin with.

And I wonder if you have any thoughts on that as a potential strategy that we could employ to make sure that we are beginning to get ahead of this massive problem rather than continuing to trail behind.

Mr. APGAR. Well, thank you for that question. We just heard that one of the central issues is execution, and we hear hundreds of stories of the type you told us brought to you by your staff and by our community connections around the country and from our own personal visits in communities. In my sense, a lot of people are feeling and saying things that are true.

When I hear that story, I think that whoever was on the other end of the phone from that individual was not executing the program as directed by our guidelines. That person sounds to me—

without more details, I couldn't be sure—that they should be eligible. Certainly, they don't need more income to qualify—they don't have incomes that are too high to qualify. And so what is the question?

That is the central focus of this effort, to bring the major—inform the major leaders, the CEOs of these companies to sort of say, tell us how that story could be happening in your company. What was the disconnect? Was it a lack of training? Was it a lack of resources on their part? Was it our problem, that the rules are too complex to implement? What is going on here? Because our sense is that many of these stories, in fact, reflect situations that could and should be corrected, that every time we miss one of those, somebody then goes into foreclosure and adds to the problem.

And so it is execution, execution, execution, and that is the major focus of the next set of initiatives that Secretary Allison indicated. Let us figure out how to get the program working as it was designed.

Mr. ALLISON. Senator Bennet, if I may add to Mr. Apgar's answer—

Senator BENNET. Please.

Mr. ALLISON.—under the rules of the program, a servicer in the program should not foreclose unless the servicer has first checked on whether the person is eligible. We are also going to be auditing this program, and that is Freddie Mac's role, to make sure that people who were eligible were offered a modification. And so we are aware of the problem and we hear these same complaints.

That is one reason why we are calling in the servicers at the end of this month, to discuss this with them. We want to see better adherence to the program. We want to see the metrics. And we have—we are developing metrics for that very reason. We have got to surveil this program to make sure that the intention is being implemented by every servicer.

Senator BENNET. I just would underscore what you have heard today, which is that the visibility and the urgency with which the issues in New York and Wall Street were addressed needs to not come in first in this race of urgency, because our homeowners are suffering tremendously, and whatever you can do to put in big block letters in the front offices of the providers that you are talking about, something that says, check twice and make sure you are doing whatever you can do to keep people in their homes, because it is in everybody's—it works to the benefit of everybody.

This is one of those cases where no one wins if a foreclosure that could have been avoided isn't avoided. No one wins. The banks don't win. The other homeowners in the neighborhood don't win. The community doesn't win. And it just would be a shame if we are not doing everything we can possibly do to expedite this or to make sure that bad decisions are forestalled so that you have the opportunity to do the work you are trying to do.

I, for one, and I am sure the rest of the Committee feels this way, would love to hear after your meeting next week or next month what the targets are and what the agreed upon steps are going forward so that we have some assurance that things are moving forward and that we have done everything that we can do. I would like to join the Chairman in saying, if there are things that

we haven't done, let us know what those things are because this housing issue is a fundamental issue for our families and also our economic recovery depends on our getting this right.

I appreciate your testimony. Thanks for being here. Thank you, Mr. Chairman.

Senator MENENDEZ. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I guess as you will conclude, that as the next-to-last, I have got to at least make a couple of quick comments about some of the comments made by my colleagues.

One, I would echo Senator Corker's comments about I hope this Committee will have a chance to examine some of our past policies where we encouraged folks to get into homes with no documentation, no money down, no equity involved, no skin in the game, and clearly one of the things that generated this crisis.

I do have to comment on Senator Johanns' comments about the stimulus. It was not perfect and I share concerns about some of the dollars getting out. But I have got to tell you, for a bill that has got north of \$200 billion of tax breaks in it that is helping at least folks in my State and businesses, small businesses on 5-year look-backs, we have had testimony here of the one little brief upstart we had in housing purchases oftentimes generated by funds in terms of that \$8,000 new purchasing tax credit, and I was a former Governor and I can assure you, at least in the Commonwealth of Virginia, and I would strongly believe that in every State around the country, there are thousands of teachers that have not been laid off because of Federal funds that are going into States to help ameliorate the budget crisis, thousands of construction workers working on roads right now that otherwise would not have been worked on, and literally millions of Americans, those who receive Medicaid payments still getting the health care they need because of that Federal assistance to States in crises where they still do have to balance their budgets, and I think that for many of those States, they have got the worst days to come in front of them.

I want to follow up on Senator Bennet's comments, as well. I candidly believe that we have a potential flood of foreclosures waiting in the wings. At least in my State, many banks have kind of slowed the process on foreclosure, waiting to see the effects of these programs that are being rolled out, and I have the same sense of urgency of colleagues on both sides of the aisle that we appreciate the challenge you have got, but we have got to get this out sooner, quicker, faster, more expeditiously.

We have the same kind of stories that Senator Bennet indicated and you are hearing, as well, that consumers are feeling like there is opaqueness in the program. A neighbor gets accepted. They get turned down. There seems to be no remedy.

The question I have—my first question, and I will try to get both of them in—the first question is, we put in place a number of incentives and sweeteners to servicers to participate in the program. I hope as you bring these servicers in and you will look at which servicers are actually acting in good faith and which are not, we have used the carrots. Do we need some sticks? And what kind of actions are we going to be taking if we can find evidence of a pat-

tern of those servicers who are not acting in good faith in terms of enacting this program. Have you thought about the sticks end?

Mr. ALLISON. Senator, we first of all are going to be publishing on a servicer-by-servicer basis their performance, beginning next month. And since we made that known, we have seen the additional activity on the part of a number of servicers, which is welcome.

Let me point out that we do have ambitious goals for this program. We want to achieve loan modifications numbering between three and four million over the next several years. We know we still have a long way to go, but this program is just getting started.

We need to have the servicers working very hard with us. We are going to be meeting with them continuously. They are also not going to receive those payments unless they are performing. So they have a strong incentive to get out and try to modify as many eligible loans as possible.

So I think a combination of public disclosure, having them come testify before your Committee, another powerful incentive to perform. We want to be working closely with you, getting more ideas about how we can do better. And we want to be out talking to the public, as well, to see how well the—

Senator WARNER. Well, I would only add that I think disclosure is important. Public embarrassment might be another step up.

Mr. ALLISON. That is right.

Senator WARNER. But when people's lives are at stake, I hope you will think, as you thought creatively in creation of this program in terms of the carrots, that you think equally creatively in terms of potential sticks or penalties.

And that would be my last question. It seems we are seeing some evidence that those servicers who still retain the loan, the whole loans, are acting in better faith—they obviously have more of a financial interest in some level of resolution—and that those baskets of investor-backed loans where the servicer has no skin in the game, that there is still a much greater pattern of dumping of those properties and not as great of participation in terms of the modification program. Are you seeing that pattern, as well?

Mr. ALLISON. I cannot tell you for certain that that is the case. I think that with the greater disclosure we are going to be making, that will become very abundantly clear over the next several months, whether that is the case or not. But I can't give you a specific answer to your question, Senator. We will be glad to look at that and come back to your office.

Senator WARNER. And again, I cannot urge you enough that whether there are additional incentives or potential penalties or sticks out there, you have got to come forward. I just am concerned with these kinds of stories that we are all hearing, and Lord knows you are hearing them directly, as well. The immediate hardship this provides upon a family or upon an overall neighborhood, maybe public embarrassment is not enough for some of the folks who are not acting in good faith in this program.

Mr. ALLISON. Thanks for your suggestion, Senator.

Senator WARNER. Thank you, Mr. Chairman.

Senator MENENDEZ. Thank you, Senator.

The Chair would be next, but I want to—

Senator SCHUMER. No, please.

Senator MENENDEZ. I want to recognize—

Senator SCHUMER. I need a few minutes to get—I would prefer a few minutes.

Senator MENENDEZ. OK, great. All right.

Let me thank you for your testimony today. Look, I want to start off putting something in context here. I appreciate Senator Johanns' comments, but in March of 2007, we had a hearing here and there was a previous Administration, and at that hearing I said we are going to have a tsunami of foreclosures and the Administration looked at me and said, well, Senator, that is an exaggeration. Unfortunately, I wish they had been right and I had been wrong.

If, in fact, we started working in March of 2007 to mitigate the tsunami of foreclosures that we had not fully seen the crest of, we would be in a much better position today. I think that is important to understand the total spectrum of what we are facing today. This Administration has had approximately 6 months since it took office, so, you know, I just want to put that in context.

Having said that, however, let me say that as the Chair of the Subcommittee on Housing, I share Chairman Dodd's concerns that he expressed in my opening statement and I am not happy. I am not happy with where we are at. I think there is a lot more to be done.

So let me start off by asking some questions here. What number of modifications do you—per month will you consider a success?

Mr. ALLISON. Senator, we certainly aren't satisfied with the level that we have today. I think that the number will vary over time, but I think we need to be on a pace to achieve three to four million modifications by the end of 2012, and that is a major undertaking. No program has ever come close to that. And that will have a major impact on many families across the country and also help to preserve homeowners.

Senator MENENDEZ. If you did three to four million by 2012, that means roughly a little over a million a year, is that fair to say?

Mr. ALLISON. Yes, sir.

Senator MENENDEZ. So if it is a million a year and you divide it by 12, you are talking about what a month, 100,000, roughly?

Mr. ALLISON. Yes. It would be around 20,000 a week, and I can tell you that in the past few weeks, we have actually exceeded that number. But we are not satisfied even with that. We would like to achieve the home modifications as rapidly as possible.

Senator MENENDEZ. Well, we are looking at 2.4 million foreclosures just this year alone, and this is the problem. You know, time is not on our side. More importantly, it is not on the side for families of this country and the consequences in the economy. So this has to move much more significantly.

If we are not at that level in this period of time that we are talking about ramping up, what is your Plan B?

Mr. ALLISON. Well, we believe, first of all, that this program, because it has just gotten started, has not nearly reached its potential. We are encouraged by the rate of improvement week to week that we have been able to achieve over the last 10 weeks and we expect further improvement down the road. We are not just satis-

fied with doing the three or four million over 3 years. We would like to achieve that faster. And we need to, week by week, get a better sense of how the servicers are doing against the number of loans that each one of them has outstanding, and we are going to be comparing the rates at which they manage to contact as many of those eligible homeowners as possible.

Senator MENENDEZ. But let me ask you, I am not happy of where we are at with the servicers. I sent a letter to them in anticipation of this hearing. Let me ask you this. You know, one of the reasons I am asking you what is your rate of success is because we can't determine whether the servicers are doing the right thing unless we know what the rate of success is. I mean, we need a little transparency and we need some information here in order to establish what are the right benchmarks. I am all for having those who are not performing be publicly known, but that—I want to echo Senator Warner's remarks. That is not enough. There have to be consequences here. We have created incentives. There have to also be consequences here at the end of the day.

And so I want to know what you are going to do with servicers if, in fact, they have signed a contract, we have created incentives, and they are not living up to it.

Let me ask you this. When are those—will those with VA, FHA, and home equity loans be eligible for the program?

Mr. APGAR. On the FHA front, yes. With the new authority in the recently enacted legislation, we are going to do an FHA modification program that is closely aligned with the overall Administration's plan. That program is ready to roll out and should be available very shortly. It will provide deep, true modifications of the type that FHA has not been able to do in the past and that will not only help those borrowers in distress, but also, because FHA already owns the mortgage risk, will probably turn a small profit back to—

Senator MENENDEZ. What is the timeframe for that?

Mr. APGAR. The next couple weeks.

Senator MENENDEZ. The next couple of weeks. What about the VA and home equity loans?

Mr. APGAR. The VA, I believe, is on the same pace. I am not sure about the question on the home equity loans. That is the second lien program, which also is close to rolling out in the next couple of weeks.

Senator MENENDEZ. Let me ask you, to what extent does the current foreclosure program depend on the borrowers being delinquent? You know, back at home in New Jersey, we have an enormous number of homeowners who tell us that their lenders tell them, perhaps incorrectly, that they first need to be delinquent on their mortgages to be eligible for the Federal programs. Having delinquency as a program requirement obviously gives borrowers bad incentives to default on their loans. What is the nature of that?

Mr. ALLISON. Senator, people do not have to be delinquent to qualify—

Senator MENENDEZ. But we hear this all the time—

Mr. ALLISON. Yes, sir—

Senator MENENDEZ. All the time, we hear people who tell us—and then they purposely—look, I have a woman who is here who

serves the Senators in the Capitol. She is not my constituent per se, she doesn't live in New Jersey, but she told me her story. She was told that she had to be delinquent in order to qualify. Then she purposely becomes delinquent in order to qualify, and now she is having a hell of a time trying to get a modification. There is something fundamentally wrong with this. I mean, I understood the law to be very clear that you don't have to be delinquent.

Mr. ALLISON. Right.

Senator MENENDEZ. How can any servicer or any lender say you have to be delinquent? There should be a consequence for that. It is false.

Mr. ALLISON. Senator, we totally agree with you, and that is another reason why we are bringing the servicers in next week to talk to them about this. We want to make sure the information they are giving out is correct. Now, they have to do additional training of their representatives. We have to make sure that we are monitoring their actual performance and auditing to make sure that people who are eligible in their population of mortgage holders—

Senator MENENDEZ. Secretary, let me just say, and I will stop here.

Mr. ALLISON. Yes, sir.

Senator MENENDEZ. Let me just say this. It is very simple. All the training in the world—there is one simple statement to anyone who works for you. You do not have to be delinquent in order to be eligible for the program. That is it. Now, how much training does that take? How much training does that take?

Mr. ALLISON. Senator, we very much agree with you, but—

Senator MENENDEZ. This is why there have to be consequences if, at the end of the day, people are not doing the right thing under the law.

Mr. ALLISON. Yes.

Senator MENENDEZ. Senator Schumer.

Senator SCHUMER. Thank you, Senator Menendez, and thank you for chairing the hearing. I thank Senator Shelby. It is an important hearing, although a good part of me can't believe that two full years after the first signs of this crisis were becoming plain for all to see, we are still sitting here talking about how to prevent foreclosures.

More to the point, 5 months after the Administration announced the Making Home Affordable Program, which was supposed to help between seven and nine million homeowners modify their mortgages, we are hearing only a few hundred thousand modifications have been offered and only a fraction of those loans have actually been modified.

You know, when it was explained to me, I thought it was great, you know, focusing on the servicers, giving them incentives. Obviously, it would have been better to have the stick of bankruptcy involved, but that is not in the cards. And it is sort of befuddling as to why it is not working, but it clearly isn't working the way it should be and so you need to change things.

Now, I have one proposal that might help here. I hear that one of the things that you are thinking about—one of the things that I am thinking about, anyway, I don't know if you are thinking about it—but one of the things I am thinking about is giving home-

owners facing foreclosure the option as a last resort of renting their home for a period of time at a fair market rate. This wouldn't cost taxpayers any money, wouldn't bail out the lenders.

Homeowners would be able to stay in their home even after defaulting on the mortgage, but they no longer own the home so there is little temptation to take advantage of this program unless all efforts at reworking the mortgage have failed.

For banks, in many cases, it would be better and cheaper than foreclosure, particularly given how depressed our housing markets are now, and maybe in a year or two they would be better.

Neighborhoods can ill afford more foreclosures. I have seen this throughout my State, downstate and upstate alike. It puts more pressure on vacant properties. The more foreclosures you have, the harder it is for housing markets to recover, which is an overall goal of this economy. And, of course, it helps preserve neighborhoods, because someone living in a home is a lot better than a vacant foreclosed home, and these foreclosed homes don't get sold too quickly given the housing market.

So would Treasury consider this kind of program? If so, can you describe how it would work, what you think the pros and cons are, and what is the likelihood it could happen?

Mr. ALLISON. Senator, we are going to be looking at that thought. That is a very thoughtful suggestion. I think we have to look at this, too, on a case by case basis. There are various programs we are rolling out right now for those who cannot afford to stay in their homes and those will include deeds-in-lieu as well as short sales of the property so they can extinguish the mortgage and we provide an allowance for them to seek housing that they can afford.

The question you are raising is whether they ought to be able to stay in that house and rent—

Senator SCHUMER. Yes. It would make sense.

Mr. ALLISON. Yes, and it is certainly an idea that we are thinking about and perhaps Mr. Apgar can talk about that from the standpoint of HUD, as well.

Senator SCHUMER. Go ahead, Mr. Apgar.

Mr. APGAR. Yes. HUD is looking at a range of options. I mean, what we have is a lot of households that are losing their home and a lot of homes that have been lost, and figuring how to put those back together either by not letting the household depart the home through some continuing rental option, or if they do leave the home, get another renter or another reuse of that property. And so we are exploring a wide range of options, both through the Neighborhood Stabilization Program—

Senator SCHUMER. So what would stand in the way of getting this done? I know you can always rent a home once it is foreclosed on. Banks do that—

Mr. APGAR. Right.

Senator SCHUMER.—if they can't sell it. But that, again, is going to involve finding a new tenant, vacancy, and all that. It is a lot easier to let the tenant stay in their home and then the value, a year or two later, maybe the market comes back up and you don't even need to foreclose on it.

Mr. APGAR. Well, we are investigating and looking at other programs that have been like that around the country. Freddie Mac had an option like that.

Senator SCHUMER. Well, give me off the top of your head—

Mr. APGAR. One of the obstacles was, quite surprisingly, that the homeowner, having gone through the anguish of delinquency, foreclosure, and what, many of them said they didn't want to stay on as renters, which was surprising to us. So the question is, what is blocking that program—

Senator SCHUMER. Yes, but what about—

Mr. APGAR.—from working where it has been tried? We will figure that out and we will see if we can make it work.

Senator SCHUMER. OK, but let us say—give me an objection, either Mr. Allison or Mr. Apgar, to a homeowner who said, I do want to stay in my home. I have lived here. I have all my stuff here. I don't know where I would move. I have my patterns. My kids go to school here. Whatever.

Mr. APGAR. If you could figure out a fair rent, it seems like it would be a fair deal.

Senator SCHUMER. OK. It doesn't seem to me to be too hard to figure out a fair rent. And I will bet, I don't know, that in many, many cases, the fair rent is less expensive to the bank—obviously, they are not going to get as much money as the mortgage was or we wouldn't be in that boat to begin with—than foreclosing.

Mr. ALLISON. Well, we are—

Senator SCHUMER. And then I have found in lots of foreclosed homes, the home gets in bad shape pretty quickly.

Mr. ALLISON. Yes. Again, we agree that you have a very thoughtful suggestion. I think we owe you a response—

Senator SCHUMER. Good.

Mr. ALLISON.—as we complete our analysis.

Senator SCHUMER. That would be great.

Mr. ALLISON. Thank you.

Senator SCHUMER. OK. Next question. I don't know what my time is here, since I am still on your time, Mr. Chairman, but I will take advantage.

[Laughter.]

Senator MENENDEZ. I am surprised.

Senator SCHUMER. Very funny, Bob.

[Laughter.]

Senator SCHUMER. The banks and servicers—ever since I persuaded him to take the DSCC, he has been less friendly to me. No, that is a joke.

The banks and servicers complain that the Administration rolled out its plan too quickly without consulting them. They haven't had time to put the necessary resources in place to handle the volume of modification requests they are facing. But at least one bank, J.P. Morgan, has, according to our information, performed much better than the others, completing approximately half of all loan modifications completed so far.

If it is just a matter of getting people and technology in place and preparing paperwork, why is one bank able to do a lot more than the others? Have you looked at seeing what their success is

compared to the not very great success of a lot of the other major servicers?

Mr. ALLISON. Senator, we have looked at their success and they should be commended for their rapid action and we are pressing others to act more rapidly—

Senator SCHUMER. But what are they doing differently? That is my question. I am not asking to give them a gold star. I am rather trying to learn from their success and how we apply it to other institutions that are not getting as many modifications done.

Mr. ALLISON. Yes, sir. Well, not speaking for J.P. Morgan, they can tell you directly, but I believe that they—

Senator SCHUMER. Well, they don't know what is happening in the other banks. They know what is happening in theirs.

Mr. ALLISON. They must have concluded that this crisis was going to be here for some time and it made much more sense to address it forthrightly and rapidly than allow it to continue to build.

Senator SCHUMER. And you say the other banks, the other servicers, most of whom are major banks—as I understand it, two-thirds of the servicers of mortgages are major TARP recipients or something to that effect. I may have the number off, but a large percentage. Are the other banks sort of ignoring reality here?

Mr. ALLISON. I think it is fair to say that some banks were slower to recognize the enormity of this problem and its potential longevity than others. And I think more and more, as Mr. Apgar testified earlier, have concluded that they must take action and we have created incentives for them to do so. And I think, again, publicizing their activities is going to have a major impact on the willingness of these companies to act rapidly.

Senator SCHUMER. Finally—go ahead, Mr. Apgar.

Mr. APGAR. Secretary Donovan invited the senior leadership of the J.P. Morgan Chase company in to explore what they were doing right in order to learn from that, and essentially they have a system of home ownership centers, calls, outreach, a more integrated system that clearly has ramped up—

Senator SCHUMER. Well, are they willing and are you willing to share that with the other banks so that—

Mr. APGAR. That will be part of the dialog at the end of the month, as we not only talk about what are the obstacles but what have been best practices other—

Senator SCHUMER. Do you think many of the other banks would be willing to accept that kind of methodology?

Mr. APGAR. We certainly hope so, because we believe that everyone shares the commitment to get this crisis under control.

Senator MENENDEZ. We have a second panel, so if you could wrap up—

Senator SCHUMER. OK. Could I do one final question?

Senator MENENDEZ. Fine.

Senator SCHUMER. Thank you. I apologize.

I have been concerned for some time with the effect of predatory equity in the residential real estate market. That is when investors buy residential properties, often in affordable communities. They pay very high prices—that is happening less now, but still happening—with the help of massive amounts of leverage. And so in

order to make a profit, they stop doing maintenance and upkeep. They make every effort to kick out low-income tenants so they can renovate the apartments and raise rents. I find this a despicable practice and I have gone after the people who do it. But the people who enable them, who lend them the money, should equally be blamed, and I know that Secretary Donovan cares about this, because when he was HUD Commissioner, we worked on it together.

Is Treasury or HUD currently working on programs that would address the problem that I have labeled predatory equity?

Mr. APGAR. Yes, we have been working on this issue. I just would point out, of course, that not only is this an issue in New York, but nationwide, we are seeing over-leveraged buildings or buildings where, just like single-family homes, there is more—the value of the property is less than the value of the outstanding mortgages. What is troubling about this is many of these mortgages are on the balance sheets of some of the smaller community banks that we were talking about earlier and makes them specifically at risk, and so we are working on options to try to address this crisis, both talking with our colleagues in Treasury as well as throughout the Administration.

Senator SCHUMER. Yes, and I will conclude now, but I think you need to talk to some of the bank examiners. The standards by which these loans were allowed to go forward were lax and unrealistic in terms of what kind of rents could pay back that kind of price that they paid for these buildings.

Mr. APGAR. Mm-hmm.

Senator SCHUMER. Thanks.

Senator MENENDEZ. Thank you, Senator Schumer.

Thank you both for your testimony. I look forward to hearing back from you on some of the issues that the Committee has raised.

With that, let me call up our second panel, invite them to come up to the table. As they come up, let me, to advance the time, introduce them.

Let me welcome our second panel. Let me start off by welcoming Thomas Perretta. He is from Chairman Dodd's State of Connecticut. And if we could ask people to please, if you are finished with listening to the hearing, leave the room quietly. Thank you. Please, have a seat.

Mr. Perretta is from Chairman Dodd's State of Connecticut. He has worked for the Connecticut Board of Education for 11 years and he is going to share with us his story of how he tried to modify his mortgage. Mr. Perretta, I just want to say what you are doing here today, coming before the Committee to discuss a very personal life story is not only meaningful but courageous. I know I speak for all of our colleagues in saying that we are very grateful for your willingness to come and share your personal story.

Let me welcome Joan Carty. She is the President and CEO of the Housing Development Fund in Bridgeport, Connecticut. Ms. Carty is a longtime community leader, having served as Director of the Bridgeport Neighborhood Fund and Stamford's Neighborhood Preservation Program. We are grateful to her for her hard work and years of experience that she brings before the Committee today.

Next, I would like to welcome Paul Willen, who is the Senior Economist and Policy Advisor at the Federal Reserve of Boston. Mr. Willen is well published in the areas of financial management and mortgage markets. He recently finished some very interesting publications on the current foreclosure crisis.

Next, I would like to welcome Mary Coffin, who is the head of Mortgage Servicing and Post-Closing at Wells Fargo Home Mortgage. In her capacity, she oversees an operation that reaches 7.9 million customers. She is a member of the Wells Fargo Executive Management Committee, where she helps to craft the company's overall strategic direction, and she has worked in the mortgage industry for more than 25 years. It doesn't appear so, but it looks like it according to the statement. It says 25 years.

Let me welcome Mr. Curtis Glovier, Managing Director at Fortress Investment Group. Mr. Glovier is a partner in Fortress's hybrid funds area, managing both government relations and private equity efforts. He brings with him many valuable years of experience working in the financial markets.

Let me also welcome Allen Jones, who is the Default Management Executive at Bank of America. Mr. Jones manages Bank of America's strategy and interaction for default management and loss mitigation with public policy groups and with Congress. Before working with Bank of America, he worked with HUD and with KPMG.

And last, let me welcome Diane Thompson, who serves as Counsel at the National Consumer Law Center. Prior to her current position, she served in the Land of Lincoln Assistance Foundation as a home ownership specialist and a supervising attorney. She belongs to many important boards, including the National Community Reinvestment Coalition's Board and the Consumer Advisor Council of the Federal Reserve.

Welcome, all. We are going to have your full statements included in the record. Because this is a large panel and we want to get all of your testimony in before any votes, we are going to ask you to stick to the 5-minute timeframe that I think the Committee advised you that you would have so we can get everybody's testimony, hopefully some questions in, and go from there.

With that, Mr. Perretta.

**STATEMENT OF THOMAS PERRETTA, CONSUMER,
STATE OF CONNECTICUT**

Mr. PERRETTA. Good morning, Mr. Chairman and Ranking Member Shelby and everyone.

My mortgage problems became evident when my wife, Susan, passed away June 1, 2008. We worked hard doing the best we could for our son, living within our means. We had vacations. We enjoyed ourselves. We stayed—I am going off the top of my head with this.

We stayed at my in-laws for a year and a half, saving money for the downpayment for the townhouse. Tommy did well in high school. She was creative in getting him through college. He graduated from Quinnipiac last year and he was going to do physical therapy. He wanted to take a year off to be with Mom. Mom didn't make it.

We worked all our lives. I am lucky. I have been working with the Stamford Board of Education for 11 years. I am in my twelfth year right now. I am very fortunate for that.

After going through, getting Tommy through college, all the bills—she had taken care of the bills for the last 24 years—Tommy, you have got to take the \$2,000. Here is a check. Go pay the mortgage. We have got to do this. She was in a nursing home at Longridge, still writing out the checks. She was still paying the bills.

When she passed away, I had to borrow money. I had no money to bury her. I borrowed—I just go done paying \$16,000 from last year to bury her. A lot of friends, my in-laws, the funeral director was very understanding. I am on a—we had a large electric bill. I am on a yearly electric plan with CL&P. I have negotiated payments with my common charges. I took the cable box out for TV. I am on cell phone only. We don't have a regular phone. We have a computer on AT&T for my son. I am taking the car back. I can't afford the car payment.

I started realizing the problems after the holidays this past year, that I was going to have to—I contacted Chase. I wanted to know what to do. I talked to a lady—they were always in touch with me—with the statement that we owed—my mortgage was \$2,031. It went up a little bit with the taxes and everything. I kept getting a bill. My late charges had piled up. I tried to keep up. At one point, I paid the first payment I was late and then another \$2,000 in 2 weeks. Income tax time came. I had money. I got some money back. I straightened out a little bit. I wanted to know if I could do something. I have to get this payment down. I can't afford it.

I had gone over a formula two different times on the telephone with two separate people from Chase, 10 minutes. I had my little briefcase. I have everything I owe right next to me. I can do it on the telephone just like that. And their reply was, I don't qualify. I don't make enough to qualify. The common sense—it didn't make sense to me. If I could make enough, I wouldn't be in this jam I am in.

Finally, Air Post Housing Development Fund. I was falling behind. They got the paperwork in to Chase on May 4. I didn't receive a reply. I lost my—God bless my wife.

Now that my son has graduated college, he is going to start chipping in. He is on a business trip right now. He is going to come in. He is going to help me by paying off the big electric bill, which is \$500 a month on top of what I regularly pay. We are halfway done with that. That was, like—she was 98 pounds. I had the heat on for the last two winters all the time. He is going to straighten out with me with the common charges. I am going to use his car a couple times when he takes the train to work. I can walk to work. I am close enough for that. And if I have to go somewhere, I get my father-in-law's truck on the weekend if I have to cut a lawn or something like that.

All I was looking for was to get the mortgage payment down. I would have figured—another common sense—and I am sorry for going off like this—another common sense thing should have kicked in. I didn't want the sympathy for the fact that I lost my wife. I was looking for the understanding that we had gotten our

mortgage with two incomes, mine and hers. Now once I notified them that I am missing her income, that we have to do something—I am behind five, 6 months with my mortgage and I sent paperwork in to them and everything. If not for Housing Development Fund, I don't know where I—I didn't know where else to go.

And that is it. I am beside myself right now. I am just waiting for a response from them. I don't have the other income. I don't understand.

Thank you very much for your time. I am sorry.

Senator MENENDEZ. No, thank you very much for sharing your story, and I am sorry for your wife's loss.

Mr. PERRETTA. Thank you.

Senator MENENDEZ. Ms. Carty.

STATEMENT OF JOAN CARTY, PRESIDENT AND CEO, THE HOUSING DEVELOPMENT FUND, BRIDGEPORT, CONNECTICUT

Ms. CARTY. Good morning, Mr. Chairman. Thank you for inviting me to testify today. My name is Joan Carty. I am the President and CEO of the Housing Development Fund in Connecticut.

Last year, because of the widespread and increasing problems with subprime lending, mortgage delinquencies, and rising foreclosures, HDF started an additional counseling program to assist families in our communities who are stressed with these problems. In the course of developing our program, we have reached out to many other partners: The Bar Association for Pro Bono Attorneys, the courts to establish working relationships with mediators, volunteers with financial and social services backgrounds to help us with the ever increasing volume of people who need guidance, and the banks, who in many cases control the outcomes of the situations facing people in foreclosure or mortgage delinquency.

We are a HUD-certified counseling agency. We have personally experienced the kind of shadow boxing that occurs when a homeowner in distress calls their lender or servicer for help. Too often, their call is bounced to a call center across the globe or the call is bounced from department to department within the bank. On many occasions, after multiple periods of time on hold, they finally reach a live person, but it is a representative who is merely following a script. Often, the lender or servicer representative has no record of prior contact with the homeowner. It is a process that often feels futile.

We have found that in too many cases, when we send clients' modification requests to banks or servicers, including the largest ones, that the modification package enters a black hole for months on end. These homeowners are in distress. Even a 30-day timeframe can radically affect their credit profile. Once they slip behind on timely payments on their mortgage or any consumer debt, their credit score goes down and their monthly interest charges can go up. In many cases, cross-default provisions mean that default on one obligation will trigger higher monthly charges on all other debt, even if they are current on it.

If we were to look for common themes as to why families are in distress, we often find that death, divorce, illness, or injury, in addition to predatory terms on many mortgages, have pushed families

to the edge of the cliff. Imagine the multipliers and harm rendered when this limbo extends for months.

I understand that the lenders and servicers need modification requests that are well documented and that contain a budget that has been carefully worked out so that the homeowner will succeed over the long term. That is the kind of service that we as a counseling agency provide to our clients. What our clients in turn need from the lenders and servicers is rapid response, responses before their lives continue to spiral downward.

It is difficult to believe that the sophisticated automated platforms that have been in use by lenders and servicers for loan origination over the past decade cannot be retooled to generate effective loan modifications with greater frequency and within tighter timeframes.

I would also suggest that rapid response will help in other ways. With delay comes added expenses, which often get added to the mortgage balance. Extensive delays in the mediation process often result in the lenders charging the homeowner multiple times for late fees, attorneys' fees, and updated appraisals.

Denial of homeowners' requests lead to expensive foreclosure processes which hurt the families involved and the communities in which the homes are located. In many instances, these foreclosures do not ameliorate losses or generate profits for the banks, given the current declines in property values throughout the country.

Additionally, it is critically important to create a system that rapidly responds to requests from homeowners who are still current on their mortgages but who know they will not be able to sustain their payments going forward.

What we are building at our agency is a system that can carry homeowners from that initial request for assistance through assessment of their situation and development of a modification request that will have viability over the long term. What we need from the lenders and servicers is their commitment to building a system that will react promptly and predictably to these reasonable requests. Thank you.

Senator MENENDEZ. Thank you.

Mr. Willen.

**STATEMENT OF PAUL S. WILLEN, SENIOR ECONOMIST AND
POLICY ADVISOR, FEDERAL RESERVE BANK OF BOSTON**

Mr. WILLEN. Senator Menendez, Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for your invitation to testify. My name is Paul Willen and I am a Senior Economist and Policy Advisor at the Federal Reserve Bank of Boston, but I come to you today as a researcher and as a concerned citizen and not a representative of the Boston Fed or any other Reserve Bank or of the Board of Governors.

My recent research has focused largely on understanding how we got here, why we had more foreclosures in one quarter in 2008 in Massachusetts than in the 6 years from 2000 to 2005 combined, and why millions of Americans have seen what is supposed to be one of the most positive experiences of their adult life, home ownership, turned into a nightmare.

Let me talk first about some misconceptions about how we got here. These are important because most of the ineffective policy efforts over the last 2 years failed because they were based on incorrect theories of the crisis. One example is the idea that large changes in payments associated with the resets of adjustable rate mortgages caused the crisis. Every serious researcher, including us, who has looked at loan-level data has failed to find support for this. Most borrowers who default on adjustable rate mortgages do so long before the first change in their monthly payment.

Another example is the claim that many borrowers who got subprime loans were steered into them and could have qualified for prime loans. We found in a large sample of subprime loans that only 10 percent met the combination of borrower credit history, downpayment, monthly income, and documentation necessary to qualify for a prime mortgage.

In our most recent paper, we focused on the question of renegotiation of troubled mortgages. We followed borrowers in the year after their first 60-day delinquency and found that lenders gave payment reducing modifications to about 3 percent of the borrowers. The leading explanation for this is that securitization generates contractual complexity and fragmented ownership, which makes it impossible for borrowers and lenders to come together for mutual benefit. Our evidence refutes this claim. Servicers are just as reluctant to modify loans when they own them as when they service them on behalf of securitization trusts.

The most plausible explanation for why lenders don't renegotiate is that it simply isn't profitable. I am using lenders loosely here to mean the bearers of the loss, the investors or their appointed representatives, the servicers. The reason is that lenders face two risks that can make modification a losing proposition. The first, which has been recognized as an issue by many observers and researchers, is re-default risk, the possibility that the borrower who receives a modification will default again and thus the modification will have only served to postpone foreclosure and increase the loss to the investor as house prices fall and the home itself deteriorates.

The second risk, which has been largely ignored, is self-cure risk, the possibility that the borrower would have repaid the loan without any assistance from the lender. About a third of the borrowers in our large sample are current on their mortgages or prepay 1 year after they become 60 days delinquent. An investor would view assistance given to such a borrower as wasted money.

Some have suggested that our estimates overstate self-cure risk, but we would argue the opposite. The borrowers most likely to benefit from, for example, a 20 percent cut in payments are borrowers without substantial income loss or deep negative equity and are thus the ones most likely to cure without assistance from the lender.

Let me say that my observations that servicers and investors may find modification unprofitable has no bearing on whether it is desirable for society at large and the economy. The private net present value to investors and the social net present value to society of a modified loan may well be very different.

Let me conclude by talking about what we have always argued is the central problem in the foreclosure crisis but that policy-

makers have only recently recognized, borrower life events like job loss, illness, and divorce. People argue that life events could not explain the surge in defaults in 2007 because there was no underlying surge in unemployment or illness that year. But that view reflects a misunderstanding of the interaction of house prices, depreciation, and life events in causing default.

Foreclosures rarely occur when borrowers have positive equity for the simple reason that a borrower is almost always better off selling if they have to leave the house anyway. Thus, detrimental life events have no effect on foreclosures when prices are rising. But when home prices fall, some borrowers can no longer profitably sell and then the income-disrupting life events take a toll. Thus, we did not need to see a surge in life events to get a surge in foreclosures, but rather a fall in house prices, which is exactly and unfortunately what we saw.

Let me finally say that a key policy concern going forward is that economic recovery alone will not eliminate the foreclosure problem. Even in a healthy economy, 300,000 people file new claims for unemployment insurance every week. Without a substantial rise in home prices, many of these people will face the combination of negative equity and job loss that leads to foreclosure. The Massachusetts foreclosure crisis of the early 1990's did not end when the economy recovered in 1993 but when vigorous house price growth eliminated negative equity in 1998.

We hope that these findings add perhaps unexpected insights into your work as policymakers, and thank you again for the opportunity to appear before you today.

Senator MENENDEZ. Thank you.

Ms. Coffin.

**STATEMENT OF MARY COFFIN, HEAD OF MORTGAGE
SERVICING, WELLS FARGO**

Ms. COFFIN. Chairman Dodd, Ranking Member Shelby, Senator Menendez, and members of the Committee, I am Mary Coffin, Executive Vice President of Wells Fargo Home Mortgage Servicing, and thank you for inviting me to speak today.

Throughout this historic public and private sector collaboration, Wells Fargo has considered it our leadership responsibility to champion solutions. We have played a key role in creating streamlined, unified modification programs to help customers in need. A prime example of our work with the Administration is the new Homeowner Affordability and Stability Plan, which we fully support. Early indications are that HARP and HAMP are of great value and will benefit a significant number of families. In fact, we believe the Administration's goal to help as many as seven to nine million homeowners over the next few years is well within reach.

In the first half of 2009, through lower rates, refinances, and modification, Wells Fargo alone has helped close to one million American homeowners. We refinanced three-quarters of a million customers through HARP and standard programs. And since our company represents approximately 20 percent of the market, we could estimate that close to four million Americans nationwide have already refinanced into lower mortgage payments.

In these turbulent times, it is important to note that more than 90 percent of the borrowers remain current on their mortgage payments. To help those in need of assistance in the first half of this year, we have provided more than 200,000 trial and completed modifications, an increase of over 100 percent from the same period 1 year ago. And notably, last month, 83 percent of Wells Fargo's modifications resulted in a payment reduction.

Acutely aware of the importance of speed, Wells Fargo worked with the government aggressively to develop and deliver HARP and HAMP. We did this in a way that was mindful of our responsibility to American taxpayers to execute solutions for those truly in need. Speed of execution was complicated by the multiple versions of the program, each with unique contractual requirements.

On March 4, the Administration first announced the components of the Homeowner Affordability and Stability Plan. On April 6, we received the final HAMP guidelines from Fannie and Freddie and began implementing the program for these customers. On April 13, we were the first to sign a HAMP contract for loans we service for private investors, as well as the loans in our own portfolio. Further details for this program finalized by May 14, and we began offering it 9 days later.

Since January, we have been providing loan workouts to Wachovia Option ARM customers who are struggling with their payments, and at the end of this month, we will add HAMP as yet another potential solution for those borrowers. With this addition, we will have fully executed HAMP for almost all of our at-risk borrowers. Since we, Wells Fargo, service one-third of the Nation's FHA loans, we are hopeful the government will soon provide this program, as well as the second lien program as it was initially described, since these borrowers are currently ineligible for a HAMP.

As of June 30, Wells Fargo was in the process of finalizing 52,000 home affordable modifications. When working with all of our seriously delinquent borrowers, 30 percent are not eligible for HAMP because they have an FHA or a VA loan, and another 15 percent do not meet the basic program requirements. Of the remaining 55 percent, whom we have all contacted, we are actively working with half, and the other half have not yet chosen to work with us.

For those borrowers who don't qualify for HAMP, we immediately seek to find another modification or alternate solution to avoid foreclosure. Before any home moves to foreclosure sale, we conduct a final quality review to ensure all options have been exhausted.

We understand this time has been frustrating for at-risk customers and that they are anxious and in need of answers. With the President's February 18 announcement that refinance and modification programs would be forthcoming, we began to experience a large increase in customer inquiries. Knowing this would occur, we anticipated the influx and increased and trained team members to handle it. Yet it has been challenging to meet customer expectations as the various program details were provided to us over a period of 90 days.

While we forecasted an increase in inquiries, including from customers current on their mortgage payments, our forecast turned

out to be low. Historically, on a monthly basis, five to 10 percent of inquiries for loan work-outs come from borrowers who are current. Since the announcement and the related increased focus on imminent default, this statistic has risen to nearly 40 percent. And, of course, not everyone who calls qualifies for imminent default.

To manage this demand, we have implemented mandatory overtime. We have streamlined document processing. We are upgrading systems to handle escrow requirements for our home equity lines and loans. And most importantly, we have increased our trained staff by 54 percent over the first half of this year to 11,500 default team members, all whom are U.S.-based.

In conclusion, we can certainly tell you we have been working very hard to responsibly execute these programs, and again, we fully support them.

I will be glad to answer any questions.

Senator MENENDEZ. Thank you.

Mr. Glovier.

**STATEMENT OF CURTIS GLOVIER, MANAGING DIRECTOR,
FORTRESS INVESTMENT GROUP, ON BEHALF OF THE MORTGAGE INVESTORS GROUP COALITION**

Mr. GLOVIER. Thank you for inviting me to testify today. My name is Curtis Glovier and I am a Managing Director at Fortress Investment Group. I am also a member of the Mortgage Investors Coalition, organized to provide policymakers with the mortgage investors' point of view. I am testifying today in my capacity as a member of the coalition.

Allow me to start by commending the Committee for your leadership in pursuing every possible action to help keep Americans in their homes. We share your frustration with the slow pace of efforts to help homeowners. I also want to thank the Chairman for coauthoring with Chairman Frank a letter last week highlighting the Hope for Homeowners Program, or H4H, and to offer our support to facilitate American families' participation in this program so that they may be able to keep their homes and build equity. The discounted refinance program offered by H4H provides the best long-term solution for the homeowner and for the recovery of the U.S. housing market.

The Mortgage Investors Coalition currently has 11 member firms with about \$200 billion in total assets under management and over \$100 billion in mortgage-backed securities. Investors in private label, that is non-Federal agency, mortgage-backed securities include asset managers, charitable institutions, hedge funds, insurance companies, municipalities, mutual funds, pension funds, universities, and others.

Investors in securitizations and mortgages generally have no interaction with the homeowners—that is the job of the servicer—and also have extremely limited decisionmaking authority with respect to modifications, foreclosures, and other servicing actions. Very often, the original lender or its affiliate acts as servicer once the loans are securitized. Loan servicing is relatively concentrated. Fifty-five percent of all mortgages are serviced by the four largest banks. It is also important to note that there are \$1.1 trillion of second liens, like home equity loans, in the residential mortgage

market, and the vast majority of these are held on bank balance sheets as opposed to in securitizations.

While the Federal Government's actions to bolster Fannie Mae and Freddie Mac and broaden the FHA's mandate have proven to be a critical stopgap measure during the housing and economic crisis, a revival of the non-agency market and return of private investors to the market is seen by many as the prerequisite to the recovery of the U.S. housing market and a return to normalcy in the capital markets.

Returning homeowners to a positive equity position provides significant opportunity and motivation for at-risk homeowners to remain in their homes and communities. A short refinancing under H4H solves both the affordability and the negative equity problems plaguing homeowners at risk of foreclosure today. The program was created to reduce principal on the existing senior lien mortgage and to eliminate the existing subordinate, second lien, which can thereby prevent unnecessary foreclosures.

The Coalition believes that a properly implemented Hope for Homeowners Program will not only provide stability for homeowners, but will also stem the declines in the housing markets and provide certainty for the fixed-income capital markets, which will bolster financial markets in general and promote increased lending and reinvestment in mortgages. We believe the program will prevent additional foreclosure inventory from adding to the overhang of bank-owned properties in the residential real estate market, thereby helping to establish a floor for housing prices. The best solution to our Nation's mortgage crisis is to significantly forgive principal on first and second lien mortgage debt in connection with the refinancing of the over-extended homeowner into a new low interest rate mortgage through the Hope for Homeowners Program.

Investors seek sustainable mortgage restructurings that address the interests of all parties and the multiple factors that have contributed to homeowner re-defaults. Compared to a short refinance program, such as H4H, a modification approach, such as the Making Home Affordable Program, has a notable shortcoming: by not addressing negative equity, homeowners are trapped in a mortgage that cannot be refinanced and a house that cannot be sold. When the program ends in 5 years, the interest rate on both the first and second mortgage will reset higher. The outstanding balance of the combined mortgage debt is likely to still exceed the value of the home, and there could be a meaningful risk of a re-default. The low prices of securities in the mortgage market today in part reflect the great uncertainty of future cash-flows and values associated with such modified loans.

While there are still operational hurdles to overcome in implementing a more effective H4H Program, the major impediment to the viability of the program is the volume of second mortgages or second liens outstanding. As indicated earlier, while a small percentage of second mortgages are sold to investors, the vast majority remain on the balance sheets of our Nation's largest banks. In fact, the four banks that service approximately 55 percent of mortgages held roughly \$441 billion of second liens on their balance sheets as of last year.

Banks have favored loan modification programs, such as Making Home Affordable, that not only defer the recognition of losses on the second lien portfolios, but also better their second lien position at the expense of the first lien investors and to the detriment of the homeowner.

How can Hope for Homeowners become a reality? It is an effort that will require participation and sacrifice by all interested parties to succeed. The government, financial institutions, and investors all share an important stake in the recovery of the American homeowner and must contribute actively to forge healthier housing and financial markets. Investors stand ready to make the sacrifice necessary to re-equitize homeowners at risk of foreclosure.

Thank you for the opportunity to testify today.
 Senator MENENDEZ. Mr. Jones.

**STATEMENT OF ALLEN H. JONES, DEFAULT MANAGEMENT
 POLICY EXECUTIVE, BANK OF AMERICA**

Mr. JONES. Good afternoon, Senator Menendez. I am Allen Jones, Bank of America's Default Management Policy Executive.

Bank of America strongly supports the Administration's Making Home Affordable Program, and we stand ready to support our borrowers with a sense of urgency. Since the start of housing crisis, Bank of America has been at the forefront of Government and industry efforts to develop loan modification programs that work and help financially distressed customers remain in their homes.

We know that more needs to be done. That said, we strongly support Administration's focus on affordability and loan modification and refinance processes in order to achieve long-term sustainability for homeowners, and we are eager to constructively participate in the upcoming meeting at Treasury.

Before getting into specifics, I want to highlight a couple of items.

First, Bank of America exited subprime lending nearly 9 years ago. Upon acquiring Countrywide, we have taken the steps to ensure our combined company is a leader in traditional mortgage products. Our April launch of the Clarity Commitment, a clear and simple one-page disclosure that accompanies every new and refinanced loan, is one demonstration of our focus on ensuring customers understand what loan they are getting and the associated costs.

Second, Bank of America has been at the forefront to develop loan modification programs as a way of avoiding foreclosures and helping financially distressed customers remain in their homes. We modified 230,000 mortgages in 2008, and we report that year-to-date we have modified 150,000 loans.

In recent weeks, the Administration's Making Home Affordable modification guidelines and supplemental guidelines have been rolled out. With the MHA program, our systems have been converted, and MHA has become the centerpiece of Bank of America's overall home retention efforts. Already approximately 80,000 Bank of America customers are in the trial modification period or are responding to efforts we have made under Making Home Affordable. We have achieved this level of accomplishment by devoting substantial resources to this effort. Our servicing team has more than

7,400 associates dedicated to home retention, double what it was a year ago.

Bank of America has also devoted significant resources to community outreach. Since the beginning of this year, we have participated in more than 120 outreach events in over 26 States.

Earlier this year, we announced our financial support and commitment to the Alliance for Stabilizing Communities, which is led by the National Urban League, the National Council of La Raza, and the National Coalition for Asian Pacific American Community Development.

We understand the importance of being there for our customers when they call and are providing a timely response to their inquiries. My teammates respond to an average of 80,000 customer calls a day and up to 1.8 million calls a month.

Our customers have multiple entry points into our home retention team. Whether on an outbound call, inbound call, outreach event, or by mail, once we have made contact with the borrower, we diagnosed the financial challenge. We isolate short-term issues such as inability to pay because of a medical bill versus long-term challenges like a loss of job or underemployment. Short-term issues may be solved through a repayment plan. Longer-term financial challenges may be solved through a loan modification.

In the event we cannot find a solution, we consider a short sale or deed in lieu of foreclosure. In the event neither of these offers work, we will work with the borrower to find a graceful exit and provide relocation assistance.

Bank of America customers will not lose their homes to foreclosure while their homes are being considered for modification. The bank places foreclosure sales on hold while it determines a customer's eligibility for its home retention programs.

With MHA, we believe there are additional opportunities for servicers to partner with the Administration and Congress to refine the program to help reach our mutual beneficial goal of helping as many borrowers as possible. We need to get this right to preserve the flow of mortgage credit to support sustainable homeownership, and at the same time protect communities and neighborhoods from avoidable foreclosures.

We look forward to working with the Congress and the Administration to accomplish these goals. Thank you.

Senator MENENDEZ. Thank you.

Well, Ms. Thompson, you get the final word here, at least at this point.

STATEMENT OF DIANE E. THOMPSON, OF COUNSEL, NATIONAL CONSUMER LAW CENTER, ALSO ON BEHALF OF NATIONAL ASSOCIATION OF CONSUMER ADVOCATES

Ms. THOMPSON. Thank you. Good afternoon, Senator Menendez. Thank you for providing me with the opportunity to testify today. My name is Diane Thompson. I am an attorney, current Of Counsel with the National Consumer Law Center. In my work at NCLC, I provide training and support to attorneys and housing counselors representing homeowners from all across the country. For nearly 13 years prior to joining NCLC, I represented low-income homeowners at Land of Lincoln Legal Assistance Foundation in East St.

Louis, Illinois. I testify here today on behalf of the National Consumer Law Center's low-income clients and on behalf of the National Association of Consumer Advocates.

My comments today will focus on the barriers homeowners face in accessing sustainable modifications under the Administration's Home Affordable Modification Program, or HAMP.

In preparing for this testimony, I reviewed my notes of conversations with hundreds of housing counselors and attorneys regarding HAMP since its rollout in early March. I also solicited updates from advocates as to their current experience with HAMP.

What happened next was astonishing. For the last several days, I have had a steady stream of phone calls and e-mails from advocates all over the country. Their frustration is palpable. Over and over they ask me: How can I tell if the servicer is telling me the truth? I know that this modification is in violation of the HAMP guidelines, but when I raise that, the servicer stopped returning my phone calls. And, fundamentally, what can I do to help the borrowers I am working with to get a loan modification? They can pay. They want to keep the house. But the servicer says no.

The housing counselors and attorneys I work with are on the front lines of our national foreclosure disaster. Many of them had high hopes for HAMP. Few, if any, now look to HAMP for assistance in their daily struggle.

My written statement details the most common problems with HAMP. Implementation has been excruciatingly slow. Months after HAMP's rollout, servicers are still telling advocates that they do not have a process in place to review homeowners for HAMP modifications or that they have put such reviews on hold for one reason or another. In the meantime, servicers have continued to proceed with foreclosures and foreclosure sales, even for homeowners who are undergoing a current review and have submitted all documentation.

Beyond delays in implementing the program, servicer noncompliance has been widespread. Participating servicers refuse to offer HAMP loan modifications, instead steering homeowners into more expensive, less sustainable loan modifications. Many servicers continue to require waivers of all legal claims and defenses. Some servicers have instructed homeowners to waive their rights to HAMP review in order to obtain any loan modification. There are reports of several servicers requiring downpayments usually in the range of thousands of dollars before they will consider homeowners for HAMP modification.

We know that the Administration has allotted \$15 billion to servicers for their participation in HAMP and will be disbursing those funds soon. We are very concerned that servicers may receive this money for non-HAMP-compliant loan modifications. HAMP is premised on servicer incentives. These incentives are unlikely to change servicer behavior without consequences for noncompliance.

Homeowners and their advocates have no mechanism to challenge a servicer's denial of a loan modification or even to determine whether or not a servicer truly performed an accurate evaluation of the homeowner's qualifications for such a modification. The key driver of whether or not a homeowner gets a loan modification—the net present value test—is not public. Nor are servicers cur-

rently required to disclose to homeowners what numbers they put into the model or what the result of the test was.

The net present value test measures whether or not the investor will profit more by modification or not. Many advocates report that servicers appear to have entered incorrect information into the net present value analysis or failed to follow it at all.

HAMP must be modified to provide greater transparency and accountability. The NPV test for qualifying homeowners must be available to the public. Servicers must be required to report to homeowners what numbers they used in the analysis and what the results of that analysis were. Homeowners who are denied a loan modification or who encounter difficulties in obtaining a loan modification need access to an independent review process.

Ultimately, we believe that, in order to be effective, HAMP may need to mandate principal reductions. With one out of five homeowners underwater, significant readjustment in principal balances are necessary for the economic stability of the country. Additionally, servicers must be required to halt all foreclosure proceedings upon commencement of a HAMP review and should not be able to proceed with a foreclosure without a HAMP review. Proceeding with the foreclosure during a review increases costs of any ultimate modifications and creates a real risk that a home will be sold in foreclosure before the review is completed.

Staying foreclosures pending review will provide a powerful incentive to servicers to expedite HAMP reviews. Homes that can be saved should not be lost to foreclosure because a servicer failed to complete a HAMP review.

If the data coming out in August and then this fall supports our experience that changes to HAMP in design and implementation cannot address the foreclosure crisis, mandated loan modifications, bankruptcy reform, and servicing legislation should be adopted by Congress.

Thank you.

Senator MENENDEZ. Thank you, Ms. Thompson. Thank you all for your testimony.

Let me start. I am disturbed at elements of your testimony, Ms. Thompson, that some servicers in violation of HAMP's rules are being asked to waive legal rights and others are being steered into non-HAMP modifications, despite representations to the contrary. Have you contacted Treasury about this? Have you shared the experiences you have had? And if so, what type of response have you gotten?

Ms. THOMPSON. We did talk with Treasury. We were at a meeting with Treasury last week, actually, discussing the net present value test and our belief that that test must absolutely be made public, and we discussed briefly at that point the issue of compliance, and we were told that we would schedule a subsequent meeting at a later date to discuss in more detail our concerns regarding compliance.

Senator MENENDEZ. What was their response to you on the net present value issue?

Ms. THOMPSON. Treasury indicated that they would be willing to discuss providing—requiring servicers to provide some information as to what the inputs into the net present value test were and

what the outputs were. They were reluctant to provide the full net present value analysis or even to require servicers to provide the entire list of inputs.

Senator MENENDEZ. Ms. Coffin or Mr. Jones, any observations about some of this in terms of violation of HAMP rules being asked to waive legal rights, steering into non-HAMP modifications?

Ms. COFFIN. I will go first. We have actually trained and worked with all of our staff and created for our organization that HAMP is at the very top of the waterfall. Now, in my testimony, you will see the timeline of execution, so some customers that we have been working with before we had it fully executed have been moved forward, even in some more aggressive modifications than even the HAMP, particularly on our pick-a-payment option ARM portfolio. But HAMP is at the very top of our waterfall, and I guess my comment to some of the statements made is that, you know, since the beginning of this, we have understood as servicers there is full transparency here, we would be fully audited, and we assume that all of our files and information have to be completely documented as to why we either chose or did not choose to do a modification. And in a conversation earlier, we know that we will be held accountable for that.

So our actions are being documented. Whether the NPV model is disclosed or not, it is going to be known by Treasury and the audits that are done as to why we did or didn't do the modification and did we do it accurately.

Mr. JONES. Senator Menendez, Bank of America fully supports the Making Home Affordable program, and as far as the challenges that we are facing, I am not aware, do not have an example to share with you, of any instance where we are not looking to do the best for our customer.

And I would like to share that beginning last year, when we did 230,000 loan modifications, in the event a borrower applied for a modification that we could not do, we sent a decline letter, and we explained exactly why we could not do that modification.

Going forward, while it is not a requirement, I do not believe, under Making Home Affordable, it is our intent to provide a similar declination letter. As Mary mentioned, we expect the process to be fully transparent, and I am happy to work with you and the members and walk you through our process.

Senator MENENDEZ. Let me ask, so neither of you are going to find in your servicers, the people who work for you, telling people that they have to be in default in order to be considered, right?

Ms. COFFIN. I would say from a historical perspective and the number of team members that we have, I could never blanketly tell you we have never told a customer that.

Senator MENENDEZ. Have you made it very clear to your employees that that is not the answer to someone?

Ms. COFFIN. Very clear. And we also record all of our phone calls, and if we hear that, we will go back and actually pull the calls, re-research them, and retrain and/or handle the employee appropriately in that circumstance.

Senator MENENDEZ. Mr. Jones, what is experienced by Bank of America?

Mr. JONES. Bank of America's experience is the exact same.

Senator MENENDEZ. Well, I am going to share some cases with both of you.

Let me ask you, Ms. Coffin and Mr. Jones, Mr. Glovier argues that you are holding second mortgages on your books at inflated values. As a result, your banks are refusing to accept reasonable payments for second mortgages and blocking homeowners from getting principal reduction through the Hope for Homeowners. How do you respond to that?

Ms. COFFIN. Go ahead. I will let you go first this time.

Mr. JONES. Sure, thanks for the question, Senator Menendez. I was here earlier for panel one and listened very closely to former Commissioner Apgar's comments and Secretary Allison's, and where we are is we look forward to the Hope for Homeowners guidelines when they come out. Today we do not have guidelines that I can comment on. So I think the story was told, when Senator Merkley offered, that only one H4H loan has been created at this point.

In addition, we await final guidance on second liens. Once we have those, we fully commit to supporting the Making Home Affordable second lien program.

Ms. COFFIN. I would second that Wells Fargo has been very actively engaged with the Administration on the HAMP program for our home equity loans. As a matter of fact, we are very anxious for it to be—and I heard today within 2 weeks—so that we can implement that.

Knowing what we believe will be the parameters of that program, as we have co-loss-mitigated someone who we are working to find a solution for a borrower who has a first with us and we own the second, we have already aggressively and proactively gone ahead to mod that, as we believe the program will be administered. That is, if we lower the interest rate on a first, we will take the second, we will lower it to the same level. If there is a principal forgiveness or forbearance done, we will also match that on a percentage basis.

I will make one other statement as to home equity that I do not think most people believe, but it is a fact. In working on our own linked portfolio—that is, where we have the first, we are servicing the first, and we own the second—that in the small delinquency that there is, when the first is seriously delinquent, over more than half the time the second is current.

So in our programs that we have been working on and our advice and expertise and our analytical research to the Administration in helping to develop a program, one of the reasons Hope for Homeowners that we brought to the attention is that it does not allow for a subordination, only requires an extinguishment of the second. And when you are sitting with a performing loan that is current, that, one, does not provide that to be a very good option; but, number two, and more importantly to Hope for Homeowners, I think we have to look at the nature of who that product is best served by.

None of these programs serve blanketly all borrowers who are in need of assistance. Take Hope for Homeowners, for example. When you work through that program today, if you really have a struggling borrower who has an affordability issue, they could not afford

the ending interest rate of that loan. It will be somewhere in the range of 8 to 10 percent.

Now, when a modification today ends up in the range that it is being produced in a HAMP, they are not going to opt for a Hope for Homeowners modification—or a refinance, excuse me.

Senator MENENDEZ. Mr. Glovier or Ms. Thompson, any observations on those?

Mr. GLOVIER. You know, I would just echo what Mr. Apgar said in his testimony, that the second liens are certainly an issue and that HUD is working on that. We do understand that HUD and Treasury are working with the large bank and bank-affiliated servicers to work through that. But we have yet to see resolution on that process.

Ms. THOMPSON. I would say that we have certainly heard from many homeowners that they have had trouble getting servicers who hold the second liens to agree to modify the second liens, even when the second liens were not performing; and that we also look forward to the new guidance under HAMP to see what happens.

There is an additional point about affordability of loan modifications, and I agree with Mr. Apgar that affordability is certainly a problem. But there is more than one way to make a loan affordable, and you can do it by reducing the interest rate, or you can often do it by reducing the principal balance. If you reduce the principal balance, you have also effectively reduced the payments.

When I was a practicing legal services attorney, all of the loan modifications that I agreed to had principal reductions as part of them, because I believe strongly that you need to have homeowners building equity, that you need to align the value of the loan with the value of the collateral. So I do not think that there is an opposition, which we sometimes set up, between affordability and principal reductions. I think principal reductions are often the most effective way to achieve long-term affordability.

Senator MENENDEZ. You testified that servicers have incentives that keep them from forgiving principal, even when doing so might be better for the investor as well as the homeowner. How do you explain that?

Ms. THOMPSON. Yes, I think it is true that—I think that the complex web of incentives for servicers—I am not sure that any servicer, that any of us fully understand it, that there are lots of different directions in which the incentives pull. But certainly servicers' primary income base is based on a percentage of what the principal balance on the loan pool is. So, by reducing principal balances, they are going to take a hit to their monthly servicing income.

They may also take a hit in the residuals. Many servicers hold residual interests, and once the principal balance loss is recognized, the residual income may be cut off for them which they would otherwise be receiving.

There are lots of other ways in which, depending on the nature of the pooling and servicing agreement, servicers can, in fact, lose money by doing principal reductions. Now, that has not prevented all servicers from doing principal reductions. Ocwen and Litton have done many loan modifications with principal reductions. But

other servicers seem extraordinarily reluctant to do it, even when from a hard-headed economic analysis it seems to make sense.

Senator MENENDEZ. You just mentioned one—I did not catch the name. Who is it that is—

Ms. THOMPSON. Ocwen and Litton have both done quite a large number of principal reduction modifications.

Senator MENENDEZ. Are there any other servicers that are being more aggressive in offering principal reductions or deeper loan modifications?

Ms. THOMPSON. My understanding is that Ocwen and Litton are leading the pack in the principal reduction modifications. I believe Carrington may as well be doing some principal reductions.

Senator MENENDEZ. Well, Mr. Willen, I appreciated your testimony. I know you are not here on behalf of the Federal Reserve, but there is a lot of great information in your findings. What policy responses do you think make sense based upon those findings?

Mr. WILLEN. Several of my colleagues and I at the bank have made a proposal—which, again, is from us, not from the bank itself—in which we argued that the most effective way to help borrowers right now would be some sort of direct assistance to the borrowers rather than trying to incentivize servicers to help them.

One of the things that we are doing right now, we put together a whole web of incentives, and I think, as Diane said, the servicer already faces a web of incentives, and we have just added a whole new one. And whether that will actually get them to help the people who we think deserve the help, and especially in light of the fact that Government money is already going into this in terms of the payments to the servicers, that doesn't seem like a very—that seems like it is—it is not clear whether that will actually help the borrowers who we want to help.

And so what we have advocated is targeting assistance to unemployed borrowers, either in the form of a grant or in the form of a loan. And one of the things that I think was appealing to us is that it is something you can do quickly, and it does not require setting up all kinds of structures with servicers. We already have a bureaucracy in place—the unemployment insurance system—that is in place to help unemployed borrowers, and this would just be one thing to add to that rather than going through the servicers.

Senator MENENDEZ. So in Mr. Perretta's case, you would advocate having the Government give him a direct grant and/or loan in order to meet his present challenge?

Mr. WILLEN. I think that if such a program existed, we would have solved his problem by now.

Senator MENENDEZ. One last question to you, Ms. Thompson. Ms. Coffin has a pie chart which I found interesting in part of her written testimony that shows that mortgages associated with Government programs, such as Fannie Mae, Freddie Mac, and Ginnie Mae, constitute nearly 70 percent of all the mortgages, but only 32 percent of the seriously delinquent mortgages.

Meanwhile, the mortgages not affiliated with those programs constitute about 30 percent of all of the mortgages in the universe, but a whopping 67 percent of all the seriously delinquent mortgages.

Doesn't this tell us that a primary cause of the financial crisis is the unregulated mortgage brokers and lenders who did not worry about whether the mortgages they issued met Fannie or Freddie's guidelines and were good for borrowers? And doesn't that make the case for a Consumer Financial Protection Agency that spreads across the spectrum of financial entities beyond banks simply and looks at all of the interests of consumers among the predatory lenders that are out there?

Ms. THOMPSON. I think there is no question but that complex, unregulated mortgages are what are driving the current foreclosure crisis. Any way that you look at the data, that is what the data shows. The adjustable rate mortgages, for example, are—it is absolutely true, as Mr. Willen said earlier, it is not the reset but the adjustable rate mortgages, these complex loans that were sold to people are absolutely driving the foreclosure crisis, and there is no question in my mind but that if we had had effective, comprehensive regulation of those products, we would not be where we are today.

Senator MENENDEZ. OK. Well, thank you all for your testimony, and we will be following up. As you heard, I think, from several of the members when we had the first panel, there is clearly a real concern about moving this process forward, getting more engaged, having our servicers be more aggressive as well as looking at what the Government's response is here. We look forward to a continuing dialog in this.

Seeing no one else here and resisting the temptation to ask unanimous consent for something incredible, I will keep the record open—

[Laughter.]

Senator MENENDEZ. For that would be the last time I would chair—keep the record open for 1 week for questions other members may have. If they are submitted to you, we really ask you to get a response to us as soon as you can. And with the thanks of the Chairman, this hearing is adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

I'm glad you could all join us today, but I have to be honest with you: I am frustrated that we have to hold this hearing.

For over 2 years, this Committee has worked to stem the tide of foreclosures in America. We've gotten plans and proposals from the Administration. We've passed legislation, made changes asked of us, and passed some more. We've received assurance after assurance from the industry.

Everybody agrees that the crisis in our housing market was the catalyst for the broader economic crisis. And everybody understands that getting out of this broader crisis requires that we stabilize our housing market and stem the tide of foreclosures.

So I'm hoping that, with stakes this high, somebody can explain to me why nothing has changed.

Today the Associated Press is reporting "The number of U.S. households on the verge of losing their homes soared by nearly 15 percent in the first half of the year as more people lost their jobs and were unable to pay their monthly mortgage bills."

Why am I still reading about lost files, under-staffed and under-trained servicers, and hours spent on hold?

Why does the National Foreclosure Mitigation Program tell us that homeowners are waiting an average of six to 8 weeks for a response?

Why am I still reading stories about homeowners, community advocates, even my own staff acting on behalf of constituents, shuffled from voicemail to voicemail as they attempt to help people stay in their homes?

Why are servicers and lenders refusing to accept principal reduction so that homeowners can start building equity and get the housing market moving again? Two years ago I brought together banks, lenders, mortgage firms, regulators, and consumer groups for a Homeownership Preservation Summit.

We all agreed, upon a statement of principles.

- First, servicers should attempt to contact subprime borrowers before loans reset, in order to identify likely defaults early enough for the loan to be modified.
- Second, modifications should be made affordable for the long term.
- Third, servicers should have dedicated teams of professionals to implement those modifications.
- And finally, we agreed that we needed real accountability, a system for measuring the progress.

We were able to come to this agreement because we all understood that nobody wins when a home is foreclosed upon.

Nobody wins when a bank has to sell a house at auction for less than it would get if it simply refinanced.

Nobody wins when a home loses \$5,000 in value for every foreclosure on the block.

Nobody wins when foreclosure rates are the single biggest threat to economic recovery.

So what happened? And what are we going to do differently? Today, I want answers.

Foreclosure is not an abstract concept. It's very real pain for American families. It's not just the loss of a house. It's the loss of a home. It's the anguish of having to uproot your family. It's the sadness of feeling like you let them down.

And it's the terrible heartache caused by the violation of the sacred promise that has long defined the American middle class: that if we work hard and play by the rules, we can build something better.

Most people in foreclosures worked hard and played by the rules. They budgeted, they saved, and they relied on brokers and lenders—professionals who were supposed to be experts—to help them achieve their dream of homeownership.

But then someone lost a job, gets sick, or, in far too many cases, discovered that they'd simply been cheated.

Last year, I met Donna Pearce—a grandmother from Bridgeport, Connecticut, where there are 5,000 families with subprime mortgages in danger of foreclosure. Donna was assured by her lender that she could refinance in 6 months, but he didn't mention the thousands of dollars in penalties that refinancing would cost—penalties she couldn't afford.

People like Donna didn't deserve to lose their homes. Neither do the 10,000 families that will receive a foreclosure notice today or the 60,000 families in my home state of Connecticut that could find themselves in foreclosure over the next 4 years.

I know I speak for my friend Senator Shelby and our colleagues on this Committee when I say I'm glad to have the support of the Administration and the industry in our effort to stem this dangerous tide.

But what we don't have is results. And so here we sit. Again. And the American people are demanding to know why.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you Mr. Chairman.

Today, the Committee will examine the state of our housing market and the Federal Government's efforts to prevent foreclosures in the midst of what is now the most severe recession in a generation. Problems in our housing market have been center-stage since the start of this crisis.

Rising default rates on sub prime mortgages appear to have triggered the financial crisis nearly 2 years ago.

Since then, default rates on all classes of mortgages have risen sharply and precipitous declines in the value of mortgage-backed securities have crippled banks and led to the insolvency of Fannie and Freddie.

As the economy has continued to worsen, millions of Americans have seen the value of their homes fall and many have lost or may lose their homes to foreclosure.

In an effort to forestall unnecessary foreclosures, Congress and the Obama Administration initially devised several programs. Nearly 1 year ago, Congress enacted the Hope for Homeowners program.

This program aimed to keep homeowners in their homes by encouraging lenders and servicers to modify mortgages. Unfortunately, this program has only modified a handful of mortgages. While recently enacted changes to the program may help improve Hope for Homeowners, it is clear that the program needs a thorough reexamination.

In many ways I believe that this hearing could begin to put the horse back in front of the cart by undertaking some of the investigative work necessary to properly address the issues surrounding the housing market in this country.

We've heard many theories about the causes of our difficulties. However, my hope is that with this hearing we can begin to gather verifiable facts which will allow us to do our own analysis. Homeowners in need will be better served if we actually identify the root causes of foreclosures and craft effective solutions, rather than simply implementing policies to counteract what we think is the problem.

As the Committee considers how to prevent foreclosures, we should begin by determining the following:

- First, and probably most important, is the degree to which escalating default rates can be attributed to unscrupulous lenders. If true predatory lending was as pervasive as some have argued, we should be able to easily document that fact. I must say, however, aside from anecdotal evidence, I have yet to see such data.

I look forward to hearing what the Administration believes is the reason for the rising default rates and what evidence they cite in support of their position.

- The second question we need to ask is: What is working?

Unfortunately, existing modification programs have not been very effective. It is important to understand why they have not been working as expected and if there is anything we can or should do in response.

- Finally, we should determine whether our policies are building the foundation for a stable and sustainable housing market, or if they are merely delaying the inevitable.

I have long criticized our housing policy for willfully ignoring long-term financial consequences, especially with respect to the GSEs. Sustainable policies must be based on economic realities and facts, not wishful thinking.

I hope today we can begin to establish some of those facts by examining the research and experiences of our panelists.

To the extent we can clearly determine what caused this crisis, we will then be able to address it more effectively and also implement policies to avoid future crises.

Thank you Mr. Chairman.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

These are difficult times for homeowners no matter where you live. My State has been more fortunate than most in that our housing market didn't experience the

boom that other parts of the country did and South Dakota banks didn't sell as many exotic loan products as bankers in other regions sold. That said, with the housing market still in free fall in parts of our country, and the unemployment rate ticking upward, the housing situation continues to be troubling. Even in places where home values have remained relatively stable during this period of turbulence are now experiencing the effects.

We all know that widespread foreclosures have negative consequences on our communities. The Administration and Congress have taken many steps to create programs to aid financial institutions in helping keep responsible families in their homes—an important goal for preserving both neighborhoods and homeownership. Yet, we are still seeing rising foreclosure numbers. We need to know if the programs need to be improved and if the financial institutions need to do more. I look forward to hearing more from today's witnesses about the progress being made to modify and refinance home loans, including the successes and the challenges.

PREPARED STATEMENT OF HERBERT M. ALLISON

ASSISTANT SECRETARY FOR FINANCIAL STABILITY, DEPARTMENT OF THE TREASURY

JULY 16, 2009

Introduction

A strong housing market is crucial for our economic recovery. It is a fundamental source of wealth and well-being for individual families and communities and plays a key role in our financial system. The recent crisis in the housing sector has devastated families and communities across the country and is at the center of our financial crisis and economic downturn. Today, I want to outline the steps that Treasury and the Administration have taken to address this crisis, help millions of homeowners and lay the foundation for economic recovery and financial stability.

This crisis took years in the making and as a result, millions of homeowners have mortgage payments they are unable to afford. The rapid decline in home prices of the past 2 years has had devastating consequences for homeowners, communities and financial institutions throughout the country. Moreover, rising unemployment and other recessionary pressures have impaired the ability of many otherwise responsible families to stay current on their mortgage payments. The result is that responsible homeowners across America are grappling with the possibility of foreclosure and displacement. Many analysts project that more than 6 million families could face foreclosure in the next 3 years if effective actions are not taken.

The Administration's Efforts

This Administration has moved with great speed to aggressively confront the economic challenges facing our economy and housing market by announcing and implementing an unprecedented mortgage modification program. Within a month of taking office, on February 18th, President Obama and Secretary Geithner announced the Making Home Affordable (MHA) Program, a critical element of Treasury's Financial Stability Plan. This program was broadly designed to stabilize the U.S. housing market and offer assistance to millions of homeowners by reducing mortgage payments and preventing avoidable foreclosures.

An initiative of this scale has never been previously attempted. Just 2 weeks after the President announced the program, the Administration, working with the banking regulators, HUD, and the Federal Housing Finance Agency, published detailed program guidelines for MHA's Home Affordable Modification Program (HAMP). On April 6th, we issued detailed servicer guidance. Today, we have 27 servicers signed up to participate in MHA. Between loans covered by those servicers and the GSEs, more than 85 percent of all mortgage loans in the country are now covered by the program.

The initiative includes the following three key components:

- (1) **The Home Affordable Refinance Program (HARP):** HARP expands access to refinancing for families whose homes have lost value and whose mortgage payments can be reduced at today's low interest rates. It helps to address the problems faced by homeowners who made what seemed like conservative financial decisions three, four or 5 years ago, but who have found themselves unable to benefit from the low interest rates available today because the value of their homes has sunk below that of their existing mortgages.

Initially, the program was able to help homeowners whose existing mortgages were up to 105 percent of their current home value. However, we moved to expand it to help those with mortgages up to 125 percent of current home value.

- (2) **The Home Affordable Modification Program (HAMP):** HAMP will provide up to \$75 billion dollars, including \$50 billion of funds from the Troubled Assets Relief Program (TARP), to encourage loan modifications that will provide sustainably affordable mortgage payments for borrowers. Importantly, HAMP offers incentives to investors, lenders, servicers, and homeowners to encourage mortgage modifications.
- (3) **Support to the GSEs:** The Administration is encouraging low mortgage rates more generally by increasing support for the Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, through an expansion of Treasury's Preferred Stock Purchase Agreements with the GSEs. To this effect, we have committed up to an additional \$200 billion of capital to the GSEs.

In addition, we have also announced the following additional HAMP measures:

- On April 28th, the Administration announced additional details related to the Second Lien Program which will help to provide a more comprehensive affordability solution for borrowers by addressing their total mortgage debt. In addition, this announcement included provisions to strengthen HOPE for Homeowners Program, which provides additional relief for borrowers with mortgage balances greater than the current value of their homes.
- On May 14th, we announced additional details related to the Foreclosure Alternatives Program, which will provide incentives for short sales and deeds-in lieu of foreclosure where borrowers are unable to complete the modification process. We also announced additional details on Home Price Decline Protection Incentives, designed to provide incentive payments for modifications to partially compensate lenders and investors for home price declines.

HAMP Design—Key Principles

Now, I will discuss these programs in greater detail. Our initiatives are built around three core concepts.

- First, the program focuses on affordability. Building on the insights of Chairwoman Bair of the FDIC, it is designed to reduce mortgage payments to an affordable level based on borrowers' gross monthly income.
- Second, HAMP's pay-for-success structure aligns the interests of servicers, investors and borrowers in ways that encourage loan modifications that will be both affordable for borrowers over the long term and cost-effective for taxpayers.
- Third, the Program establishes detailed guidelines for the industry to use in making loan modifications with the goal of encouraging the mortgage industry to adopt a standard that better suits borrowers and lenders, both in and out of MHA.

In the past, a lack of agreed-upon guidelines has limited the number of loan modifications that are completed, even in instances where modifications would have been beneficial to all involved. Driving the industry toward standardized modifications based on HAMP should help increase the number of modifications.

That will be good for borrowers, good for lenders, good for mortgage lending standards and good for improved stability of our overall financial system.

HAMP Design—Eligibility Criteria

Next, I will discuss the eligibility criteria for the modification program, designed specifically to help responsible American homeowners with the greatest need for assistance and to provide that assistance at the least cost to taxpayers.

Modifications are potentially available to all borrowers regardless of loan-to-value ratio, so borrowers can qualify no matter how much the price of their home has fallen.

The modification plan was designed to be inclusive, with a loan limit of \$729,750 for single-unit properties, and higher limits for multi-unit properties. At this level, over 97 percent of the mortgages in the country have a principal balance that might be eligible.

Finally, because it is more effective to reach borrowers before they have missed a payment, the modification program includes incentives for the modification of loans where borrowers are current on their payments, but can demonstrate financial hardship or imminent risk of default.

HAMP Design—Modification Process

Next, I will discuss the modification process.

Under HAMP's loan modification guidelines, mortgage servicers are prevented from "cherry-picking" which loans to modify in a manner that might deny assistance to borrowers at greatest risk of foreclosure.

Participating servicers are required to service all loans in their portfolio according to HAMP guidelines, unless explicitly prohibited by pooling and servicing agreements, and further must make reasonable efforts to obtain waivers of any limits on participation. Participating servicers are also required to evaluate every eligible loan using a standard net present value (NPV) test. The NPV test compares the net present value of cash-flows with modification and without modification. If the test is positive, the servicer must modify the loan.

Under the program, servicers must reduce the borrower's first lien mortgage to a 31 percent debt-to-income (DTI) ratio, meaning that the monthly mortgage payment is no greater than 31 percent of gross monthly income. To reach this payment, the servicer must use a specified sequence of steps:

1. Reduce the interest rate, subject to a rate floor of 2 percent.
2. If the 31 percent DTI has not been reached, extend the term or amortization period of the loan up to a maximum of 40 years.
3. If the 31 percent DTI still has not been reached, forbear principal until the 31 percent ratio is achieved.

Principal forgiveness may be applied at any stage. Additionally, each loan must be considered for a HOPE for Homeowners refinancing.

The borrowers' modified monthly payment of 31 percent DTI will remain in place for 5 years, provided the borrower remains current, and following the modification the interest rate will step up each year to a specified cap that will be fixed for the life of the loan. We believe HAMP creates new fixed-rate loans that homeowners can afford and can understand.

HAMP Design—"Pay for Success" Incentive Structure

HAMP offers "pay for success" incentives to servicers, investors and borrowers for successful modifications. This aligns the incentives of market participants and ensures efficient expenditure of taxpayer dollars.

Servicers receive an up-front payment of \$1,000 for each successful modification after completion of the trial period, and "pay for success" fees of up to \$1,000 per year, provided the borrower remains current. Homeowners may earn up to \$1,000 toward principal reduction each year for 5 years if they remain current and pay on time.

HAMP also matches reductions in monthly payments dollar-for-dollar with the lender/investor from 38 percent to 31 percent DTI. This requires the lender/investor to take the first loss in reducing the borrower payment down to a 38 percent DTI, holding lenders/investors accountable for unaffordable loans they may have extended.

To encourage the modification of current loans expected to default, HAMP provides additional incentive to servicers and lender/investors when current loans are modified.

Signs of Progress

Our progress in implementing these programs to date has been substantial, but we recognize that much more has to be done to help homeowners. Today, I want to highlight some key points of success:

- We have signed contracts with 27 servicers, including the five largest. Between loans covered by these servicers and loans owned or guaranteed by the GSEs, more than 80 percent of all mortgage loans in the country are now covered by the program.
- 325,000 trial modifications have been offered under the program. Tens of thousands of trial modifications are underway.

At this early date, MHA has already been more successful than any previous similar program in modifying mortgages for at risk borrowers to sustainably affordable levels, and helping to avoid preventable foreclosures.

Nonetheless, we recognize that challenges remain in implementing and scaling up the program, and are committed to working to overcome those challenges and reach as many borrowers as possible. In particular, we are focused on addressing challenges in three key areas: capacity, transparency and borrower outreach.

Expanding Servicer Capacity

We are taking a number of steps and working with servicers to expand nationwide capacity to accommodate the number of eligible borrowers who can receive assistance through MHA. I highlight some key measures below:

One, we are also asking that all servicers move rapidly to expand servicing capacity and improve the execution quality of loan modifications. This will require that servicers add more staff than previously planned, expand call center capacities, provide a process for borrowers to escalate servicer performance and decisions, bolster training of representatives, enhance on-line offerings, and send additional mailings to potentially eligible borrowers.

Two, just last week, as a part of the Administration's efforts to expedite implementation of HAMP, Secretaries Geithner and Donovan wrote to the CEOs of all of the servicers currently participating in the program. In this joint letter, they noted that "there appears to be substantial variation among servicers in performance and borrower experience, as well as inconsistent results in converting trial modification offers into actual trial modifications." They called on the servicers "to devote substantially more resources" to the program in order for it to fully succeed.

The joint letter to participating servicers also requests that the CEOs designate a senior liaison, authorized to make decisions on behalf of the CEO, to work directly with us on all aspects of MHA and attend a program implementation meeting with senior HUD and Treasury officials on July 28, 2009. Treasury also requested that each servicer detail the specific steps that the servicer will take toward effective implementation and compliance.

Three, we are taking additional steps to expedite implementation, including more standardization of documentation and disclosure of the NPV evaluation.

Transparency and Accountability

As Secretary Geithner has noted, we are committed to transparency and better communication in all of Treasury's programs. Accordingly, Treasury is focused on continued transparency and servicer accountability to maximize the effectiveness of HAMP. Specifically, we are planning to take three additional concrete steps in conjunction with the servicer liaison meeting to enhance transparency in the program:

One, by August 4th, we will begin publicly reporting servicer-specific results on a monthly basis. These reports will provide a transparent and public accounting of individual servicer performance by detailing the number of trial modification offers extended, the number of trial modifications underway, the number of official modifications offered and the long terms success of modifications.

Two, we will work to establish specific operational metrics to measure the performance of each servicer. These performance metrics are likely to include such measures as average borrower wait time in response to inquiries, the quality of information provided to applicants, procedures for document processing and review, and response time for completed applications.

We are also planning to deploy a data reporting tool that will contain over 130 data elements and will be able to provide a comprehensive assessment of the program at the loan, servicer, and mortgage market levels. This will enable the program to be effectively measured against specific performance benchmarks.

Finally, we have asked Freddie Mac, in its role as compliance agent, to develop a "second look" process pursuant to which Freddie Mac will audit a sample of MHA modification applications that have been declined. This "second look" process will be designed to minimize the likelihood that borrower applications are overlooked or that applicants are inadvertently denied a modification.

We have also expanded the efforts of the Federal Government to combat mortgage rescue fraud and put scammers on notice that we will not stand by while they prey on homeowners seeking help under our program.

Borrower Outreach

The third challenge we are tackling aggressively is borrower outreach. We recognize the importance of borrower outreach and education and are committing significant resources, in partnership with servicers, to reach as many borrowers as possible. Here, we have taken a number of steps:

- We have launched a consumer focused website, *www.MakingHomeAffordable.gov*, with self-assessment tools for borrowers to evaluate potential eligibility in the MHA program. This website is in both English and Spanish and already has over 22 million page views.
- We have worked with an interagency team to establish a call center for borrowers to reach HUD approved housing counselors, so that they are able to receive direct information and assistance in applying for the MHA program.

- Working closely with Fannie Mae, we have also launched an effort to hold foreclosure prevention workshops and borrower education events in cities facing high foreclosure rates. The first such outreach event was held in Miami in June.

Much more has to be done and we will continue to work with other agencies and the private sector to reach as many families as possible.

Program Limitations

Finally, we recognize that any modification program seeking to avoid preventable foreclosures has limits, HAMP included. Even before the current crisis, when home prices were climbing, there were still many hundreds of thousands of foreclosures. Therefore, even if HAMP is a total success, we should still expect millions of foreclosures, as President Obama noted when he launched the program in February.

Some of these foreclosures will result from borrowers who, as investors, do not qualify for the program. Others will result because borrowers do not respond to our outreach. Still others will be the product of borrowers who bought homes well beyond what they could afford and so would be unable to make the monthly payment even on a modified loan.

Nevertheless, for millions of homeowners, HAMP will provide a critical opportunity to stay in their homes. It will bring relief to the communities hardest hit by foreclosures. It will provide peace of mind to families who have barely managed to stay current on their mortgages or who only recently have fallen behind on payments. It will help stabilize home prices for all American homeowners and, in doing so, aid the recovery of the U.S. economy.

Conclusion

In less than 5 months, including the initial startup phase, HAMP has accomplished a great deal and helped homeowners across the country. But we know that more is required to help American families during this crisis and will aggressively continue to build on this progress. For example, we are taking additional steps to implement programs including:

1. the Second Lien Program;
2. the Foreclosure Alternatives Program;
3. Home Price Decline Protection incentives; and
4. strengthening of HOPE for Homeowners.

Each of these supplemental programs is designed to increase the effectiveness and take-up of the basic modification plan.

Sustained recovery of our housing market is critical to lasting financial stability and promoting a broad economic recovery.

We look forward to working with you to help keep Americans in their homes, restore stability to the U.S. housing market and growth to the U.S. economy.

Thank you. I look forward to your questions.

PREPARED STATEMENT OF WILLIAM APGAR

SENIOR ADVISOR FOR MORTGAGE FINANCE,
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

JULY 16, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on the progress that the Obama Administration is making to stabilize the U.S. housing market through the Making Home Affordable (MHA) program, the integration of the HOPE for Homeowners element into the larger plan, and other Administration efforts to provide relief to homeowners and neighborhoods suffering from the effects of the foreclosure crisis.

My name is William Apgar and I serve as Senior Advisor for Mortgage Finance to HUD Secretary Shaun Donovan. In this capacity, I have worked closely on the development and implementation of the Administration's Making Home Affordable program which was announced on February 18, 2009, the HOPE for Homeowners program, and other efforts intended to address the housing crisis.

Making Home Affordable: Progress and Challenges

We are all aware that the U.S. is facing an unprecedented foreclosure crisis—with millions of Americans projected to lose their homes within the next few years. Working together, Congress and the Administration have undertaken a number of initiatives designed to prevent foreclosures and mitigate the impact of foreclosed and abandoned properties on local neighborhoods and the broader economy.

At the center of the Administration's effort to address the housing crisis is the Making Home Affordable Program, a comprehensive program to stabilize the housing markets by providing affordable refinance and modification opportunities for at-risk borrowers. Since the launch of the program in March, 27 servicers—representing more than 85 percent of the market—have signed up. So far, these servicers have collectively extended trial modification offers to more than 325,000 borrowers.

Despite this significant progress, we recognize that more has to be done to reach additional homeowners facing, or at risk of, foreclosure and ensure that they are assisted in a timely manner. As with any new program, we have encountered a few difficulties in launching the Making Home Affordable Program. Many consumers have had trouble reaching their servicers and receiving a timely response from servicers after they have submitted applications for modification. Other consumers have complained of receiving inaccurate or misleading information from servicers. HUD is working with Treasury to quickly resolve issues surrounding program implementation and execution.

For instance, we have had ongoing meetings and conversations with servicers to encourage them to be more responsive. To further underscore the importance of prompt servicer response, last week Secretaries Donovan and Geithner sent letters to the CEOs of the participating financial institutions urging them to add servicing capacity and improve the quality of execution necessary to reach the sizable number of homeowners at risk of foreclosure and to designate a senior official to serve as a liaison with the Administration and work with HUD and Treasury on the implementation of all aspects of MHA. By early August, we will be able to start reporting servicer specific results publicly.

In addition, we are exploring a variety of mechanisms to enable servicers to leverage their relationships with nonprofits and other entities to help expedite the processing and approval of modification applications. HUD and Treasury are working to create a network of trusted advisors to guide borrowers through the application process, help them prepare complete application packages, and troubleshoot if the borrower appears to have been improperly deemed ineligible for the program. Moreover, HUD is also working with Treasury and the Homeownership Preservation Foundation to further train and utilize housing counseling to better resolve consumer complaints against servicers.

Evolving Nature of MHA

The MHA program continues to evolve in order to respond to the changing nature and magnitude of the foreclosure crisis. For example, on April 28, the Administration announced the framework for a program that would facilitate the modification of second liens when a first lien is modified. Second mortgages can create significant challenges to helping borrowers avoid foreclosure because they can increase borrowers' monthly mortgage payments beyond affordable levels. Up to 50 percent of at-risk mortgages have second liens, and many properties in foreclosure have more than one lien.

Also, on July 1, Secretary Donovan announced an expansion of the Administration's Home Affordable Refinance Program (HARP) to include participation by borrowers who are current on their payments but have first mortgage loan-to-value ratios of up to 125 percent. Mortgage rates remain at near historic lows providing many homeowners with high rate mortgages the ability to refinance into lower rates and experience lower monthly payments. Unfortunately, millions of responsible homeowners have seen the value of their homes drop so dramatically that they are unable to take advantage of these lower rates. In many hard hit communities in California, Florida and Nevada, a large number of homeowners have experienced significant reductions in home values and have been unable to participate in the program. Under authorization provided by the Federal Housing Finance Agency, borrowers whose mortgages are currently owned or guaranteed by Fannie Mae or Freddie Mac will now be allowed to refinance those loans even in situations where the value of their first mortgage is as much as 125 percent of the current value of their home. By increasing this LTV cap from the previously authorized 105 percent, this new initiative will expand the ability of the program to aid many hard hit borrowers, particularly those in states suffering from the most extreme declines in home prices.

Similarly, in recognition that the MHA program will not assist every at-risk homeowner or prevent all foreclosures, the Administration announced foreclosure alternatives for borrowers and HUD is working on a number of neighborhood stabilization initiatives. Under the details announced on May 14, MHA will provide incentives for servicers and borrowers to pursue short sales and deeds-in-lieu (DIL) of foreclosure in cases where the borrower is generally eligible for a MHA modifica-

tion but does not qualify or is unable to complete the process. These options eliminate the need for potentially lengthy and expensive foreclosure proceedings, preserve the physical condition and value of the property by reducing the time a property is vacant, and allows the homeowners to transition with dignity to more affordable housing. The new details simplify the process of pursuing short sales and deeds-in-lieu, which will facilitate the ability of more servicers and borrowers to utilize the program. The program provides a standard process flow and minimum performance timeframes and standard documentation. The final details of the program are being finalized, and will be announced as soon as completed.

New Legislative Authorities: HUD's Role

In addition to efforts to improve the execution of the program that was first announced in February, the Obama Administration is now working to implement new and improved program features authorized by the "Helping Families Save Their Homes Act of 2009" signed into law on May 20, 2009. The legislation eases eligibility requirements and streamlines the application process for the HOPE for Homeowners (H4H) program and provides the Federal Housing Administration (FHA) with additional loss mitigation authority to assist FHA borrowers under MHA.

We want to commend Chairman Dodd and other members of the Committee for your leadership in getting this important legislation enacted. When fully implemented, the improved H4H program is expected to provide relief to certain at-risk homeowners who are underwater on their mortgages and are not covered by other programs, including Fannie Mae and Freddie Mac programs. The new FHA loss mitigation program will enable homeowners with mortgages insured by the FHA to obtain assistance under terms roughly comparable to borrowers in other segments of the market, without increasing costs to the taxpayer.

HOPE for Homeowners: As you know, H4H was initially authorized under the Housing and Economic Recovery Act of 2008 to provide a mechanism to help distressed homeowners refinance into FHA insured loans. The temporary program, established within the FHA, is premised on the view that the creation of equity for troubled homeowners is likely to be an effective tool for helping families keep their homes and avoid foreclosure. Unfortunately, due to several obstacles to participation, including steep borrower fees and costs, complex program requirements, and lack of operational flexibility in program design, the original H4H program has only served a handful of distressed home owners. We believe that the legislative improvements combined with the integration of the H4H into the Administration's MHA program will make the program a more attractive and less burdensome option for underwater borrowers seeking to refinance their loans and regain equity in their homes.

The improved H4H program will provide a new program option for certain at-risk borrowers who are underwater on their mortgages and are not eligible to participate in the GSE refinancing program. When a borrower approaches participating servicers for assistance, the servicer will be required to offer the option for a H4H refinancing in tandem with a MHA Trial Modification option. The program only serves homeowners who do not own other homes, demonstrate their ability to meet their H4H mortgage payment obligations, have not intentionally defaulted on any other substantial debt in the last five years, and do not have other significant sources of wealth. To ensure proper alignment of incentives, servicers and lenders will receive pay-for-success payments for Hope for Homeowners refinancings similar to those offered for Home Affordable Modifications. These additional supports are designed to work in tandem and take effect with the improved and expanded program.

Though the program promises substantial benefits to underwater borrowers best served by an increased equity position in their homes, treatment of second liens poses significant challenges to the implementation of H4H. First, the presence of a second lien complicates the execution of a mortgage refinance even under the best of circumstances. As the effort to offer consumers the option of modifying both first and second liens has demonstrated, since the second liens tend to be held in portfolio by several of the Nation's largest banking institutions, while first liens are owned by a wider range of investors, coordinating the communication and decision making between these two separate financial interests can be logistically complex.

Equally challenging is the determination of a fair allocation of payments to each of these two distinct investment interests needed to facilitate the refinancing of an underwater mortgage. Under the improved and integrated H4H, HUD has flexibility to pay to extinguish second liens consistent with MHA guidelines, and the potential to provide investors a share of the price appreciation in exchange for taking a significant "hair cut." Even in situations where there is little prospect of realizing any future appreciation, many first lien investors, under the concept of "one loss—one

time,” appear increasingly willing to accept the required “hair cut,” and execute a clean exit from the transaction.

Unfortunately, the calculation of second lien holders is decidedly more complex. Even in situations where the combined LTVs of first and second liens exceed the current market value of the home, second liens may have some value. In particular representatives of banking institutions that hold sizeable numbers of second liens in their portfolios report that in some situations, borrowers who are delinquent on their first lien are continuing to make payments on their second lien, providing some measure of benefit to second lien holders. Of course, where the first lien is underwater, once the property moves to foreclosure, the second lien is worthless.

In light of these complex and often conflicting interests, determining a fair compensation system for holders of second liens is difficult. In this regard the recent letter to the heads of the five bank regulators (FRB, OCC, NCUA, FDIC, OTS) dated July 10 and jointly signed by Senate Banking Committee Chairman Dodd and House Financial Services Committee Chairman Frank is instructive. In assessing methods used to estimate the value of second liens held on the balance sheet of the Nation’s largest banks, the letter expressed the concern “that loss allowance associated with these subordinated liens may be insufficient to realistically and accurately reflect their value, especially in light of the historically poor performance of first lien mortgages and seriously diminished value of the underlying collateral.” The letter goes on to observe that in situations where banks are allowed to carry these loans at potentially inflated values, they may be reluctant to “negotiate the disposition of these liens, and thus may stand in the way of increasing participation in the H4H.”

To better understand these issues, HUD and Treasury are now working with the OCC and other regulators that supervise the activities of the large national banking entities that hold in portfolio the largest share of second liens. In addition to ensuring that current regulatory policy does not act to encourage banks to seek to delay the realization of portfolio losses by allowing these entities to carry assets at inflated valuations, these conversations will also draw on the considerable expertise of the OCC and other regulators to help HUD craft an extinguishment schedule that will provide fair compensation to the holders of the second lien assets.

In sum, HUD remains committed to reissuing guidance on the operation of the reconstituted version of H4H program. The goal is a program that works—a program that provides real benefits to a group of homeowners best served by an increased equity position in their homes, while at the same time providing fair treatment to the interests of the investor/owners of first and second liens and adequate compensation for the other parties participating in the transaction.

The FHA Modification Program: As noted above, HUD is also now working to finalize guidance implementing the Federal Housing Administration’s (FHA) Home Affordable Modification Loss Mitigation Option which is an important complement to the MHA and will provide homeowners in default with greater opportunity to reduce their mortgage payments to sustainable levels. The FHA’s long-standing Loss Mitigation Program has given lenders who provide FHA-insured mortgages the authority and responsibility to assist homeowners who have fallen into financial difficulties with their home mortgages. The new legislation will increase the number of distressed homeowners receiving assistance by expanding the authority of FHA to engage in foreclosure prevention by allowing the use of new tools. Under new authorities, FHA can offer a partial claim up to 30 percent of the unpaid principal balance as of the date of default combined with a loan modification. **In addition, it permits loss mitigation tools to kick in for loans that face “imminent default,” rather than just for loans in default. Moreover, FHA is granted the authority to facilitate loan modifications through assignment of loans in order to address servicer loss mitigation disincentives relating to having to purchase loans from Ginnie Mae pools.**

Additional Challenges

Even as the Obama Administration is working to improve the execution of the Making Home Affordable and to deploy new program features authorized under the “Helping Families Save Their Homes Act,” we continue to examine new approaches to expand the reach of the foreclosure avoidance efforts and stabilize housing markets in communities around the country. As I noted in testimony before the House Financial Services Committee last week, the Administration stands ready to explore with Congress additional ideas to aid at-risk borrowers that may not qualify currently qualify for the MHA.

- The current very high level of unemployment is making the already difficult task of helping families struggling to meet their mortgage payment even harder. Initial efforts by the government to prevent foreclosures were not primarily designed to assist unemployed individual in some of the hardest hit commu-

nities. As the economy has weakened, unemployment has become an increasing cause of mortgage default and foreclosure. Recognizing this, the Administration is now exploring a series of programmatic options that can help unemployed workers get the mortgage assistance that they need.

- Next, recognizing that there is an impending crisis in the multifamily mortgage sector which could have devastating effects for tenants, HUD Secretary Donovan has led the Administration's review of potential means to expand access to bond financing to assist State and Local Housing Finance Agencies in continuing to pursue their important financing role to increase both affordable homeownership and rental housing opportunities. HUD has also created an internal task force to develop a better understanding of this emerging crisis, has reached out to Treasury and the Federal Housing Finance Agency (FHFA) to explore new approaches to confront this situation, and is now completing a top to bottom review of HUD's own multi-family initiatives to identify new programmatic alternatives. Building on these efforts, HUD looks forward to working with the Committee to explore various options for stabilizing the multi-family housing sector.
- Finally, Secretary Donovan has challenged HUD to do all that we can to work with Congress and the Administration to insure that the nearly \$6 billion appropriated to date for the Neighborhood Stabilization Program (NSP) plays its intended role in helping to stabilize housing markets and combat blight. In many communities, NSP is starting to generate real results, but HUD will continue to monitor program activities, identify strategies that produce real results, and work to make program modifications that will help ensure that this funding is deployed quickly, wisely, and well.

Conclusion

Once again, I would like to thank you for the opportunity to participate in today's hearing. HUD shares your concerns about the progress of Administration's efforts to address the foreclosure crisis and can assure you that we are working to resolve issues related to implementation and execution of core programs and to implement new elements to improve and refine MHA in the near future. I am happy to answer any questions you may have.

PREPARED STATEMENT OF THOMAS PERRETTA

CONSUMER, STATE OF CONNECTICUT

JULY 16, 2009

Good morning, Chairman Dodd and Ranking Member Shelby.

My mortgage problems became evident when my wife, Susan, passed away in 2008.

All our lives we were a hard-working couple, giving the best we could to our son, Tom Jr., and living modestly. In addition to our regular jobs, we each had various part-time jobs.

Before we bought the town house in 2001, we lived for 1 ½ years at my in-laws to save up money for that purchase, which would be a home for us and our son.

I have been working with the Connecticut Board of Education for 11 years and Susan worked for Stamford Health. In 2004 she found her ideal job at Sacred Heart School, where she was a guidance counselor in college placement. She was earning about \$40,000 annually. With our joint incomes we were able to keep our family finances going smoothly and send Tom Jr. to Quinnipiac University.

But in 2005, just as Sacred Heart was closing permanently, Susan was diagnosed with leukemia. In April she had chemotherapy which was followed by a bone marrow transplant October 21, 2005.

My medical insurance covered her medical payments, although not the co-pays. Finally Susan began receiving Social Security disability of \$1,400 monthly. As Tom Jr. had begun college in 2004, this helped but not enough.

Throughout the years Susan had managed our finances and in order to keep Tom Jr. in college, we applied for a home equity loan from Wachovia and began increasing credit card debt. Susan helped Tom Jr. apply for student loans, and we also took out one parent-student loan.

Because we had both worked all our lives, Susan even began looking for a job after her bone marrow transplant, even though she was still weak. In April 2008 Susan developed an infection and became extremely weak. While at a nursing home her health deteriorated and she never returned home.

In order for her to have a proper funeral I borrowed \$16,000 from friends. I have just finished paying that amount off. Suddenly after 25 years in which Susan handled the bills, I was overwhelmed but I realized I had to keep paying the mortgages on the townhouse.

We had a first with Chase and a second with Wachovia. I got a grip on some of these and started chipping away at our debt. I was making payments to Chase at the branch. At the beginning of 2009, as money became tight and I was worried about making payments I went to the Chase branch for help because I could not keep up.

The Chase customer service representative told me someone would phone me, but no one did.

At the beginning of 2009 I spoke to a Chase representative over the phone asking for help in a loan modification and her reply was that I did not make enough to qualify. I was unable to convey that I had just been through the tragic death of my wife and was trying to settle everything in a reasonable manner.

In the past few months Chase collections has been calling me at work, but no one has ever suggested that they might help me, or proposed a single positive step for resolution. The last calls were just a few weeks ago.

It seemed that Chase did not realize that people like me, who have just had an overwhelming event in their life, may still be honest responsible human beings who need help.

I turned to a housing counselor at the Housing Development Fund and they are trying to help me negotiate with Chase since February. So far they also have not received a reply, even though my mortgage is a FNMA and should qualify for Make Your Home Affordable. A package with my request for a modification was sent to Chase on May 4th.

I explained to the counselor that with all the bills piling on top of each other, I was unable to pay the common charges of my condo association and am now in a one-year agreement with them. I also have an agreement with the electrical company. Other creditors have worked with me, only Chase is still not doing that.

Now that Tom Jr. graduated from college and is working he will be contributing to the household income. He will help me in paying off the past due common charges (the agreement is for \$500 a month) and I am giving up my car which will lower my expenses by \$300.

With all these steps in place, some of which the counseling agency proposed, I can make payments of \$1,400 if Chase/FNMA will work with me.

People like me should be the ones the banks are helping. I am now 6 months past due. I hope that Chase will give me a modification soon.

PREPARED STATEMENT OF JOAN CARTY

PRESIDENT AND CEO, THE HOUSING DEVELOPMENT FUND,
BRIDGEPORT, CONNECTICUT

JULY 16, 2009

Good afternoon, Chairman Dodd and Ranking Member Shelby. Thank you for inviting me to testify today. My name is Joan Carty. I am the President and CEO of the Housing Development Fund (HDF) in Stamford, CT. HDF is a community development financial institution that has operated in Connecticut for the last twenty years. We provide financing to developers of affordable housing, technical assistance to local governments, homeownership counseling and down payment assistance to first time homebuyers. We have helped almost 5,000 people secure safe, decent and affordable housing. Less than 2 percent of our homebuyers are in delinquency or default. We credit that solid track record to the fact that they were counseled, educated, and that we only allowed our clients into 30-year, fixed rate first mortgages.

HDF partners with the banking community, local housing authorities and municipalities in its core business. We have leveraged over \$145 million in first mortgages with our SmartMove and Homebuyer Assistance loan programs. HDF has worked with the Greenwich, Stamford and Darien housing authorities to help residents educate themselves about homeownership. HDF also worked with the cities of Stamford and Norwalk to put forth innovative and inclusive inclusionary zoning systems in these communities. We have partnered with developers to market their below market rate units as well. Last year, because of the widespread and increasing problems with subprime lending, mortgage delinquencies and rising foreclosures, HDF started an additional counseling program to assist families in our communities who were stressed with these problems. In the course of developing our program we have reached out to many other partners: the Bar Association for pro bono attorneys, the

courts to establish working relationships with the mediators, volunteers with financial and social services backgrounds to help us with the ever increasing volume of people who need guidance, and the banks—who in many cases control the outcomes of the situations facing people in foreclosure or mortgage delinquency.

We are a HUD certified counseling agency and down payment assistance lender. We have personally experienced the kind of shadow boxing that occurs when a homeowner in distress calls their lender or servicer for help. Too often, their call is bounced to a call center across the globe, or the call is bounced from department to department within the bank. On many occasions, after multiple periods of time on hold, they finally reach a live person but it is a representative who is merely following a script. Often the lender or servicer representative has no record of prior contact with the borrower. It is a process that often feels futile.

We have found that in too many cases when we send clients' modification requests to banks or servicers such as JP Morgan Chase or Goldman Sachs-owned Litton, that the modification package enters a black box for months on end. These borrowers are in distress; even a 30 day time frame can radically affect their credit profile. Once they slip behind on timely payments of their mortgage or any consumer debt, their credit score goes down, and their monthly interest charges can go up. In many cases cross default provisions mean that default on one obligation will trigger higher monthly charges on other debt, even if the borrower had remained current for that obligation. If we were to look for common themes as to why families are in distress, we often find that death, divorce, illness or injury, in addition to predatory terms on many mortgages, have pushed families to the edge of the cliff. Imagine the multipliers and harm rendered when this limbo extends for months.

I understand that the lenders and servicers need modification requests that are well documented and that contain a budget that has been carefully worked out so that the borrower will succeed in the modification over the long term. That is the kind of service that we as a counseling agency provide to our clients. What our clients in turn need from the lenders and servicers is rapid response. Responses before their lives continue to spiral downward. It is difficult to believe that the sophisticated automated platforms that have been in use by lenders and servicers for loan origination over the past decade cannot be retooled to generate effective loan modifications with greater frequency and within tighter timelines.

I would also suggest that rapid response will help in other ways. With delay comes added expenses, which often get added to the mortgage balance. Extensive delays in the mediation process often result in the lenders or servicers charging the borrower multiple times for late fees, attorneys' fees, and updated appraisals. Denial of borrowers' requests lead to expensive foreclosure processes, which hurt the families involved and the communities in which the homes are located. In many instances, these foreclosures do not ameliorate losses or generate profits for the banks given the current declines in property values throughout the country. Additionally, it is critically important to create a system that rapidly responds to requests from homeowners who are still current on their mortgages but who know they will not be able to sustain their payments going forward.

What we are building at our agency is a system that can carry borrowers from that initial request for assistance through assessment of their situation and development of a modification request that will have viability over the long term.

What we need from the lenders and servicers is their commitment to building a system that will react promptly and predictably to these reasonable requests.

For two decades, HDF has proven it can deliver housing solutions that work for Connecticut—for families, for lenders, for developers, for neighborhoods. We believe that affordable housing is an investment in people—employees, parents, children, neighbors—without whom the state's whole economy would suffer. Strong markets and strong communities need a diverse mix of households. And that calls for a supply of housing and housing opportunities that low- and moderate-income people can afford and remain in despite temporary setbacks.

Appendix

The Housing Development Fund Banking Partner:

Bank of America

Citibank, FSB

Commerce Bank

Fairfield County Bank

Fieldpoint Private Bank and Trust

First County Bank

Hudson City Savings Bank
Hudson United Bank
Milford Savings Bank
Naugatuck Savings Bank
Newtown Savings Bank
Patriot National Bank
People's United Bank
Savings Bank of Danbury
TD Banknorth
Union Savings Bank
U.S. Trust of Connecticut
Wachovia Bank, N.A.
Webster Bank

TESTIMONY OF

Paul S. Willen
Senior Economist and Policy Advisor
Federal Reserve Bank of Boston

BEFORE

The U.S. Senate Committee on Banking, Housing, & Urban Affairs Hearing on
“Preserving Homeownership: Progress Needed to Prevent Foreclosures”

July 16, 2009

Chairman Dodd, Ranking Member Shelby, and distinguished members of the Committee, I thank you for your invitation to testify today. My name is Paul Willen, and I am one of the Senior Economists and Policy Advisors at the Federal Reserve Bank of Boston, which as you know is one of the twelve regional Reserve Banks in the Federal Reserve System. I would like to stress that the views I share with you today are mine, not necessarily those of the Federal Reserve Bank of Boston, the other Reserve Banks, or the Federal Reserve's Board of Governors.

In the time allotted today I plan to briefly summarize some key findings in the research that I and several talented co-authors have done over the last two years – findings that I think are particularly relevant to the issue of foreclosure prevention. I have also submitted a written statement to the committee, which contains more detail on our research, and which I respectfully request be accepted for the record.

I hope that my comments today and our broader research will be helpful to the Committee, as you consider the important issues that are the focus of this hearing.

The limited success of foreclosure prevention strategies undertaken to date results, at least partly, from reliance on theories about the causes of the crisis that – while intuitively appealing – are at odds with the data. In my remarks today I will focus on four facts from the data which contradict widely held beliefs about the causes of the crisis:

1. Resets of adjustable rate mortgages have not been the main driver of borrower payment problems.
2. Household life events like job loss and illness played a central role in the surge in foreclosures that started in 2007, even prior to the start of the recession.
3. Most borrowers who got subprime mortgages would not have qualified for a prime mortgage for that transaction.
4. The practice of securitization is not the main reason that lenders have failed large numbers of home mortgages. A more plausible explanation is that it is simply unprofitable for them to do so.¹

¹We use lender here to refer to the institution that provided funds (the bank or the investor in

I would respectfully submit that policies that ignore these facts - however well intentioned - will address some smaller problems while regrettably ignoring much more serious ones.

According to the conventional wisdom, large payment increases associated with the first reset of subprime adjustable rate mortgages led to large numbers of foreclosures. To test this in the data, researchers – including but not only my co-authors and me – have looked at a large sample of individual loan histories which provide information about both the expected payments owed by borrowers and whether borrowers made those payments. If resets were truly important, we would expect to see a dramatic increase in the likelihood that a borrower has trouble with his or her payment to coincide with the first reset of an adjustable-rate-mortgage. But we see no such relationship in the data and, in fact, the majority of borrowers who default on subprime adjustable rate mortgages start missing payments long before the rate increases with a reset.²

Part of the reason for the confusion about the resets is the widespread and, we have found, incorrect belief that rates on subprime ARMs spike dramatically at the reset. Our research reveals that in fact the so-called “teaser” rates on subprime mortgages were very high to begin with. Indeed the phrase “teaser rate” is something a misnomer as it was typically 3 percentage points higher than the rate on an equivalent prime mortgage. The bump in rates at the reset, which is typically tied to six month London Inter Bank Offered Rate (LIBOR), was only about 3 percentage points when LIBOR peaked in 2007, and the Fed Fund rate cuts in the fall of 2007 largely eliminated the reset as an issue entirely. Starting in 2008, most subprime mortgages saw no change in the rate at the reset. The fact that there was no improvement in loan performance corresponding to interest rate cuts suggests the limited scope of resets as a problem.

Allow me a point of clarification that is more than mere semantics. Some com-
the case of a securitized loan) or anyone representing their interests (including the servicer or the trustee).

²For details, see Panel C of Figure 6 in “Reducing Foreclosures,” by Foote, C., K. Gerardi, L. Goette and P. Willen. NBER Working Paper 15063 and forthcoming in the *NBER Macro Annual*. June 2009. Attached.

mentators have erroneously equated subprime mortgages with alternative-mortgage products like so-called Option-ARMs. Option-ARMs, which allow borrowers to pay less than the interest on the loan, and make up for it by adding to the principal balance, were not generally marketed to subprime borrowers, and our investigation of the data suggests that the typical pool of subprime loans had no Option ARMs at all. In fact, the majority of problem subprime loans were fully-amortized loans and many of them were, in fact, fixed rate mortgages. Option ARMs have been and will continue to be a problem but they are not, nor have they ever been, the main source of problems in the mortgage market.

A second point. The conventional wisdom until very recently minimized the role of so-called “life events” like unemployment and illness in generating defaults on subprime mortgages. People argued that life-events could not explain the surge in defaults in 2007, because there was no underlying surge in unemployment or illness that year. But I believe that view reflects a misunderstanding of the interaction of house price depreciation and life events in causing default. Foreclosures rarely occur when borrowers have positive equity, for the simple reason that a borrower is almost always better off selling if they have to leave the house anyway. Thus, detrimental life events have no effect on foreclosures when prices are rising. Consider that in 2001, Massachusetts suffered a fairly severe recession which led to a big increase in delinquencies, but the number of foreclosures actually fell to a record low, as shown in the chart I have included with my testimony (Figure 1). But when home prices fall, some borrowers can no longer profitably sell, and then the income-disrupting life-events really take a toll. Thus we did not need to see a surge in life-events to get a surge in foreclosures, but rather a fall in house prices – which is exactly, and unfortunately, what we saw.

In understanding the role of unemployment in foreclosures, for example, one has to understand that large numbers of households suffer job losses – “separations,” in the lingo of labor economics – even when the economy is doing well. Even in the summer of 1999, in the best labor market in a generation, 300,000 individuals filed new claims for unemployment insurance every week. Because house prices were rising rapidly,

few of these job losses ended in foreclosure. But the recession that started at the end of 2007 and worsened dramatically in the fall of 2008 has aggravated the problem. The separation rate has increased and importantly, the finding rate – the rate at which unemployed workers get new jobs – has fallen to record lows. While a recession certainly makes the foreclosure problem worse, it is not necessary to generate large numbers of employment-related foreclosures.

One key policy concern I see is the likelihood that the problem of negative home equity and job loss will persist even after the economy recovers. A borrower with negative equity is, unfortunately, somewhat like a patient with a weak immune system – shocks easily absorbed by a “healthy” homeowner can prove fatal to a homeowner with negative equity. To see this depicted, please note again Figure 1. In Massachusetts, house prices stopped falling in 1992 and a vigorous economic recovery started the following year; but we saw elevated foreclosure numbers for the next five years. The reason is, I believe, rather easily determined: homeowners who bought at the peak of the market in 1988 did not have positive home equity and the protection it brings from foreclosure until house prices fully recovered the 1988 peak in 1998.

My third point relates to the oft-made claim that many borrowers who used subprime mortgages were “steered” into subprime loans and, in fact, would have qualified for prime loans. Part of the problem here relates again to a misunderstanding of what a subprime loan is. What differentiates a subprime loan from a prime loan is not the loan itself – a subprime adjustable rate mortgage is no different from a prime adjustable rate mortgage – but rather the characteristics of the transaction: the size of the down payment, the ratio of the monthly payment to income, the credit history of the borrower, the level of documentation provided by the borrower, among other things.

Careful analysis of the data shows that the vast majority of borrowers who took out subprime loans could not have qualified for prime loans. We looked at a large sample of subprime mortgages in New England in 2007 and defined a prime loan as a loan to an owner-occupant, with a loan-to-value ratio of 90% or less, full documentation of income and assets, a borrower FICO scores of 620 or higher, and a monthly payment

that was less than 45% of monthly income. Only 9.6% of the mortgages identified as subprime met these criteria. Furthermore, that subset of prime-qualifying buyers got mortgages with characteristics very similar to prime mortgages available at the time – 65% had fixed interest rates and the average initial interest rate for these loans was 6.7%.³

It should be clear that borrowers may well have been steered into transactions that required subprime loans. For example, a real estate agent may have convinced them to buy an expensive house or a mortgage broker may have encouraged them to do a cash-out refinance that in either case required a loan that no prime lender would approve given their income and credit history. But conditional on the actual transaction, there is no evidence right now that borrowers who used subprime loans could have qualified for a prime loan. The evidence typically cited to make the claim that borrowers were steered is that over the period 1999 to 2006, the fraction of borrowers who used subprime loans but had FICO scores typically associated with prime mortgages increased sharply, going from about 35% to 70% in our data. What this evidence fails to take into account is that over that same period, all the other characteristics of the loans deteriorated sharply: the average LTV for a subprime borrower with 660 FICO went from 82% to 95%.⁴

My fourth and final comment today relates to foreclosure prevention strategies. Foreclosures are bad for homeowners, but they are also bad for lenders, which typically recover less than half the principal owed to them. So it seems natural to think that borrowers and lenders could work together to arrive at some happy medium in which the borrower gets to stay in his or her home and the lender continues to receive payments, albeit smaller ones. In our most recent paper, we find that such renegotiation is extremely rare. Through careful statistical work using a dataset with 29 million active residential loans, we were able to look at borrowers in the year after they became seriously delinquent. Our main finding is that lenders are reluctant to

³For details, see attached, Foote, C., K. Gerardi, L. Goette and P. Willen. "Just the Facts: An initial analysis of the subprime crisis." 2008. *Journal of Housing Economics*, 17(4):291-305.

⁴See Figure 7 of Foote, C., K. Gerardi, L. Goette and P. Willen (2008), attached.

renegotiate loans: only about 3 percent of the seriously delinquent borrowers in our sample received payment reducing loan modifications in the year subsequent to their first 60-day delinquency.⁵

A leading explanation for this relative paucity of renegotiation is the view that since most loans are securitized now, the fragmented ownership and contractual complexity inherent in such transactions makes it difficult for borrower and lender to come to a mutually beneficial agreement. But our data does not support this theory. We find servicers equally reluctant to modify loans, whether they are owned in portfolio or serviced on behalf of securitization trusts.

We argue that a more plausible explanation for the unwillingness of lenders to renegotiate is that it simply isn't profitable. The reason is that lenders face two risks that can make modification a losing proposition. The first, which has been recognized as an issue by many observers and researchers, is "redefault risk" – the possibility that the borrower who receives a modification will default again, and thus the modification will have only served to postpone foreclosure and increase the loss to the investor as house prices fall and the home itself (the collateral) quite possibly deteriorates. The second risk, which has been largely ignored but I believe is no less important, and arguably more, is "self-cure risk" – the possibility that the borrower would have repaid the loan without any assistance from the lender. About a third of the borrowers in our large sample are current on their mortgages or prepay a year after they become sixty days delinquent. An investor would view assistance given to such a borrower as "wasted" money.

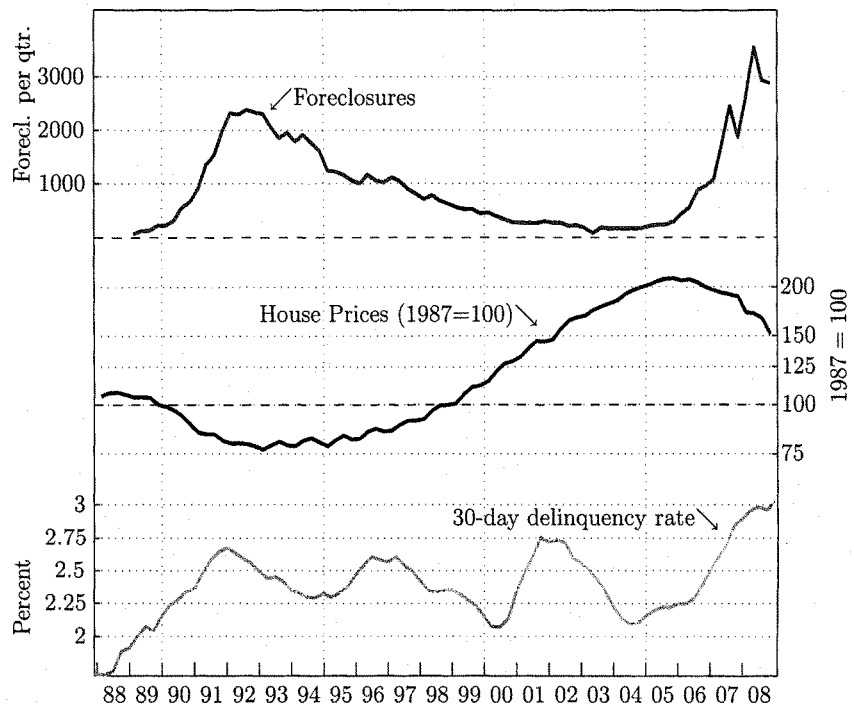
Let me conclude by saying that my observation, rooted in our investigation of the data, that servicers and investors may find modification unprofitable should not be misconstrued as suggesting that modification is not desirable for society at large and the economy. The private net present value and the social net present value of a modified loan may well be very different. An investor may have an urgent need for cash that leads it to find the short-term payoff of a foreclosure far more attractive

⁵See attached, Adelino, M., K. Gerardi and P. Willen. "Why Don't Lenders Renegotiate More Home Mortgages? Defaults, Self-Cures and Securitization." FRBB PPDP 09-04, July 2009.

than the uncertain longer-term (but potentially larger) payoff from a modified loan.

We hope that these empirical findings about the crisis add important, and perhaps unexpected, insights to your work as policymakers. Thank you again for the opportunity to appear before you today. I would of course be happy to address any questions you might have.

Figure 1: Massachusetts House Price Growth, Foreclosures and Delinquencies, January 1989 to December 2008



NBER WORKING PAPER SERIES

REDUCING FORECLOSURES:
NO EASY ANSWERS

Christopher Foote
Kristopher Gerardi
Lorenz Goette
Paul Willen

Working Paper 15063
<http://www.nber.org/papers/w15063>

NATIONAL BUREAU OF ECONOMIC RESEARCH
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Reducing Foreclosures: No Easy Answers
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ABSTRACT

This paper takes a skeptical look at a leading argument about what is causing the foreclosure crisis and distills some potential lessons for policy. We use an economic model to focus on two key decisions: the borrower's choice to default on a mortgage and the lender's subsequent choice whether to renegotiate or "modify" the loan. The theoretical model and econometric analysis illustrate that "unaffordable" loans, defined as those with high mortgage payments relative to income at origination, are unlikely to be the main reason that borrowers decide to default. In addition, this paper provides theoretical results and empirical evidence supporting the hypothesis that the efficiency of foreclosure for investors is a more plausible explanation for the low number of modifications to date than contract frictions related to securitization agreements between servicers and investors. While investors might be foreclosing when it would be socially efficient to modify, there is little evidence to suggest they are acting against their own interests when they do so. An important implication of our analysis is that the extension of temporary help to borrowers suffering adverse life events like job loss could prevent more foreclosures than a policy that makes mortgages more "affordable" on a long-term basis.

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1 Introduction

One of the most important challenges now facing U.S. policymakers stems from the tide of foreclosures that now engulfs the country. There is no shortage of suggestions for how to attack the problem. One of the most influential strands of thought contends that the crisis can be attenuated by changing the terms of “unaffordable” mortgages. It is thought that modifying mortgages is not just good for borrowers in danger of losing their homes but also beneficial for lenders, who will recover more from modifications than they would from foreclosures. Proponents of this view, however, worry that without government intervention, this win-win outcome will not occur. Their concern is that the securitization of mortgages has given rise to contract frictions that prevent lenders and their agents (loan servicers) from carrying out modifications that would benefit both borrowers and lenders.

In this paper, we take a skeptical look at this argument. Using both a theoretical model and some loan-level data, we investigate two economic decisions, the borrower’s decision to default on a mortgage and the lender’s choice between offering a loan modification and foreclosing on a delinquent loan. We first study the “affordability” of a mortgage, typically measured by the DTI ratio, which is the size of the monthly payment relative to the borrower’s gross income.¹ We find that the DTI ratio at the time of origination is not a strong predictor of future mortgage default. A simple theoretical model explains this result. While a higher monthly payment makes default more likely, other factors, such as the level of house prices, expectations of future house price growth and intertemporal variation in household income, matter as well. Movements in all of these factors have increased the probability of default in recent years, so a large increase in foreclosures is not surprising. Ultimately, the importance of affordability at origination is an empirical question and the data show scant evidence of its importance. We estimate that a 10-percentage-point increase in the DTI ratio increases the probability of a 90-day-delinquency by 7 to 11 percent, depending on the borrower.² By contrast, an 1-percentage-point increase in the unemployment rate raises this probability by 10-20 percent, while a 10-percentage-point fall in house prices raises it by more than half.

¹DTI ratio stands for “debt-to-income” ratio. A more appropriate name for this ratio is probably “payment-to-income” ratio, but we use the more familiar terminology. Throughout this paper, we define DTI as the ratio of mortgage-related payments to income, rather than all debt payments; this is sometimes called the “front end” DTI.

²As explained below, these estimates emerge from a duration model of delinquency that are based on instantaneous hazard rates. So, the statement that an 10-percentage-point increase in DTI increases the probability of 90-day delinquency by 7 percent means that the DTI increase multiplies the instantaneous delinquency hazard by 1.07, not that the DTI increase raises the probability of delinquency by 7 percentage points.

The fact that origination DTI explains so few foreclosures should not surprise economists, given the mountain of economic research on the sources and magnitude of income variation among U.S. residents. The substantial degree of churning in the labor market, combined with the trial-and-error path that workers typically follow to find good job matches, suggests that income today is an imperfect predictor of income tomorrow. Consequently, a mortgage that is affordable at origination may be substantially less so later on, and vice versa.

We then address the question of why mortgage servicers, who manage loans on behalf of investors in mortgage-backed securities, have been unwilling to make mass loan modifications. The evidence that a foreclosure loses money for the lender seems compelling. The servicer typically resells a foreclosed house for much less than the outstanding balance on the mortgage, in part because borrowers who lose their homes have little incentive to maintain them during the foreclosure process.³ This would seem to imply that the ultimate owners of a securitized mortgage, the investors, lose money when a foreclosure occurs. Estimates of the total gains to investors from modifying rather than foreclosing can run to \$180 billion, more than 1 percent of GDP. It is natural to wonder why investors are leaving so many \$500 bills on the sidewalk. While contract frictions are one possible explanation, another is that the gains from loan modifications are in reality much smaller or even nonexistent from the investor's point of view.

We provide evidence in favor of the latter explanation. First, the typical calculation purporting to show that an investor loses money when a foreclosure occurs does not capture all relevant aspects of the problem. Investors also lose money when they modify mortgages for borrowers who would have repaid anyway, especially if modifications are done *en masse*, as proponents insist they should be. Moreover, the calculation ignores the possibility that borrowers with modified loans will default again later, usually for the same reason they defaulted in the first place. These two problems are empirically meaningful and can easily explain why servicers eschew modification in favor of foreclosure.

Turning to the data, we find that the evidence of contract frictions is weak, at least if these frictions result from the securitization of the loan. Securitization agreements generally instruct the servicer to behave "as if" it owned the loan in its own portfolio, and the data are consistent with that principle. Using a dataset that includes both securitized and non-securitized loans, we show that these two types of loans are modified at about the same rate. While there is room for further empirical work on this issue, these results minimize the likely importance of contract-related frictions in the modification decision. Even though

³An even more important reason that lenders rarely recover the full balance of the mortgage is that the borrower owed more on the home than the home was worth. Below, we show that negative equity is a necessary condition for foreclosure; people rarely lose their homes when they enjoy positive equity.

it may be in *society's* interest to make modifications (because of the large externalities from foreclosure), it may not be in the *lender's* interest to do so, whether or not this lender is an investor in a mortgage-backed security or a portfolio lender.⁴

Our skepticism about the arguments discussed above is not meant to suggest that government has no role in reducing foreclosures. Nor are we arguing that the crisis is completely unrelated to looser lending standards, which saddled borrowers with high-DTI mortgages, or interest rates that reset to higher levels a few years into the loans.⁵ Rather, we argue that a foreclosure-prevention policy that is focused on high-DTI ratios and interest-rate resets may not address the most important source of defaults. In the data, this source appears to be the interaction of falling prices and adverse life events, such as job loss.

The remainder of this paper is organized as follows. Section 2 outlines a simple model of the default decision that helps organize ideas about potential sources of the foreclosure crisis. Section 3 shows that, as would be implied by the simple model, the affordability of a mortgage at origination as measured by DTI is not a strong predictor of mortgage default, especially compared with other variables that reflect income volatility and falling house prices in a fundamental way. Section 4 adapts the model to encompass the decision of the lender to offer a modification, and then provides evidence that securitization contracts are not unduly preventing modifications. Section 5 concludes with some lessons for foreclosure-reduction policy that are suggested by our results.

2 Affordability and Foreclosure: Theory

One of the most commonly cited causes of the current foreclosure crisis is the mass origination of unaffordable or unsustainable mortgages. Ellen Harnick, the senior policy counsel for the Center for Responsible Lending, characterized the crisis this way when she recently testified before Congress:

The flood of foreclosures we see today goes beyond the typical foreclosures of years past, which were precipitated by catastrophic and unforeseen events such as job loss, divorce, illness, or death. The current crisis originated in losses triggered by the unsustainability of the mortgage itself, even without any changes in the families' situation, and even where the family qualified for, but was not offered,

⁴A foreclosure imposes externalities on society when, for example, a deteriorating foreclosed home drives down house prices for the entire surrounding neighborhood.

⁵For a discussion of the role of looser lending standards, see Mian and Sufi (2009) and Dell'Ariccia, Igan, and Laeven (2009).

a loan that would have been sustainable.⁶

The claim that the foreclosure crisis results from unaffordable or unsustainable loans has been endorsed by a number of influential policy analysts.⁷ But the concept of “unaffordability” is rarely defined precisely. To economists, something is unaffordable if it is unattainable under any circumstances, even temporarily. For example, an economist might say: “For me, the penthouse apartment at the Time Warner Center in New York is unaffordable (\$50 million when finished in 2004).” But a non-economist might say, “For me, the dry-aged ribeye at Whole Foods (\$19.99 a pound) is unaffordable.” The problem is that, for most Americans, a regular diet of ribeye steaks is attainable; a consumption bundle that includes two pounds of ribeye every night is not impossible for most families. They do not choose this bundle because of relative prices: the tradeoff between the ribeye and other consumption is unappealing (for example, the family might prefer a new car). In this case, economists, if they were being precise, would say that the ribeye was “affordable” but “too expensive.” Along the same lines, economists might argue that an unaffordable mortgage is one that is really too expensive, in the sense that the benefits that come with making payments on the mortgage no longer outweigh the opportunity costs of doing so. In the next subsection, we build a simple model of these benefits and costs in order to evaluate what makes a borrower decide that a mortgage is unaffordable and thus to default on it. In describing this model, we will use the common usage definition of “affordable,” though we really mean “too expensive.”

2.1 A simple model

Assume a two-period world ($t = 1, 2$), with two possible future states, good and bad. The good state occurs with probability α_G , while the bad state occurs with probability α_B (where $\alpha_B = 1 - \alpha_G$). In the first period, the value of the home is P_1 with a nominal mortgage balance of M_1 . In this period, the borrower decides between making the mortgage payment, a fraction m of the mortgage balance M_1 , and staying in the home, or stopping payment and defaulting. Because this is a two-period model, we assume that in the second

⁶Harnick (2009), p. 5.

⁷A recent report from the Congressional Oversight Panel of the Troubled Asset Recovery Program (hereafter denoted COP) states that “[t]he underlying problem in the foreclosure crisis is that many Americans have unaffordable mortgages” (COP report, p. 16). The report adds that the unaffordability problem arises from five major factors: (1) the fact that many mortgages were designed to be refinanced and cannot be repaid on their original terms, (2) the extension of credit to less creditworthy borrowers for whom homeownership was inappropriate, (3) fraud on the part of brokers, lenders, and borrowers, (4) the steering of borrowers who could qualify for lower cost mortgages into higher priced (typically subprime) mortgages, and (5) the recent economic recession.

period the borrower either sells the home or defaults on the mortgage. If the good state occurs, the price of the house in the second period is P_2^G , while if the bad state occurs, the price is P_2^B . We will assume that $P_2^B < M_2$, where M_2 is the remaining nominal mortgage balance in the second period.

The first key insight of the model is that if equity is positive, the borrower will never default on the house. Selling dominates foreclosure when equity is positive because the borrower has to move out either way and the former strategy yields cash while the latter does not. Exactly what constitutes positive equity is a bit tricky empirically. Borrowers have to pay closing costs to sell the house and may be forced to accept a lower price if they sell in a hurry. Thus, the balance of the mortgage may be slightly less than the nominal value of the home, but with these extra expenses factored into the equation, the borrower may not have positive equity to extract.

The empirical evidence on the role of negative equity in causing foreclosures is overwhelming and incontrovertible. Household-level studies show that the foreclosure hazard for homeowners with positive equity is extremely small but rises rapidly as equity approaches and falls below zero. This estimated relationship holds both over time and across localities, as well as within localities and time-periods, suggesting that it cannot result from the effect of foreclosures on local-level house prices.⁸

Because default does not occur if $P_1 \geq M_1$, we focus on the case where $M_1 > P_1$. The decision for the borrower is whether or not to make the periodic mortgage payment mM_1 . The cost of making the payment is the payment amount, net of the rent that the borrower would have to pay for shelter in the event of default. The benefit to the borrower includes the option in the next period to sell the house at a profit in the good state where $P_2 > M_2$, or the option to default in the bad state and lose nothing. We assume that the decision to default costs the borrower some amount Λ next period, which can be interpreted as some combination of guilt, shame, and reduced access to future credit. Under these conditions, we can collapse the default decision into the following inequality:⁹

$$\text{Default} \Leftrightarrow \frac{\alpha_G(P_2^G - M_2) + \Lambda}{mM_1 - \text{rent}_1} < 1 + r. \quad (1)$$

The basic point here is that a borrower views the mortgage payment (or more precisely the excess of the mortgage payment over his rent) as an investment in a security that pays off in the next period as long as the value of the house exceeds the strike price, which is the

⁸See Sherlund (2008), Danis and Pennington-Cross (2005), and Deng, Quigley, and Order (2000) for default regressions. See Gerardi, Shapiro, and Willen (2007) for an exhaustive discussion of the identification issues in the study of house prices and foreclosure.

⁹For details on a very similar model, see Foote, Gerardi, and Willen (2008).

outstanding balance on the mortgage. If the return on the investment exceeds the alternative investment, here assumed to be the riskless rate, then the borrower stays in the home. If instead the return falls short, then the borrower decides that the riskless asset is a better investment and defaults.

Thus far, income appears to play no role in the default decision. In this sense, our model follows the traditional option-theoretic analyses of the mortgage default decision, in which the mortgage is viewed as a security priced by arbitrage, and household income is irrelevant.¹⁰

The problem with the model described above is that it gives no role to individual heterogeneity, except potentially through differences in Λ . According to the model, all borrowers living in similar houses with similar mortgages should default at roughly the same time. Yet, in the data, we observe enormous heterogeneity in default behavior across otherwise similar households. Moreover, there is a pattern to this heterogeneity: households that suffer income disruptions default much more often than households that do not; younger homeowners default more often; and households with few financial resources default more often.

To address these limits, we make two small changes to the model. If we assume that housing is a normal good, households that suffer permanent reductions in income will prefer less housing, and thus their alternative rent payment will fall. So we allow rent to vary by individual household, denoting it $rent_i$. But, more significantly, we introduce borrowing constraints. Borrowing constraints mean that the relevant interest rate is no longer “the” riskless rate but the household’s shadow riskless rate. Under the assumption of log utility and exponential discounting, this rate equals:

$$1 + r_i = (1 + \delta_i)^{-1} \left(E \begin{bmatrix} c_{i,1} \\ c_{i,2} \end{bmatrix} \right)^{-1}$$

where $c_{i,t}$ is consumption of household i at time t and δ_i is a household-specific discount rate. Then we can re-write equation (1) as:

$$\text{Default} \Leftrightarrow \frac{\alpha_G(P_2^G - M_2) + \Lambda}{mM_1 - rent_i} < 1 + r_i. \quad (2)$$

This model can shed light on the question of what really constitutes an unaffordable mortgage. A mortgage is unaffordable if the marginal rate of transformation between current and future consumption implied by the mortgage falls short of the marginal rate of

¹⁰See Kau, Keenan, and Kim (1994), for example.

substitution. What makes a mortgage “unaffordable,” that is, too expensive?

1. **Low house price appreciation.** A higher probability of price appreciation (higher α_G) increases the expected return to staying in the house. In this sense, our treatment is similar to the standard user cost calculation in the literature, whereby increased house price appreciation lowers the cost of owning a home.¹¹
2. **High monthly payments.** All else equal, higher m makes the mortgage less attractive. This is consistent with the views expressed in the quote that opened in this section: Many families, for one reason or another, took on mortgages with high payments that are likely to dissuade them from keeping their mortgage current. Typically, the burden of a mortgage’s payments at origination is measured by the DTI ratio. Thus, analysts who believe that this type of unaffordability is at the heart of the crisis often support proposals designed to lower DTI ratios on a long-term basis.
3. **Permanent and transitory shocks to income.** Permanent shocks lower $rent_i$. Also, *if* the borrower is constrained, then a transitory shock that leads to a lower level of income will lead to high consumption growth and thus a high shadow riskless rate, which makes staying less attractive. The quote that opens this chapter expresses the view that income shocks were important drivers of foreclosure in the past, but that these shocks are less important today. However, if income shocks are in fact the most important source of distress in the housing market, then a policy that grants troubled borrowers substantial but temporary assistance could be effective. Temporary assistance may not help borrowers facing permanent income shocks, but it would help borrowers undergoing transitory setbacks.
4. **Low financial wealth.** A borrower with little financial wealth is more likely to be constrained and thus more likely to have a high shadow riskless rate.

2.2 Monthly payments, income, and affordability

Once we recognize the role that unforecastable income shocks can play in foreclosure, we can further divide the concept of affordability into what we will call *ex ante* and *ex post* affordability. A loan is *ex post* unaffordable if the borrower decides to default on it. A loan is *ex ante* unaffordable if the probability that it will become *ex post* unaffordable exceeds some threshold. To decide whether a loan is *ex ante* affordable, an underwriter or policymaker needs to forecast the evolution of stochastic variables like income, payments,

¹¹See Poterba (1984) and, more recently, Himmelberg, Mayer, and Sinai (2005).

and house prices, and then choose some threshold probability of *ex post* unaffordability. In this section, to clearly convey our points, we consider an extreme model, in which *ex post* affordability depends entirely on the ratio of monthly payments to income, the DTI ratio. Thus, our forecasting model will involve only the required monthly payment and the borrower's income.

To forecast income, we follow the macro literature and assume that changes to the logarithm of a borrower's labor income y_t consist of a predictable drift term α_t , a transitory (and idiosyncratic) shock ε_t , and a permanent shock η_t :

$$y_t = \alpha_t + y_{t-1} + \varepsilon_t + \eta_t.$$

We use estimates from Gourinchas and Parker (2002) for the process for the "average person" in their sample and assume that the borrower is 30 years old.

For the monthly payments, we assume that either they are constant, or they follow the typical path of a 2/28 adjustable-rate mortgage (ARM). A 2/28 ARM is a common subprime mortgage that has a fixed payment for the first two years, after which the payment is determined by the so-called fully indexed rate, typically hundreds of basis points over the six-month London interbank offered rate (Libor).¹² We assume that the initial rate is 8.5 percent (the average initial rate for a sample of 2/28 ARMs originated in 2005) and that the first adjustment occurred in 2007, when the six-month Libor was 5.25 percent. A spread over Libor of 600 basis points was typical during this period and would imply a fully indexed rate of 11.25 percent, which generates a payment increase of roughly one-third. We focus on the 2/28 ARMs because they were, by far, the most common type of subprime loan and have accounted for a hugely disproportionate share of delinquencies and foreclosures in the last two years. Other loans, like option ARMs, allow for negative amortization and have far higher payment shocks at reset, but were rarely marketed to subprime borrowers, and thus, have not accounted for a large share of problem loans so far.

Table 1 shows some basic results. The first key finding is that the threshold for *ex post* affordability must be much higher than the threshold for *ex ante* affordability. If one sets them equal, then about 70 percent of borrowers will end up with unaffordable mortgages at some point in the first three years, even without resets. This is important because it means that one cannot decide on *ex ante* affordability by using some *a priori* idea of what is a reasonable amount to spend on housing. In other words, if spending one third of one's income on housing is considered too much (as low-income housing studies often claim), then one has to set the *ex ante* criterion well below 33 percent of income.

¹²This spread is determined by the risk characteristics of the borrower.

The second finding is that resets are of only limited importance. Many commentators have put the resets at the heart of the crisis, but the simulations illustrate that it is difficult to support this claim. The payment escalation story is relevant if we assume that there is no income risk *and* that the initial DTI is also the threshold for *ex post* DTI. Then loans with resets become unaffordable 100 percent of the time and loans without resets never become unaffordable. But adding income risk essentially ruins this story. If the initial DTI is also the threshold for *ex post* DTI, then, with income risk, about 70 percent of the loans will become unaffordable even without the reset. The reset only raises that figure to about 80 percent. If, on the other hand, we set the *ex post* affordability threshold well above the initial DTI, then the resets are not large enough to cause *ex post* affordability problems. The only scenario in which the reset makes a significant, quantitative impact is when we set the initial DTI very low and the threshold for *ex post* affordability very high. In this case the likelihood of default roughly doubles with resets.

The third finding is that setting the right initial DTI can help reduce foreclosures if the *ex post* affordability criterion is sufficiently high, but this finding is very sensitive to the assumption about income volatility. The first column of Panel C shows that if the *ex post* criterion is 50 percent, then loans with 31 percent DTI at origination become unaffordable only about 16 percent of the time, whereas those with 50 percent DTI do so roughly 70 percent of the time. The problem here is that the troubled borrowers who obtain subprime loans or who need help right now are unlikely to have the baseline parameters from Gourinchas and Parker (2000). If we assume that they have a standard deviation of transitory shocks twice as large as average, then column 4 shows that the benefits of low DTI are much smaller. Going from 38 percent DTI to 31 percent DTI only lowers the number of borrowers who will face *ex post* unaffordability by 30 percent from 54 percent to 38 percent. Put another way, if our goal is “sustainable” mortgages, neither 31 percent nor 38 percent would fit that definition.

3 Affordability and Foreclosure: Evidence

In this section we perform an empirical analysis of the potential determinants of default identified in the previous section, including falling house prices, labor income shocks, and high DTI ratios. Because a loan that is prepaid is no longer at risk of default, we also investigate prepayments in a competing risks framework.

3.1 Data

The data used in this paper come from loan-level records, compiled by LPS Applied Analytics, Inc., from large loan-servicing organizations.¹³ This dataset has fields for key variables set at the time of each loan's origination, including the amount of the loan, the appraised value and location of the property that secures the loan, whether the loan is classified as prime or subprime, whether the loan is a first or second lien, and whether the loan is held in portfolio or has been packaged into a mortgage-backed security (MBS). We can also observe a host of interest-rate variables, such as whether the loan is fixed-rate or adjustable-rate and the manner in which the interest rate changes in the latter case. Additionally, the performance of each loan can be monitored over time. For each month in which a given loan is in the data, we know its outstanding balance, the current interest rate, and the borrower's payment status (that is, current, 30-, 60-, or 90-days delinquent, in foreclosure, etc.). We also know whether a loan ended in payment, prepayment, or default.

As of December 2008, the LPS dataset covered nearly 60 percent of active residential mortgages in the United States, representing about 29 million loans with a total outstanding balance of nearly \$6.5 trillion.¹⁴ Nine of the top 10 servicers in the U.S. are present in our data, including Bank of America/Countrywide and Wells Fargo. Cordell, Watson, and Thomson (2008) write that because the LPS data come from large servicers (who now dominate the servicing market), the unconditional credit quality of the average loan in the LPS data is probably lower than that of a randomly sampled U.S. mortgage, because smaller servicers are more prevalent in the prime market. However, when assessing the representativeness of the LPS data, it is important to note that we can tell whether a loan in the data is prime or subprime.¹⁵ Additionally, we usually have access to other variables reflecting risk, including the borrower's credit (that is, FICO) score, loan-to-value at origination, etc. This allows us to condition on several factors affecting loan quality.

One of the strengths of the LPS dataset is that it is one of the few loan-level databases that include both conforming prime loans and subprime loans. Table 2 lists the numbers of prime and subprime loans in the data, disaggregated by the investors for whom the servicers are processing payments and the seniority of the mortgage (first lien, second lien,

¹³The dataset was originally created by a company called McDash Analytics; LPS acquired McDash in mid-2008. Among housing researchers, the dataset is still generally called the "McDash data." The description of the LPS dataset in this section draws heavily from Cordell, Watson, and Thomson (2008). The dataset was purchased in late 2008 by a consortium that included the Board of Governors of the Federal Reserve System and eight regional Federal Reserve Banks.

¹⁴Because of the size of the data (about 600 gigabytes), we never took possession of it when performing our analysis. Instead we downloaded random samples of various size from the servers of the Federal Reserve Bank of Kansas City.

¹⁵Subprime loans are defined by the servicers themselves as loans with a grade of either "B" or "C."

etc.). About 33 percent of the mortgages in the dataset are held in the securities of Fannie Mae, with another 22 percent held in Freddie Mac securities. Around 18 percent of the loans are held in “private securitized” pools; these are the loans that are also covered by the well-known LoanPerformance dataset.¹⁶ A little less than 10 percent of the loans in the LPS data are held in the portfolio of the servicer itself.

While the LPS dataset now covers more than half of the U.S. mortgage market, coverage was not as extensive in earlier years. The LPS dataset has grown over time as new servicers have been added, with a substantial spread in coverage of the market in 2005 (when most of our samples begin). Whenever a new servicer is added to the dataset, that servicer’s existing portfolio is incorporated into the dataset. Future loans from that servicer are added a month or two after the loans close. This pattern has the potential to introduce unrepresentative loans into the data, because loans that stay active for many years (and thus are likely to be added when their servicers enter the LPS data) are a nonrandom sample of all loans. One way to ameliorate potential problems of left-censoring is to analyze only those loans that enter the data within the year that the loans were originated.¹⁷ A separate issue is the fact that not all servicers collected the exact same variables, so the preponderance of missing data changes over time. Unfortunately, DTI is recorded for only about half the loans in the sample, as shown in Table 3. On one hand, this is disheartening, because an analysis of DTI is a prime goal of this section. On the other hand, the sample is sufficiently large that we do not want for observations. Moreover, the fact that DTI is so spottily recorded — especially in comparison to the FICO score — indicates that investors and servicers place little weight on it when valuing loans. This is, of course, what the model of section 2 would predict. A final concern about the LPS data is that we do not know whether there are other loans on the property that secures any given loan. Thus, given some path of local house prices, we are able to construct an ongoing loan-to-value ratio for any loan in the dataset, but we cannot construct a *combined* loan-to-value ratio for the borrower on that loan. We are therefore unable to calculate precise estimates of total home equity.¹⁸

¹⁶The dataset from LoanPerformance FirstAmerican Corp. includes loans that were securitized outside of the government-sponsored agencies, Fannie Mae and Freddie Mac. It therefore includes loans that are subprime, Alt-A, and non-conforming (that is, jumbo loans). The coverage of private securitized loans is broader in the LoanPerformance data than it is in LPS, as LoanPerformance has about 90 percent of the private-label market.

¹⁷Most loans in our sample were included in the data one or two months after origination.

¹⁸For a borrower with only one mortgage, the loan-to-value ratio on his single mortgage will, of course, be his total loan-to-value figure. However, we are unable to know whether any particular borrower in the data has more than one mortgage.

3.2 Affordability and origination DTI: Results from duration models

To learn how different risk characteristics and macroeconomic variables affect loan outcomes, we run Cox proportional hazard models for both defaults and prepayments.¹⁹ In this context, the proportional hazard model assumes that there are common baseline hazard functions that are shared by all loans in the data. The model allows for regressors that can shift this hazard up or down in a multiplicative fashion. The specific type of proportional hazard model that we estimate, the Cox model, makes no assumption about the functional form of the baseline hazard. Rather, the Cox model essentially “backs out” the baseline hazard after taking account of the effects of covariates. The baseline hazards for both potential outcomes (default and prepayment) are likely to be different across the two types of loans (prime and subprime), so we estimate four separate Cox models in all. We define default as the loan’s first 90-day delinquency, and our main estimation period runs from 2005 through 2008. In this section, we use a random 5 percent sample of the LPS data.

The results of these models should not be interpreted as causal effects. If we see that borrowers with low loan-to-value ratios (LTVs) default less often (and we will), we cannot tell whether this arises because of something about the loan or something about the borrowers likely to choose low-LTV mortgages. Even so, a finding that DTI at origination is not a very strong predictor of default would undermine the claim that unaffordable mortgages are a more important cause of default than income shocks and falling prices.

Table 4 presents summary statistics of the loan-level characteristics that are included in the proportional hazard models. The average DTI at origination for prime loans in our sample is 35.1 percent, while the mean DTI for subprime loans is about 5 percentage points higher. Subprime loans also have generally higher LTVs and lower FICO scores. Figure 1 provides some additional detail about these risk characteristics by presenting the entire distributions of DTIs, LTVs, and FICO scores. While the distribution of prime DTIs is somewhat symmetric, the distribution of DTIs for subprime loans is strongly skewed, with a peak near 50 percent. Another interesting feature of the data emerges in the bottom row of panels, which presents LTVs. For both prime and subprime loans, the modal LTV is 80 percent, with additional bunching at multiples of five lying between 80 and 100. Recall that in the LPS data, an LTV of 80 percent does not necessarily correspond to 20 percent equity. This is because the borrower may have used a second mortgage to purchase the home (or may have taken out a second mortgage as part of a refinance). Unfortunately, there is no way to match loans to the same borrower in the LPS dataset, nor is there a flag to denote

¹⁹For details about hazard models, see Kiefer (1988).

whether any given loan is the only lien on the property. The large number of 80-percent LTVs, however, strongly suggests that these loans were accompanied by second mortgages. Thus, in our empirical analysis, we include a dummy variable that denotes whether the particular loan has an LTV of exactly 80 percent.²⁰

In addition to loan-specific characteristics, the Cox models also include the cumulative changes in statewide house prices and county-level unemployment rates that have occurred since the loan was originated.²¹ Figures 2 and 3 present the distributions for these data; unlike the figures for DTI, FICO, and LTV, each loan in the sample contributes a number of monthly observations to each of these two figures. Figure 2 shows that the distribution of price changes is skewed toward positive changes. In part, this reflects the large number of loans originated in the early years of the sample (2005–2006), when house prices were rising. In our empirical work we allow positive price changes to have different effects than negative price changes.²²

Finally, we also include a number of interactions among risk characteristics and macro variables. These interactions play an important role, given the strong functional form assumption embedded in the proportional hazard model. Denote $h(t|\mathbf{x}_j)$ as the hazard rate for either a default or a prepayment, conditional on a vector of covariates \mathbf{x}_j . The proportional hazard assumption is

$$h(t|\mathbf{x}_j) = h_0(t) \exp(\mathbf{x}_j \beta_x),$$

where $h_0(t)$ is the shared baseline hazard and β_x represent coefficient estimates. Because $\exp(\beta_1 x_1 + \beta_2 x_2)$ equals $\exp(\beta_1 x_1) \exp(\beta_2 x_2)$, there is in a sense a multiplicative interaction “built in” to the proportional hazard assumption. Entering various interactions directly ensures that interactions implied by the estimated model are not simply consequences of the functional form assumption. Of course, as with any regression, the presence of interactions makes interpretation of the level coefficients more difficult, because the level coefficients will now measure marginal effects at zero values of the other variables. Hence, we subtract 80 from the loan’s LTV before entering this variable in the regressions. In this way, a value of zero in the transformed variable will correspond to the most common value of LTV in the data. We transform DTI by subtracting 35 for prime loans and 40 for subprime loans, and

²⁰For ease of interpretation, we define this variable to equal one if the borrower does *not* have an LTV of 80 percent.

²¹Obviously, county-level house prices would be preferable to state-level prices, but high-quality, disaggregated data on house prices are not widely available. Our state-level house prices come from the Federal Housing Financing Authority (formerly the OFHEO price index).

²²Because of the importance of negative equity in default, the difference between a price increase of 10 percent and an increase of 20 percent may be much less consequential for a loan’s outcome than whether the house price declines by 10 or 20 percent. However, recall that we cannot figure total equity in the house, because we do not observe all mortgages.

we transform FICO by subtracting 700 for prime loans and 600 for subprime loans.

Figure 4 graphs the baseline default hazards for both prime and subprime loans. The subprime default hazard (dotted line) is much higher than the hazard for prime loans (note the different vertical scales on the figure). There is an increase in the subprime default hazard shortly after 24 months, a time when many loans reset to a higher interest rate. At first blush, this feature of the subprime default hazard would appear to lend support to oft-made claims that unaffordable resets caused the subprime crisis. Recall, however, that a hazard rate measures the instantaneous probability of an event occurring at time t among all subjects in the risk pool at time $t - 1$. While the default hazard shows that the default probability rises shortly after 24 months, the subprime prepayment hazard, graphed in Figure 5, shows that prepayments also spiked at the same time. The surge in prepayments means that the relevant pool of at-risk mortgages is shrinking, so that the *absolute number* of subprime mortgages that default shortly after the reset is rising to a much smaller extent than the hazard rate seems to imply. Thus, our results are not inconsistent with other research that shows that most subprime borrowers who defaulted did so well before their reset date.²³

Table 5 presents the coefficients from the Cox models. The model for prime defaults (first column) generates a significantly positive coefficient for the DTI ratio: .0105, with a state-clustered standard error of .0009. When working with proportional hazard models, it is common to report results in terms of “hazard ratios,” $\exp(\beta_j)$, the multiplicative shift in the baseline hazard engendered by a unit change in the regressor of interest. The DTI coefficient in the prime default regression generates a hazard ratio of $\exp(0.0105) \approx 1.0105$, indicating that a one-percentage-point increase in DTI shifts the default hazard up by 1.05 percent.²⁴ While statistically significant, the effect is small as a practical matter. Recall that Table 4 showed that the standard deviation of DTI in the prime sample is 13.8 percentage points, so a one-standard-deviation increase in DTI for prime borrowers results in a hazard ratio of $\exp(13.8 \cdot 0.0105) \approx 1.156$. This effect can be compared to the effect of decreasing a borrower’s FICO score by one standard deviation. The FICO coefficient in the first column (-0.0124) has about the same absolute value as the DTI coefficient, but the standard deviation in FICO scores is much greater (61.6 points). Thus, a one-standard-deviation drop in the FICO score results in a hazard ratio of $\exp(-61.6 \cdot -0.0124) \approx 2.147$.

Other coefficients in the first column also have reasonable signs and magnitudes. More defaults are to be expected among loans with high LTVs as well as loans with LTVs that

²³See Sherlund (2008), Mayer and Pence (2008), and Foote, Gerardi, Goette, and Willen (2008).

²⁴Because of the way we transformed our variables, this marginal effect corresponds to a prime borrower with a 700 FICO score, a DTI of 35, and an LTV of 80 percent.

are exactly 80 percent (and which thus suggest the presence of a second mortgage). The unemployment rate enters the regression with a large coefficient (.2068), so that a one-percentage-point increase in the unemployment rate results in a hazard ratio of about 1.23. House-price changes also enter significantly, though there is little evidence for different coefficients based on the direction of the price change (both the positive-change and negative-change coefficients are close to $-.058$).²⁵ These estimates indicate that a 10-percentage-point increase in housing prices shifts the hazard down by about 44 percent. When evaluating the effect of these macroeconomic coefficients on defaults, it is important to recall the earlier qualifications about identification. An exogenous increase in delinquencies may increase housing-related unemployment and cause housing prices to fall. Nevertheless, it is gratifying to see that the results of the model are consistent with other work that shows a direct causal effect of prices on default in ways that are immune to the reverse-causation argument (Gerardi, Shapiro, and Willen (2007)).

The second column of the table presents the estimates from the subprime default model.²⁶ As in the prime column, all of the individual-level risk characteristics enter the model significantly. And, as before, movements in FICO scores have a more potent effect on default than movements in DTI, though the difference is not as extreme. For subprime borrowers, a one standard-deviation increase in DTI results in a hazard ratio of $\exp(.0072 * 11.1) = 1.083$. This percentage change is smaller than the corresponding shift for prime mortgages, but recall that the baseline default hazard for subprime mortgages is also much higher. In any case, for subprime loans, the effect of raising DTI by one standard deviation is still smaller than the effect of lowering FICO by one standard deviation, shifting the baseline hazard up by about 21 percent rather than 8.3 percent.

We ran a number of robustness checks to ensure that the small DTI coefficients we obtained are accurate reflections of the underlying data. In principal, these coefficients could be biased down for two reasons. First, when DTI is recorded noisily, or when borrowers give inaccurate representations of their incomes in order to qualify for loans, then measurement error will attenuate the DTI coefficients toward zero. To see how much this matters in practice, we ran the default regressions on fully documented loans only. The DTI coefficients in both the prime and subprime default regressions became even smaller when we did so. We then estimated on the model only using prime loans held by Fannie Mae or Freddie Mac. Again, the prime DTI coefficient becomes smaller.²⁷ A second, more serious potential

²⁵Negative price changes are entered as a negative numbers, not as absolute values.

²⁶The level coefficients for LTV, FICO, and DTI now correspond to marginal effects for a subprime borrower with a 600 FICO score, an LTV of 80 percent, and a 40 percent DTI.

²⁷The subprime coefficient became slightly larger, rising from 0.0072 to 0.0127, but Fannie and Freddie hold only about 12 percent of the subprime loans in our regression sample.

source of downward bias arises because we cannot link separate mortgages taken out on the same house. Thus the DTI coefficients in our models reflect the onerousness of first mortgage only. One imperfect way of addressing this issue is to throw out loans that are likely to have second mortgages — specifically, the mortgages for which the LTV on the first lien is exactly equal to 80 percent. Our DTI coefficients again become smaller when we do so. However, better data is needed to fully address the role that DTI plays in default when more than one mortgage is present.

Turning back to the baseline estimates, two additional results from the default regressions are consistent with the idea that idiosyncratic income risk is an important determinant of mortgage outcomes. First, among subprime borrowers, the effect of DTI on the likelihood of default is smaller for borrowers with high FICO scores. The coefficient on the interaction of FICO and DTI in the second column is significantly negative ($-.000055$, with a standard error of $.000017$). Thus, for a subprime borrower with a 700 FICO score, the total marginal effect of an increase in DTI on his default probability is only $.0017$, an effect that is insignificantly different from zero.²⁸ The fact that high-FICO borrowers in the subprime pool are better able to tolerate high DTIs suggests that these borrowers may have been able to make good predictions of their future incomes and of the likely variation in these incomes. These borrowers may have desired high-DTI mortgages that were unattractive to prime lenders, so they entered the subprime pool. A second set of results pointing to the importance of income volatility is the coefficients on the unemployment–FICO interactions. These coefficients are significantly negative in both the prime and subprime regressions, indicating that the ARMs of high FICO borrowers are generally hurt more severely, in percentage terms, by increases in the aggregate unemployment rate. If idiosyncratic income variation among high-FICO borrowers is relatively low, then it is perhaps not surprising that their mortgages are relatively more sensitive to aggregate fluctuations.

Results from the prepayment regressions are presented in the third and fourth columns of Table 5. Prime borrowers tend to refinance somewhat more quickly out of high-DTI mortgages, while DTI has an insignificant effect on subprime prepayment. Of particular note in both regressions is the strong effect that house prices have on prepayment. The coefficients on all price terms are positive, indicating that higher prices encourage prepayment and lower prices reduce it. The effect of price declines on subprime refinancing is particularly strong.

Figure 6 puts the pieces together by simulating the number of monthly defaults under various assumptions about loan characteristics, house prices, and unemployment. To do this,

²⁸To see this, note that a 700 FICO score corresponds to a score of 100 in our transformed FICO metric for subprime borrowers. Thus, the relevant DTI coefficient for a 700-FICO borrower is the level coefficient on DTI ($.0072$) plus 100 times the interaction of DTI and FICO ($-.000055$). This sum approximately equals $.0017$.

we first shift the baseline hazards for both default and prepayment to be consistent with the assumptions and the coefficient estimates from the model. We then calculate what these adjusted hazards would imply for the size of an initial risk set of 100 loans.²⁹ Multiplying the risk set in a given month times the hazard of either defaults or prepayments gives the total number of the 100 original loans that are expected to default or prepay in that month. Panel A of Figure 6 presents the data for prime defaults. The solid line assumes a baseline case of no changes in house prices or unemployment along with the baseline DTI value (35 percent for prime loans). The dashed line just above it assumes that DTI is 45 rather than 35. As one would expect from the modest size of the coefficient in the first column of Table 5, increasing DTI has a modest effect on monthly defaults. The next lines return DTI to 35 but either raise the unemployment rate by 2 percentage points or reduce housing prices by 10 percent. These assumptions have a much larger positive effect on prime defaults than the assumption of higher DTI. Falling house prices also strongly discourage prime prepayments, as shown in Panel B.

The bottom two panels of Figure 6 present the results for subprime loans. In Panel C, we see a small uptick in defaults between 24 and 30 months, presumably due to the interest-rate resets on subprime 2/28 mortgages. This increase, however, is smaller than the bulge in the baseline hazard at about this time, because the risk set has been significantly reduced by prepayments. Panel C also shows the nearly imperceptible effect of higher DTI. Here, the experiment is raising DTI from the baseline subprime value of 40 percent to 50 percent. As with prime defaults, the effect of this increase is small relative to the effect of unemployment and house prices. Finally, Panel D shows that falling house prices have particularly severe effects on the prepayments of subprime loans.

The patterns displayed in Figure 6 are consistent with a large role for income volatility in mortgage defaults discussed in section 2. Higher unemployment rates increase defaults, as more people are likely to lose jobs and become liquidity constrained during recessions. Falling housing prices also raise defaults, because they increase the likelihood that a homeowner who receives a negative income shock will also have negative equity, and will thus be unable to sell his home for enough to repay the mortgage. This interaction of income shocks and falling prices is sometimes called the “double-trigger” model of default, because it claims that defaults occur when two things happen at the same time: the borrower suffers some adverse life event while he also has negative equity in his home.

²⁹For example, if both the default and prepayment hazards have been adjusted upwards by the implied assumptions on covariates and coefficient estimates, then the risk set will be whittled more quickly away by defaults and prepayments.

3.3 Affordability and falling prices: Quantifying “walk-away” defaults

The previous subsection showed that high levels of origination DTI are not predictive of high default rates, especially in comparison to variables like FICO scores and features of the macroeconomic environment like falling house prices and rising unemployment. Our preferred interpretation of this pattern is that falling prices lead to negative equity, which can lead to default and foreclosure when a borrower receives a large negative income shock. However, as the model of section 2 shows, housing prices have a direct effect on the affordability of a home that does not involve income volatility. A lower probability of future price appreciation (lower α_G) raises the user cost of owning a home and makes default more likely. If there is no hope that the price of the house will ever recover to exceed the outstanding balance on the mortgage, the borrower may engage in “ruthless default” and simply walk away from the home. Kau, Keenan, and Kim (1994) show that optimal ruthless default takes place at a negative-equity threshold that is well below zero, due to the option value of waiting to see whether the house price recovers.³⁰ Once the default threshold has been reached, however, default remains optimal if no new information arrives.

Of course, we cannot observe the expectations of individual homeowners to see whether their defaults coincide with extremely gloomy forecasts of future house prices. However, we can exploit a particular feature of the ruthless default model to get a rough upper bound on how many people are walking away from their homes. If the ruthless default model is a good characterization of the data, then delinquent borrowers should simply stop making payments, never to resume again. There is no reason for a ruthless defaulter to change his mind and start making payments once more (unless his expectation of future house prices suddenly improves). On the other hand, if income volatility is interacting with falling prices to produce double-trigger defaults, then we should see delinquent borrowers cycling through various stages of delinquency as various shocks to their incomes are realized and they struggle to keep their homes. In the LPS data, we observe each borrower’s monthly delinquency status so we can compare the number of “direct defaults” to the number of “protracted defaults.” The fraction of 90-day delinquencies that arise via direct defaults will be an upper bound on the importance of walk-away defaults, because some people may have suffered particularly severe declines in income and had to stop making payments abruptly, even though they wanted to keep their homes.

To set the stage for this analysis, we first present so-called “roll rates,” which measure the

³⁰The presence of this option value explains why negative equity is a necessary but not sufficient condition for default.

likelihood that a borrower in one stage of delinquency will transition into another. Figure 7 graphs these rates for borrowers who start a month in different delinquency stages.³¹ Panel A considers people who begin a month in current status. Since January 2001, about 1 to 2 percent of current borrowers have become 30 days delinquent each month. Interestingly, the number of people rolling from current to 30 days delinquent has only recently exceeded the levels of the 2001 recession, even though foreclosures have been far higher than they were then. Another interesting pattern in this panel is that the current-to-30-day roll rate was low in 2004 and 2005, when many supposedly unaffordable mortgages were originated. Panel B considers borrowers who begin the month 30 days late. A fairly constant 40 percent of these borrowers make their next payment to remain 30 days late the next month. Until 2007, about 40 percent of borrowers who were 30 days late made two payments to become current again, with the remaining 20 percent failing to make a payment at all and thereby becoming 60 days late. In the past few months, however, more persons who were 30 days late are rolling into 60-day status, considered the start of serious delinquency. Panel C shows that the fraction of 60-day delinquencies that roll into 90-day status has risen sharply over the past two years, with corresponding declines in the fractions of borrowers making two or three payments. Yet the fraction of 60-day delinquencies making one payment to remain 60 days late has remained fairly constant. Finally, Panel D analyzes borrowers who begin the month 90 days late. This is a somewhat absorbing state, because there is no formal 120-day status.

The main takeaway from Figure 7 is that many people who are delinquent have no desire to stay that way. Many people who are seriously delinquent come up with two or three payments in an attempt to climb out of the status, or manage one payment so as not to slide further down. Still, these graphs do not answer the precise question of how many people who become 90 days delinquent simply stopped making payments. We define this type of direct default as a 90-day delinquency that satisfies three requirements:

- The borrower is current for three consecutive months, then registers a 30-day, a 60-day, and a 90-day delinquency in succession during the next three months;
- The borrower had never been seriously delinquent before this six-month stretch;
- The borrower never becomes current or rolls down to 30-day or 60-day status after this stretch.

Panel A of Table 6 lists the fraction of direct defaults for the entire United States, starting in 2003. These rates differ by the year that the mortgage is originated and the

³¹As was the case with the duration models, the roll rates are based on a random 5 percent sample of the LPS data.

year in which the default occurred. Among all 2003–2008 mortgages that defaulted in 2008, fewer than half, 41.6 percent, were direct defaults. This percentage was higher for loans made at the height of the housing boom, as 44.6 percent of 2005 mortgages defaulting in 2008 were direct defaults. This is consistent with the idea that mortgages likely to have the largest amounts of negative equity are the most likely to ruthlessly default. But among these mortgages, fewer than half simply stopped making payments, and even this fraction is an upper bound on the true fraction of ruthless defaults.³² Panel B Table 6 uses data from four states that have had particularly severe price declines and thus are more likely to have ruthless defaulters.³³ As we would expect, the share of direct defaulters is higher in these states, reaching 55.1 percent in 2008. The 2008 fraction of direct defaults in the remaining 47 states (including DC) is less than one-third, as seen in Panel C.

To sum up, falling house prices are no doubt causing some people to ruthlessly default. But the data indicate that ruthless defaults are not the biggest part of the foreclosure problem. For the nation as a whole, less than 40 percent of homeowners who had their first 90-day delinquency in 2008 stopped making payments abruptly. Because this figure is an upper bound on the fraction of ruthless defaults, it suggests ruthless default is not the main reason why falling house prices have caused so many foreclosures.

4 Foreclosure and Renegotiation

A distressing feature of the ongoing foreclosure crisis is the seeming inability of the private market to stop it. A lender typically suffers a large loss when it (or its agent) forecloses on a house. On the surface, it would appear that the lender would be better off modifying any delinquent loan in the borrower’s favor and taking a small loss, as opposed to refusing a modification, foreclosing on the mortgage, and suffering a large loss. Lender behavior is especially perplexing if high DTI ratios are causing the crisis. Surely making the mortgage affordable by reducing a borrower’s DTI to 38 or 31 percent is preferable to foreclosure for the lender as well as the borrower. Given this apparent puzzle, a number of analysts have argued that the securitization of mortgages into trusts with diffuse ownership is preventing “win-win” modifications from taking place. In this section, we provide an alternative explanation for why modifications are rare. We then consult the LPS dataset and the historical record to see how the different explanations square with the data.

³²It is also important to point out that right-censoring may be inflating these numbers a little, since some of the borrowers who we identify as direct defaulters in the last 3 months of the data, may make a mortgage payment in the future.

³³The states are Arizona, California, Nevada, and Florida.

4.1 The renegotiation-failure theory

Lenders often take large losses on foreclosed homes, which are typically sold for much less than the outstanding balances of the defaulted mortgages. Conversely, the modifications offered to borrowers are generally modest. A study by White (2009) provides the following data:

The average loss for the 21,000 first mortgages liquidated in November was \$145,000, representing an average loss of 55 percent of the amount due. Losses on second lien mortgages were close to 100 percent. In comparison, for the modified loans with some amount of principal or interest written off, the average loss recognized was \$23,610. This seven-to-one difference between foreclosure losses and modification write-offs is striking, and lies at the heart of the failure of the voluntary mortgage modification program. Particularly for foreclosed loans with losses above the 57 percent average, some of which approach 100 percent, the decisions of servicers to foreclose is mystifying.... At a minimum, there is room for servicers to be more generous in writing down debt for the loans they are modifying, while still recovering far more than from foreclosures in the depressed real estate market of late 2008.³⁴

To explain the small number of concessions and the large number of foreclosures, many analysts blame institutional factors related to the collection of mortgages into mortgage-backed securities (MBS). Such loans are owned by trusts on behalf of a large number of individual investors, rather than by a single entity (such as a local bank). White's quote mentions the decisions of loan servicers, who are responsible for funneling mortgage payments to these MBS investors and performing various other tasks related to securitized mortgages.³⁵ Most importantly, when a borrower falls behind on his mortgage, it is the servicer who decides whether a loan modification or a foreclosure is more appropriate.

Analysts who blame securitization for the low number of modifications argue that the incentives of the servicers have become decoupled from those of investors, who ultimately bear the losses entailed in foreclosure. We label this claim the *renegotiation-failure theory*. Securitization can potentially limit modifications in at least two ways. First, servicers can be hamstrung by restrictive agreements they signed with investors at the origination of the mortgage trust, well before the crisis hit.³⁶ The actions of a servicer working for a trust are

³⁴White (2009), pp. 14–15.

³⁵Mortgages held in the portfolio of a single financial institution are normally serviced by that institution.

³⁶For example, the authors of the COP report write that “[r]estrictions on mortgage servicers' ability to modify loans are an obstacle that has contributed to foreclosure that destroys value for homeowners and investors alike” (p. 50.)

governed by so-called Pooling and Servicing Agreements (PSAs). Among other things, these agreements specify the latitude that servicers have when deciding between modification and foreclosure. As a general rule, PSAs allow servicers to make modifications, but only in cases where default is likely and where the benefit of a modification over foreclosure can be shown with a net-present-value (NPV) calculation. Second, proponents of the renegotiation-failure theory claim that servicers are afraid that they will be sued by one tranche of investors in the MBS if they make modifications, even if these modifications benefit the investors in the trust as a whole. Because different tranches of investors have different claims to the payment streams from the MBS, a modification may alter these streams in a way that will benefit one tranche at the expense of another. One might think that the PSAs would have foreseen this possibility, but some analysts claim that the PSAs were not written with an eye to the current foreclosure crisis. Thus, it is claimed that there is enough ambiguity in the PSAs to make servicers wary of getting caught up in “tranche warfare,” so servicers are thought to follow the path of least resistance and foreclose on delinquent borrowers.³⁷

A central implication of this theory is that securitization and the related frictions embedded in the contracts between investors and servicers are preventing modifications that would make even the lender better off. As Eggert (2007) states:

The complex webs that securitization weaves can be a trap and leave no one, not even those who own the loans, able effectively to save borrowers from foreclosure. With the loan sliced and tranced into so many separate interests, the different claimants with their antagonistic rights may find it difficult to provide borrowers with the necessary loan modifications, whether they want to or not (p. 292).³⁸

4.2 Reasons to doubt the renegotiation-failure theory

There are, however, reasons to doubt the renegotiation-failure theory. First, there is little evidence on the extent to which PSAs have limited modifications in practice.³⁹ A 2007 study by Credit Suisse of approximately 30 PSAs concluded that fewer than 10 percent of them completely ruled out modifications. About 40 percent of the PSAs allowed modifications, but with some restrictions. These restrictions included a limit on the percentage

³⁷The authors of the COP report write that “[s]ervicers may also be reluctant to engage in more active loan modification efforts because of litigation risk” (p. 46).

³⁸Other policy analysts have adopted a similar view. For example, the COP writes in its recent report that “A series of impediments now block the negotiations that would bring together can-pay homeowners with investors who hold their mortgages Because of these impediments, foreclosures that injure both the investor and homeowner continue to mount” (COP report, p. 2).

³⁹For a discussion of the role of PSAs in reducing modifications, see Cordell, Dynan, Lehnert, Liang, and Maukopf (2008), which also discusses the incentives faced by servicers more generally.

of mortgages in the pool that could be modified without permission from the trustee of the mortgage-backed security (often 5 percent), and/or a floor for the mortgage rate that could be applied in the event of a modification that entailed a reduction in the borrower's interest rate. The remainder of PSAs contained no restrictions. It is unlikely that even PSAs with 5-percent caps are preventing modification to any significant degree. The Congressional Oversight Panel for the Troubled Asset Recovery Program examined a number of securitized pools with 5-percent caps and found that none had yet approached this cap.⁴⁰ Moreover, one can make a case that the typical PSA actually *compels* the servicer to make modifications if these modifications are in the best interests of the investor. According to Cordell, Dynan, Lehnert, Liang, and Mauskopf (2008), "While investors seem somewhat concerned about servicer capacity, they do not convey widespread concern that servicers are relying overmuch on foreclosures relative to modifications." In fact, investors opposed additional incentives for modifications:

Investors with whom we spoke were not enthusiastic about an idea to reimburse servicers for expenses of loss mitigation. In their view, such payments could lead to more modifications than warranted by the NPV calculations. They also felt that the PSA adequately specified that modifications that maximized NPV should be undertaken. A typical response from an investor was, Why should I pay servicers for doing something that I already paid them to do?⁴¹

Regarding the fear of lawsuits, no servicer has yet been sued for making too many loan modifications. There has been a well-publicized lawsuit filed by a group of investors against a servicer doing modifications, but the details of this suit should not make other servicers wary about making modifications.⁴² Moreover, Hunt (2009) studied a number of subprime securitization contracts and found not only that outright bans on modifications were rare, but also that most contracts allowing modifications essentially instructed the servicer to behave as if it were the single owner of the loan:

The most common rules [in making modifications] are that the servicer must follow generally applicable servicing standards, service the loans in the interest of the certificate holders and/or the trust, and service the loans as it would

⁴⁰COP report (p. 44).

⁴¹Cordell, Dynan, Lehnert, Liang, and Mauskopf (2008), p. 19.

⁴²Specifically, an MBS investor has sued two large servicers, Countrywide and Bank of America, for promising to make mass modifications as part of a settlement that Countrywide and Bank of America struck with the government in a predatory lending case. The key argument by the investor in this lawsuit was that the modifications were done not because they were profitable for the investors, but rather to settle a predatory lending lawsuit, which the plaintiffs of that lawsuit claimed was the responsibility of Countrywide, in its capacity as the originator of the troubled loans.

service loans held for its own portfolio. Notably, these conditions taken together can be read as attempting to cause the loans to be serviced as if they had not been securitized. (p. 8, insertion added)

The Hunt (2009) findings speak directly to whether the modification of securitized mortgages is analogous to the restructuring of troubled corporations, as has been suggested by some economists. As was illustrated in negotiations over the recent Chrysler bankruptcy, a single corporate bond holder can block a deal that is in the interests of all other stakeholders in the firm.⁴³ But any analogy between corporate bankruptcy and mortgage modification is not appropriate. Not only can the typical mortgage servicer proceed with a modification without the approval of *all* investors, the servicer does not need the approval of *any* investor to modify a loan. Thus, there is no possibility of a hold-up problem. The authors of the typical PSA appear to have anticipated the problems that could arise with dispersed ownership, so the contract instructs the servicer to behave as if it alone owned the loan. To preview our empirical results, we find that the data are consistent with the claim that servicers are carefully following this type of contract.

While there can be substantial disagreement about the importance of any particular institutional impediment to loan modification, perhaps the most compelling reason to be skeptical about the renegotiation-failure theory is the sheer size of the losses it implies. We can use White's figures quoted above to come up with a back-of-the-envelope calculation for the total losses that follow from the renegotiation-failure theory. One figure often cited for the total number of foreclosures that can be prevented with modifications is 1.5 million.⁴⁴ For a dollar figure, we can multiply this number of preventable foreclosures by the \$120,000 that White claims is lost by investors for each foreclosure performed.⁴⁵ This results in a total deadweight loss of \$180 billion.

Losses of this size may be hard to square with economic theory, as Eric Maskin recently pointed out in a letter to the *New York Times*. Maskin wrote his letter in response to an earlier op-ed that had claimed the government has a role in facilitating loan modifications, specifically mass write-downs of principal balances.⁴⁶ According to Maskin: "If, as claimed, such write-downs are truly 'win-win' moves — allowing borrowers to keep their homes and giving mortgage holders a higher return than foreclosure — they may not need the government's assistance." The writers of the original op-ed column had claimed that servicers now

⁴³See "A Chrysler Creditor Finds Himself Torn," *The Wall Street Journal*, April 30, 2009.

⁴⁴This figure comes from FDIC Chairman Sheila Bair. For details see "Sheila Bair's Mortgage Miracle," *Wall Street Journal*, December 3, 2008.

⁴⁵White (2008)

⁴⁶The op-ed to which Maskin responded is Geanakoplos and Koniak (2008). Maskin's letter appeared on March 7, 2009.

have an undue incentive to foreclose rather than modify loans. Maskin pointed out that if this were the case, then

mortgage holders themselves have strong motivation to renegotiate those contracts, so that the servicers' incentives are corrected. That would be a win-win move (for mortgage holders, servicers and borrowers), and to complete their argument, the writers must show why it won't happen.

Economists will recognize the reasoning in Maskin's critique. The Coase Theorem implies that economically efficient decisions will be made as long as property rights are well-defined and transactions costs are not of first-order importance. Under these conditions, it does not matter that servicers are not the ones who suffer the \$180 billion losses entailed in foreclosure, or even that existing PSAs might unduly limit modifications. The party that suffers the potential losses — the investors — has an incentive to make side payments or to change contractual arrangements so as to prevent these massive losses from occurring. To take this reasoning one step further, if one class of investors has more to gain from modification than another class stands to lose, the first class has an incentive to strike deals with (or buy out) the second class. Consequently, to be consistent with the Coase Theorem, the renegotiation-failure theory must also assert that the transactions costs implied by securitization are large enough to derail these efficiency-enhancing arrangements, at the cost to lenders of \$180 billion.

4.3 A theory of loan modifications

There is another way to explain the low number of modifications that does not rely on enormous transactions costs and yet is consistent with the Coase Theorem. It is simply that most potential modifications are negative-NPV transactions from the standpoint of investors. In other words, when all the relevant costs and benefits are considered, servicers may *already* be acting in the best interests of the investors when they foreclose.⁴⁷

To start with, modifications do not always prevent foreclosures, especially when defaults are of the double-trigger variety. Consider a borrower who has lost his job. No permanent modification can make the house affordable if the borrower has no income. Lenders often offer "forbearance" in these cases, whereby the borrower pays sharply reduced payments for a time. The borrower is then obligated to make up these arrears, with interest, later on. Lenders may be reluctant to offer forbearance for any length of time if they are unsure

⁴⁷Note that because of externalities from foreclosures, modifications may be in society's interests even if they are not investors' interests.

when the borrower will find a new job (and at what wage). When the value of the house that collateralizes the loan is falling, and when all parties know that the house has probably become unaffordable to the borrower, then the servicer may simply decide to take a loss now by foreclosing, rather than risk an even larger loss down the road.⁴⁸

The possibility that borrowers will re-default on their loans reduces the *benefits* of loan modifications and thereby makes them less likely to occur. There are also reasons to think that *costs* of modifications are higher than many housing analysts recognize. These analysts typically ignore the costs of modifications that are made to borrowers who would have repaid their loans anyway. Consider a lender facing a troubled borrower who is requesting a modification. If the lender fails to modify the loan and the borrower defaults, the lender will lose because (as White points out above), the cost of modifying the loan falls far short of the cost of foreclosing. We will call this loss “Type I error.” However, Type I error is only part of the story, as the lender faces another potential problem. If, unbeknownst to the lender, the borrower requesting the modified loan will not default in the absence of a modification, then the lender will lose the money he would have received according to the original terms of the loan. We call this situation “Type II error.” For a modification to make economic sense from the lender’s perspective, Type I error must exceed Type II error.

More formally, we can follow Foote, Gerardi, and Willen (2008), who consider a lender with a borrower who owes m on a house currently worth p_H dollars. This borrower will default with probability α_0 , in which case the lender recovers p_H less λ dollars in foreclosure costs. A modification lowers the value of the loan to $m^* < m$ and the probability of foreclosure to $\alpha_1 < \alpha_0$. Note that we do not assume that modification guarantees full repayment of the mortgage — there is some probability of re-default when $\alpha_1 > 0$. Some simple arithmetic shows that renegotiation occurs when:

$$\text{Renegotiation} \Leftrightarrow \underbrace{(\alpha_0 - \alpha_1)}_{\text{Reduction in foreclosure prob.}} \times \underbrace{(m^* - (p_H - \lambda))}_{\text{Reduced loss}} > \underbrace{(1 - \alpha_0)}_{\text{Pct. repay without mitigation}} \times \underbrace{(m - m^*)}_{\text{Reduced value of the mortgage}} \quad (3)$$

The first term corresponds to the Type I error — if a foreclosure is prevented, the lender recovers m^* rather than $p_H - \lambda$. The second term corresponds to the Type II error — borrowers who would have repaid in full, but take advantage of principal reduction to reduce their debt burden.

⁴⁸We have been told that there is a macabre saying in the servicing industry: “The first loss is the best loss.”

The following reformulation of equation (3) is instructive:

$$m - m^* < \frac{\alpha_0 - \alpha_1}{1 - \alpha_1} [m - (p_H - \lambda)]. \quad (4)$$

The right-hand side is the maximum possible concession the lender can profitably make. To understand this, consider some simple examples. If we set α_0 , the probability of default without a modification, equal to 1, then equation (4) becomes

$$m^* > p_H - \lambda.$$

This is the case that White (2009) has in mind when he writes, “Particularly for foreclosed loans with losses above the 57 percent average, some of which approach 100 percent, the decisions of servicers to foreclose is mystifying.”⁴⁹ In White’s extreme example of 100 percent loss given default, even a modification that reduces the probability of default from 1 to anything even infinitesimally less than one, and in which the lender recovers infinitesimally more than 0, makes economic sense.

However, even a little uncertainty about whether the borrower will default invalidates the above logic. If we assume modification ensures that the loan will repay with certainty ($\alpha_1 = 0$), then equation (4) becomes:

$$m - m^* < \alpha_0 [m - (p_H - \lambda)]. \quad (5)$$

It is easy to see in this equation exactly how the math works against modification. Suppose the expected loss is 57 percent and the likelihood of default is 50 percent, then the lender can only reduce the value of the loan by 28.5 percent.

How big are Type I and Type II errors in practice? Results in Gerardi and Willen (2009) show that for most categories of homeowners in Massachusetts, Type II is large relative to Type I error: even with major stresses, most homeowners will not default on their mortgages. The authors find that concessionary modifications make sense only for multi-family properties purchased with subprime mortgages.

Equation (3) clearly illustrates that the observation that a foreclosure, on the surface, seems to lead to greater monetary losses than an apparently reasonable modification is not *prima facie* evidence of inefficiency. Such foreclosures may well be *ex ante* efficient, when the issue of moral hazard is factored into the equation. This type of moral hazard explains why mortgage investors are not unduly concerned about too few modifications being performed,

⁴⁹White (2009), p. 15.

and why, to date, there have been no lawsuits against servicers encouraging them to do more modifications.

4.4 Statistical evidence on loan modifications

The LPS data allow us to perform an econometric test of the renegotiation-failure theory, because these data contain information on the ultimate holder (investor) of the residential mortgages. Specifically, we are able to tell whether a mortgage is held on the balance sheet of a financial institution, securitized by a government sponsored enterprise (GSE) such as Freddie Mac (FHLMC) or Fannie Mae (FNMA), or securitized by a non-agency, private institution. With this information, combined with information that allows us to identify modified loans, we are able to compare the relative modification frequency between loans held in portfolio and loans that are securitized. If institutional constraints inherent in the securitization process are preventing profitable modifications, then we expect to see in the data relatively few modifications among securitized loans, as compared with loans held in portfolio.

The LPS dataset does not include direct information on loan modifications. However, it does contain updated loan terms at a monthly frequency, with which we are able to identify loan modifications indirectly (and imperfectly).⁵⁰ With these data we label a loan as modified if there is a change in its terms that was not stipulated by the initial terms of the contract. These changes include interest-rate reductions, principal-balance reductions, and term extensions. We can also identify principal-balance and mortgage-payment *increases* that reflect the addition of arrearages to the balance of a loan.⁵¹

Table 7 reports the number of modifications made by quarter from the first quarter of 2007 through the last quarter of 2008, disaggregated by the type of modification made. Each of the numbers in the table is a multiple of 10 because we used a 10 percent random sample and scaled up the numbers we found. The first column simply reports the total

⁵⁰The Office of Thrift Supervision (OTS) and Office of the Comptroller of Currency (OCC) used very similar data from LPS to analyze the outcomes of recent mortgage modification programs (OCC and OTS Mortgage Metrics Report, Third Quarter 2008) In their report, they used supplementary data directly from large mortgage servicers that included the identification of loans in the LPS data that had been modified. While we do not have access to those data, our findings are fairly consistent with theirs.

⁵¹There are two potential mistakes we can make in this exercise. First, we may falsely identify modifications ("false positives") because of measurement error in the data (for example, a mistake in the updated balance or interest rate) or some endogenous behavior on the part of the borrower (for example, a borrower making extra principal payments). Second, we may miss modifications ("false negatives") because our algorithm for finding modifications is incomplete. In this section we are more concerned with false positives than with false negatives, so we use a conservative set of criteria. See Adelino, Gerardi, and Willen (2009) for a detailed explanation of the exact algorithm used to identify modified loans in the LPS data.

number of loan modifications performed and shows that they have become more common as the housing market has weakened. By our calculations, there appear to be more than seven times as many modifications performed in the fourth quarter of 2008 as in the first quarter of 2007.

In addition to the rapid growth in loan modifications, the composition of modifications has changed over time. This can be seen in the remaining columns of Table 7, which list the incidence of modifications of different types.⁵² A somewhat surprising finding is that most modifications entailed *increases* in the principal balance of a mortgage. Such increases are likely due to the addition of arrearages to the outstanding mortgage balance for delinquent borrowers, and they often increase the monthly mortgage payment by a nontrivial amount. Table 7 shows that while the absolute numbers of balance-increasing modifications are still rising, they are falling as a percentage of total modifications. In the last few quarters in our data, interest-rate reductions, which necessarily involve a decrease in the mortgage payment, have become more frequent, rising to more than 25 percent of all modifications performed in 2008:Q4. Adelino, Gerardi, and Willen (2009) provide further information regarding the behavior of monthly mortgage payments for loans that have undergone a modification. The authors find that until the fourth quarter of 2008, modifications involving payment increases were more common than those involving payment decreases. In addition, they find that the average and median magnitudes of payment decreases have recently increased from approximately 10–14 percent in the period between 2007:Q1 and 2008:Q2, to approximately 20 percent in the final two quarters of 2008. Based on the logic from our simple framework above, it is likely that these will have more success than modifications involving increases in the payment and/or balance.

Figure 8 contains some evidence from the LPS data to support this claim. The figure contains Kaplan-Meier non-parametric, survival estimates (also known as the product limit estimator) of the transition from modification to default.⁵³ The figure considers a loan to be in default when it becomes 90 days delinquent (approximately three missed payments).

⁵²In many cases a mortgage will experience multiple types of modifications at the same time. For example, we see cases in the data in which the interest rate is decreased and at the same time the term of the loan is extended. Thus, the percentages in Table 7 are not calculated with respect to the number of loans modified, but rather with respect to the number of modifications performed.

⁵³The Kaplan-Meier estimate of the survival function for delinquency is given by:

$$\hat{S}_t = \prod_{t_i < t} \frac{n_i - m_i}{n_i}, \quad (6)$$

where $S(t)$ is the probability that a borrower will not default through time t , d_i corresponds to the number of loans that default at time t_i , while n_i corresponds to the number of loans that are “at-risk” of default at time t_i , or in other words the number of loans that are still active and that have not defaulted before time t_i .

The figure shows that modifications involving a decrease in the monthly payment are far more successful than those involving an increase in the payment. For example, after one year, the probability that a modified loan involving a payment increase becomes 90 days delinquent is approximately 69 percent. In contrast, a modified loan involving a payment decrease has a probability of becoming 90 days delinquent of approximately 52 percent.⁵⁴ Of course, it should be noted that the underlying data in Figure 8 come predominantly from loan modifications that took place in 2007 and early-to-mid 2008, while the majority of modifications in the LPS data occurred in the last two quarters of 2008. The Kaplan-Meier estimator does account for right-censoring, but in order to draw more conclusive inferences we will need to observe more data on these recent modifications. Another noteworthy observation from Table 7 is that the incidence of principal reductions is extremely low in our data. This is likely due to two factors. First, the LPS data under-represent the subprime mortgage market.⁵⁵ A few servicers that focus almost exclusively on subprime mortgages have recently begun modification programs that involve principal reduction.⁵⁶ In addition, from a theoretical perspective, principal reduction plans suffer from the severe incomplete-information problem noted earlier. Balance reductions are appealing to both borrowers in danger of default and those who are not. As a result, lenders have a strong incentive to provide modifications only to those borrowers who are most likely to default. Adelino, Gerardi, and Willen (2009) provide evidence to support this claim, as they show that modified loans in the LPS dataset are characterized by high leverage, high initial debt-to-income ratios, and low initial credit scores. These are the loans that are most likely to default without a modification (that is, loans where α_0 is high).

Table 8 contains modification statistics broken down by the holder of the mortgage. We distinguish between mortgages held in portfolio, mortgages securitized by a GSE such as Fannie Mae or Freddie Mac, and mortgages securitized by a private entity. For each quarter of 2008, we calculate the percentage of loans outstanding at the beginning of each quarter that were modified at some point in that quarter. Each panel in the table corresponds to a different sample of mortgages. Panel A corresponds to all types of mortgages in the data. Panel B corresponds to both subprime and Alt-A mortgages.⁵⁷ Finally, each panel in

⁵⁴The pattern is similar if we assume the more stringent definition of default, corresponding to the situation in which foreclosure proceedings are initiated by the holder of the mortgage. In this case, modified loans involving a payment increase have a probability of experiencing a foreclosure of about 34 percent, while modifications involving a payment decrease have an associated probability of about 17 percent.

⁵⁵The majority of subprime mortgages are securitized by non-agency firms, and for the period of interest, the LPS dataset includes approximately 35 percent of mortgages securitized by non-agency corporations.

⁵⁶An October report by Credit Suisse notes that Ocwen Loan Servicing, LLC and Litton Loan Servicing LP were the only subprime servicers that had performed a nontrivial number of principal reduction modifications. Neither of these servicers contribute to the LPS dataset.

⁵⁷The definition of subprime and Alt-A comes directly from the servicers that contribute to the LPS

the table is disaggregated into three parts, corresponding to different denominators used in calculating the percentages. The first part uses all loans outstanding at the beginning of the respective quarter, the second part uses all loans that are 30 days delinquent at the start of the respective quarter, and the third part uses all loans that are 60 days delinquent at the start of the respective quarter. By limiting the sample to delinquent loans, we are partially controlling for differences in credit quality between loans held in portfolio and loans that are securitized. This control turns out to be important. In both of the panels, and in almost all quarters, modifications for privately securitized loans are more frequent than for portfolio loans when the relevant universe is the full sample of loans. However, privately securitized loans are generally riskier than other loans, so this discrepancy may simply reflect the fact that more privately securitized loans are in danger of foreclosure and are thus, candidates for modification. When we narrow the focus to *delinquent* loans, the results become more balanced. Portfolio loans have a slightly higher incidence of modification compared with privately securitized in Panel A, while modifications are more common among portfolio loans in many instances in Panel B (except in the fourth quarter of 2008).

There are at least two patterns of note in Table 8. First, while delinquent loans held in portfolio appear to be modified more frequently than privately securitized mortgages (except for subprime and Alt-A mortgages, as defined in the LPS data), the discrepancy is not as large as it is often made out to be in policy circles and in media reports. For the sample of all 30-day delinquent loans (Panel A) held in portfolio, 6.81 percent were modified in the third quarter of 2008 and 8.55 percent in the fourth quarter of 2008. In comparison, 6.28 percent and 6.23 percent of privately securitized mortgages were modified in the third quarter and fourth quarter of 2008, respectively. We see similar, although slightly larger discrepancies for 60-day delinquent loans, but in many instances the sign changes for subprime and Alt-A loans (Panel B). The second take-away from the table is that the GSEs appear to have been much more reluctant to modify loans, with the exception of Freddie Mac in the third and fourth quarters of 2008. While the summary statistics presented above suggest that the incidence of modification does not seem to be greatly impeded by the process of securitization, there are a variety of factors that could be contributing to the variation in Table 8, including substantial differences in characteristics between portfolio-held loans and securitized loans. In addition, there may be significant lags between the time when a loan becomes delinquent and the point when it is modified that are not captured in Table 8. For example, if it were the case that the percentages of modified loans were the same, but portfolio-held loans were modified more quickly than privately securitized loans, Table 8 would show more portfolio-held loans being modified (since the

dataset. There is no additional distinction between subprime and Alt-A in the LPS dataset.

slower, privately securitized modifications would not be picked up in the table). For this reason, a slightly more formal analysis is necessary, in which other observable differences between securitized and portfolio loans are controlled for, and in which the timing issues as well as right-censoring are also taken into account. Censoring is an especially important problem, as there are currently many delinquent loans outstanding that are, or will soon be, good candidates for modification, as the housing market continues to decline.

Figure 9 displays Kaplan-Meier estimates of the survival function with respect to the transition from delinquency to modification, broken down by the holder of the mortgage. While the Kaplan-Meier estimator does not control for other observable differences in mortgage characteristics, it does account for censoring and the timing issues discussed above.⁵⁸ The figure contains two plots. The first plot displays estimates of the survival function corresponding to the transition from 30 days delinquency (one mortgage payment behind) to modification of all mortgages originated after 2004 in the LPS dataset, while the second plot uses only data from subprime/Alt-A mortgages in the LPS data originated after 2004. There are a few notable patterns contained in Figure 9. First, looking at the universe of all mortgages, privately securitized loans and GNMA loans are *more* likely to have been modified than loans held in portfolio and FNMA loans over a fairly long horizon. Conditional on 30-day delinquency, a privately securitized loan has a 15 percent probability of being modified after two years, and a 26 percent probability after three years, compared with 11 percent and 16 percent for loans held in portfolio, respectively.⁵⁹ Over a shorter horizon, (less than one year), there is very little difference across different types of loans when conditioning on 30-day delinquency. The patterns are slightly different for the sample of subprime/Alt-A loans, as the incidence of modification is virtually the same over all horizons for portfolio-held and privately securitized loans.⁶⁰

Before concluding our analysis of loan modifications, we take note of some other papers that have examined the issue with the same data. Piskorski, Seru, and Vig (2009) find that seriously delinquent portfolio loans in the LPS data are less likely to experience a completed foreclosure than seriously delinquent securitized loans. The authors attribute

⁵⁸Adelino, Gerardi, and Willen (2009) estimate Cox proportional hazard models of the transition from delinquency to modification, in which differences in observable loan and borrower characteristics are controlled for, and find results that support the patterns in Figure 9.

⁵⁹These probabilities increase substantially for loans that become 60 days delinquent, but the relative patterns are similar. Conditional on 60-day delinquency, a privately securitized loan has a 27 percent probability of being modified after two years, and a 40 percent probability after three years, compared with 23 percent and 32 percent for loans held in portfolio, respectively. See Adelino, Gerardi, and Willen (2009) for these plots.

⁶⁰There are a trivial number of GNMA subprime loans in the data, and thus we drop GNMA from the graph. In addition, there are only a small number of FNMA and FHLMC subprime loans that are seasoned beyond two years, and thus we decided to truncate the graph for these types of loans after two years.

this finding to a greater willingness of portfolio lenders to modify loans, but a careful analysis of the data does not support this inference. First, as we seen, portfolio lenders are not more likely to modify mortgages.⁶¹ Portfolio lenders might be making “better” modifications than servicers of securitized loans, which could in theory explain the smaller number of foreclosures among delinquent portfolio loans. However, Adelino, Gerardi, and Willen (2009) show that the sheer number of modifications among all types of seriously delinquent loans (about 7 percent) is far too low for differences in modification quality to explain Piskorski et al.’s findings. A second issue stems from Piskorski et al.’s use of a completed foreclosure as the relevant loan outcome. If portfolio lenders were truly more willing to modify, as Piskorski et al. claim, then we would expect not only fewer bad outcomes among portfolio loans (that is, fewer foreclosures), but also more good outcomes (for example, more transitions to current status or to prepayment). After all, servicers immediately classify modified loans as current. But Adelino et al. also show that delinquent portfolio loans are no more likely to transition to current or prepaid status than securitized loans.⁶² All told, the likely explanation for the Piskorski et al. finding of fewer foreclosures among delinquent portfolio loans is not a higher willingness of portfolio lenders to modify loans, but rather various accounting and regulatory issues that make portfolio servicers less willing to complete the foreclosure process.

4.5 Historical evidence on loan modifications

In addition to comparing securitized vs. non-securitized loans today, we can evaluate claims about contract-related frictions by looking at the historical record. It is often claimed that renegotiation was frequent in the past, before securitized mortgages were common. For example, a report from the Congressional Oversight Panel for the Troubled Asset Recovery Program states that

For decades, lenders in this circumstance could negotiate with can-pay borrowers to maximize the value of the loan for the lender (100 percent of the market value) and for the homeowner (a sustainable mortgage that lets the family stay in the home). Because the lender held the mortgage and bore all the loss if the family couldn’t pay, it had every incentive to work something out if a repayment was

⁶¹The Piskorski et al. paper never tries to identify modifications directly, as we do.

⁶²This finding may seem inconsistent with the reduced likelihood of completed foreclosures among portfolio loans. But a complicating fact is that most of the loan data is right-censored. The difference in completed foreclosures is offset by an increased number of loans that are more than 90 days delinquent or in some stage of foreclosure when the data is truncated.

possible.⁶³

Other authors, including Zingales (2008) and Geanakoplos and Koniak (2008), have also claimed that renegotiation used to be common, but we know of no historical studies that verify this claim. There are, however, reasons to be skeptical. First, foreclosures were quite common in the past. Between 1929 and 1936, lenders carried out 1.8 million foreclosures in the United States. To put that number in perspective, keep in mind that the number of occupied dwellings more than quadrupled from 22.9 million in 1930 to 105 million in 2000.⁶⁴ In addition, increases in credit and increases in owner-occupancy have resulted in the number of owner-occupied, mortgaged homes rising from 4.8 million in 1940 to 39 million in 2000. Thus, an equivalent figure for the current crisis would be between 8.3 and 17 million foreclosures.

Another way to compare foreclosures in the current era with foreclosures during the Depression is to look at the performance of vintages of loans. The top panel of Figure 10 shows the fraction of loans foreclosed upon by year of origination for the three principal sources of credit in that period: savings and loan institutions (S&L), life insurance companies, and commercial banks. The worst vintages were those of the late 1920s, when approximately 30 percent of loans originated by life insurance companies ended in foreclosure, 20 percent of S&L mortgages ended in foreclosure, and about 15 percent of commercial bank loans were foreclosed upon. The bottom panel shows the fraction of homeownerships (not loans) originated each year in Massachusetts from 1988 through 2008 that eventually ended in foreclosure.⁶⁵ Since at least some of these foreclosures did not occur on purchase mortgages, but rather on subsequent refinances, one can view this as an upper bound on a similar measure using current data. What is clear is that we see far *fewer* foreclosures than we did in the 1930s. These statistics are difficult to square with the claim that renegotiation was more common in the past.

In fact, historical documents do suggest that modifications occurred in the past. The Home Owners Loan Corporation (HOLC), set up by the federal government in 1933 in the midst of the Great Depression, would buy loans at a deep discount from lenders and re-underwrite the borrower into a new mortgage consistent with the borrower's financial situation at the time. However, it is important to understand that the economic situation was extremely poor, as 40 percent of American homeowners were more than 15 months in arrears. In terms of our model, this made Type I error large and Type II error small.⁶⁶

⁶³COP report, p. 2.

⁶⁴Source: U.S. Census of Housing, 2000, Table DP-4, and 1950, Part 1, Table J.

⁶⁵See Gerardi, Shapiro, and Willen (2007) for details regarding the Massachusetts data.

⁶⁶See Harriss (1951) for details about HOLC.

Unfortunately, we do not have detailed data on the subsequent mortgages to analyze the ultimate experiences of HOLC borrowers.

In addition, commercial banks commonly modified loans in this time period. Behrens (1952) shows that as many as 40 percent of the loans originated in a given year would be modified at least once, and as many as half of those more than once. However, it is important to understand that until the 1930s, commercial banks could not make long-term amortized loans, so renegotiation for term extensions and interest rate changes was common. According to Behrens, “It should also be observed that the low level of interest rates current in the 1930s as compared with that prevailing during the 1920s doubtless stimulated a good many of the loan modifications, primarily for those loans in good standing...”

In general, discussions of foreclosure from contemporary sources in “past decades” never mention concessionary modification as a strategy for dealing with troubled borrowers. A book on what we would now call “best practices” in mortgage banking, written in the mid-1950s, gives a detailed discussion of how to contact delinquent borrowers, but then recommends turning the problem over to an attorney.⁶⁷ The author then discusses how to deal with the sale of a foreclosed property but never suggests that the servicer should make concessions to help the borrower continue making payments. Even HOLC, to a large extent, considered mostly non-concessionary modifications and foreclosed on almost 20 percent of the borrowers to whom it lent.⁶⁸

Foreclosure has always been a common outcome in mortgage lending, even for the best-intentioned of lenders. The first borrower ever to obtain a loan from a Building and Loan Society in the U.S. was eventually forced out of his home. A man named Comly Rich took out a mortgage on April 11, 1831, but “was frequently fined for failure to pay his dues and interest.” The problems were resolved in what amounts to a foreclosure: both the house and the mortgage were transferred to another borrower.⁶⁹

5 Conclusion

In this paper, we have attempted to make two main points. First, while the concept of mortgage “affordability” is often used in explanations of the current rise in mortgage defaults, this concept is not helpful if it is not defined precisely. Many people believe that the affordability of a mortgage is adequately summarized in the DTI at origination. However, this ratio does not appear to be a strong predictor of default. What really matters

⁶⁷Pease and Cherrington (1953).

⁶⁸Harriss (1951).

⁶⁹See Bodfish (1931), pp. 66–72.

in the default decision is the mortgage payment relative to the borrower's income in the present and future, not the borrower's income in the past. Consequently, the high degree of volatility in individual incomes means that mortgages that start out with low DTIs can end in default if housing prices are falling. A second, related point concerns the apparent unwillingness of loan servicers to turn "bad" (that is, high-DTI) mortgages into "good" (low-DTI) mortgages. It is true that lenders may lose a great deal of money with each individual foreclosure, but the loan modifications might have negative NPV if they are sometimes extended to people who are likely to pay on time anyway. And the benefits of modifications are uncertain if borrowers have lost their jobs.

What do these findings suggest for foreclosure-reduction policy? One suggestion would be to focus a program on the effects of income volatility, helping people who lose their jobs get through difficult periods without having to leave their homes. For example, the government could replace a portion of lost income for a period of one or two years, through a program of loans or grants to individual homeowners.⁷⁰ For more permanent and very large setbacks, the government could help homeowners transition to rentership through short sales or other procedures. Whatever policies are adopted, the results of this paper suggest that policies that encourage moderate, long-term reductions in DTIs face important hurdles in addressing the current foreclosure crisis.

⁷⁰For details of such a plan, see <http://bosfed.org/economic/paymentssharingproposal.pdf>.

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Table 1: Probability that a loan will become “unaffordable” at least once in the first three years, where unaffordability is defined as DTI above a certain threshold.

	(1)	(2)	(3)	(4)
std(η_t)	15%	15%	0%	15%
std(ε_t)	21%	21%	0%	42%
Resets	No	Yes	Yes	No
A. Ex Post Unaffordable Defined as DTI>31%				
Initial DTI = 31%	70.1	81.7	100.0	72.6
B. Ex Post Unaffordable Defined as DTI>38%				
Initial DTI = 31%	45.6	60.5	0.0	58.6
Initial DTI = 38%	70.3	81.8	100.0	74.7
C. Ex Post Unaffordable Defined as DTI>50%				
Initial DTI = 31%	16.4	30.6	0.0	38.3
Initial DTI = 38%	36.5	51.8	0.0	54.8
Initial DTI = 50%	69.7	81.4	100.0	72.0

Table 2: Shares of various loans in LPS data, by seniority, subprime status, and investor: December 2008

Investor	First-lien Prime and Near Prime	Second-lien Prime and Near Prime	First-lien Subprime	Second-Lien Subprime	Other	Total
<i>Panel A: Counts</i>						
GSE Securitized:						
Fannie Mae	9,410,856	7,292	48,093	130	0	9,466,371
Freddie Mac	6,342,870	2,672	7,911	0	15	6,353,468
Ginnie Mae	4,709,406	391	751	1	6	4,710,555
Private Securitized	4,224,463	208,722	486,469	121,987	250	5,041,891
Portfolio	2,224,951	412,691	87,843	11,823	32,267	2,769,575
Unknown	121,635	1,830	7,953	76	0	131,494
Other	271,696	4,173	122	0	0	275,991
Total	27,305,877	637,771	639,142	134,017	32,538	28,749,345
<i>Panel B: Percentages</i>						
GSE Securitized:						
Fannie Mae	32.73	0.03	0.17	0.00	0.00	32.93
Freddie Mac	22.06	0.01	0.03	0.00	0.00	22.10
Ginnie Mae	16.38	0.00	0.00	0.00	0.00	16.38
Private Securitized	14.69	0.73	1.69	0.42	0.00	17.54
Portfolio	7.74	1.44	0.31	0.04	0.11	9.63
Unknown	0.42	0.01	0.03	0.00	0.00	0.46
Other	0.95	0.01	0.00	0.00	0.00	0.96
Total	94.98	2.22	2.22	0.47	0.11	100.00

Notes: The investor “Other” category includes local housing authorities, the Federal Home Loan Bank (FHLB), and GNMA Buyout Loans.

Table 3: Incidence of Missing DTI Ratios and FICO Scores in LPS data, By Year of Loan Origination

	DTI Ratio			FICO Score		
	All	Prime	Subprime	All	Prime	Subprime
2002	88.3	88.1	100.0	22.2	22.4	10.0
2003	65.1	64.5	90.9	22.2	22.1	26.2
2004	44.1	42.7	60.8	16.1	17.1	4.4
2005	40.4	40.6	38.8	15.5	16.5	5.1
2006	40.3	40.4	39.8	17.4	17.9	12.9
2007	31.7	32.1	22.5	13.3	13.8	1.6
2008	42.5	42.5	26.2	12.3	12.3	0.0
All years	50.1	50.2	48.6	17.4	17.9	8.7

Table 4: Summary Statistics: Loans Originated from 2005–2008

	Prime		Subprime	
	Mean	Std Dev	Mean	Std Dev
DTI Ratio	35.1	13.8	40.0	11.1
FICO Score	714.1	61.6	609.0	54.9
LTV Ratio	73.4	18.2	79.2	12.5
Adjustable Rate Dummy	.21	.40	.56	.50
Number of Loans	501,317		41,132	

Figure 1: Loan-Specific Characteristics in LPS Sample

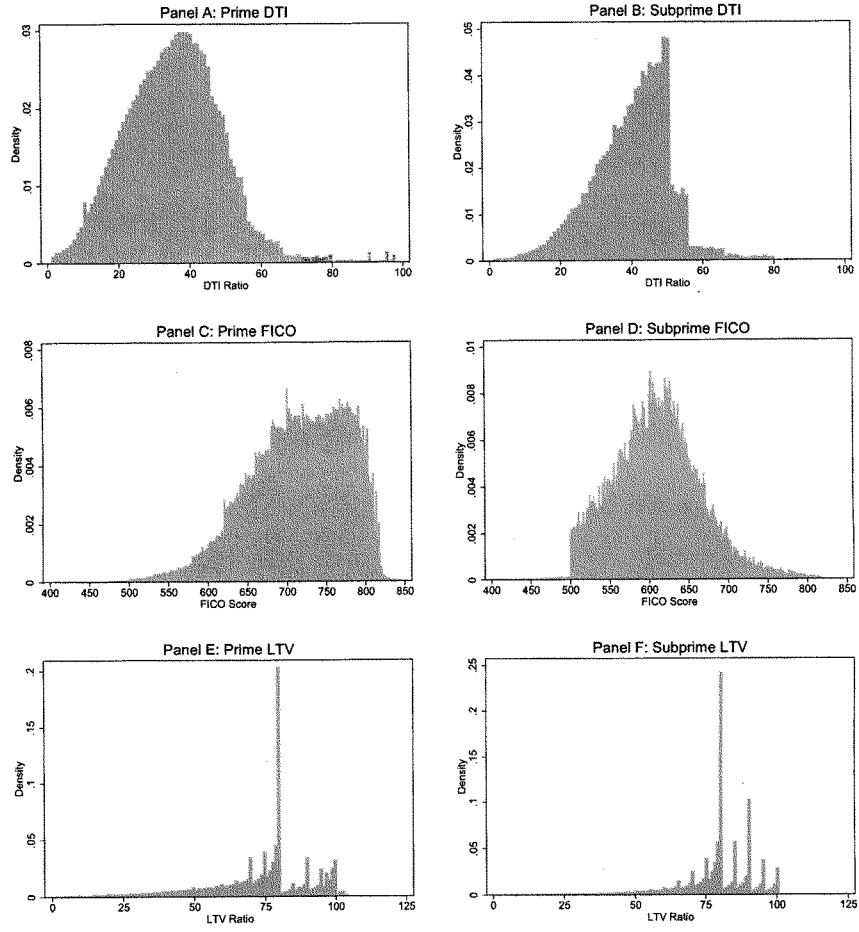


Figure 2: Cumulative Changes in State-Level House Prices for LPS Loans

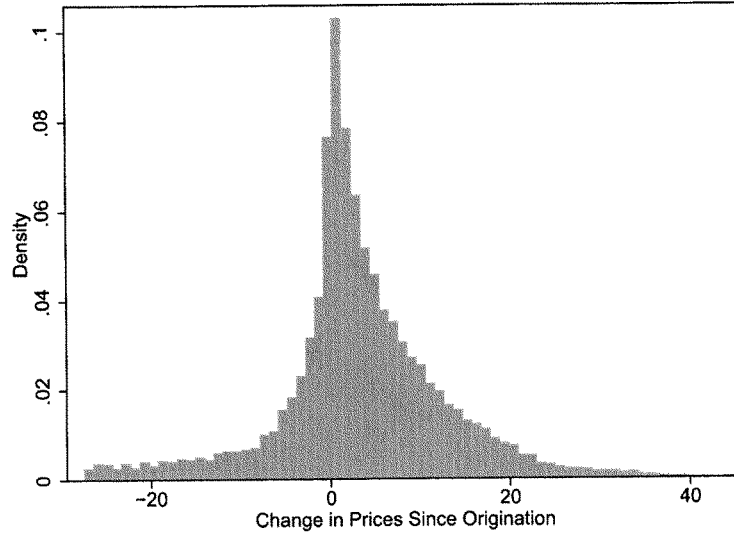


Figure 3: Cumulative Changes in County-Level Unemployment for LPS Loans

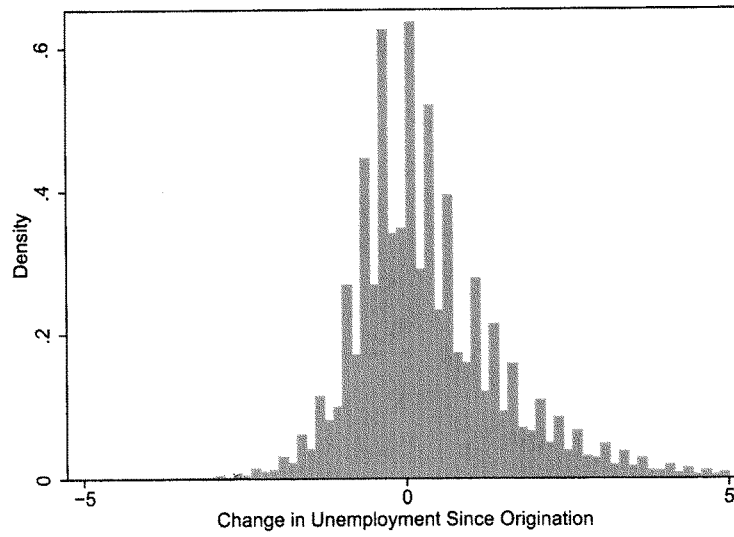


Figure 4: Baseline Default Hazards: Prime and Subprime Loans

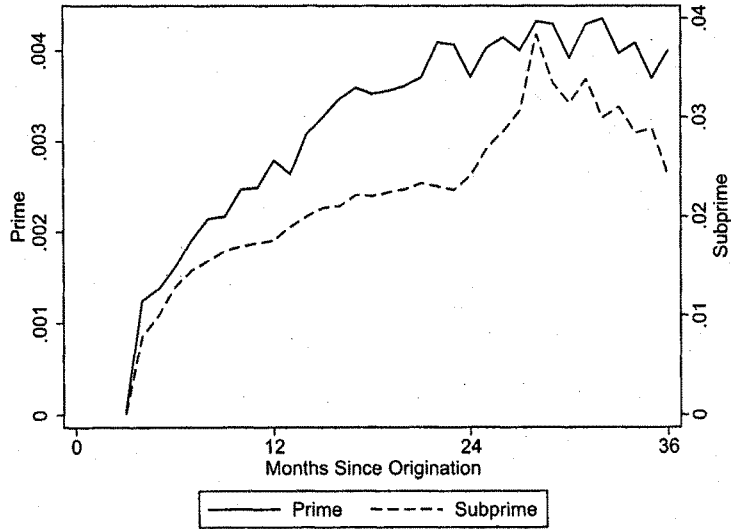


Figure 5: Baseline Prepayment Hazards: Prime and Subprime Loans

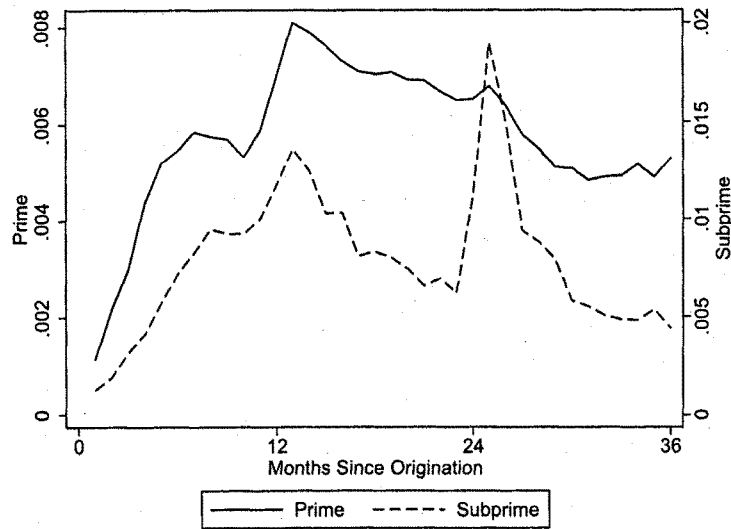


Table 5: Estimates from Cox Proportional Hazard Models

	Prime Defaults	Subprime Defaults	Prime Prepayments	Subprime Prepayments
DTI Ratio	.0105** (.0009)	.0072** (.0012)	.0046** (.0005)	-.0003 (.0012)
FICO Score	-.0124** (.0003)	-.0035** (.0003)	-.0004 (.0002)	-.0016** (.0005)
LTV Ratio	.0308** (.0021)	.0212** (.0026)	-.0108** (.0010)	-.0234** (.0017)
LTV \neq 80 dummy	-.2973** (.0453)	-.1836* (.0738)	.1126** (.0219)	.2447** (.0286)
Adjustable Rate Dummy	.7521** (.0539)	.5074** (.0354)	.6465** (.0568)	.5605** (.0537)
Δ UR	.2068** (.0207)	.1007** (.0156)	-.0344 (.0210)	-.0476 (.0345)
Δ HP \geq 0	-.0571** (.0061)	-.0516** (.0071)	.0236** (.0032)	.0384** (.0043)
Δ HP $<$ 0	-.0592** (.0051)	-.0451** (.0049)	.0555** (.0062)	.0925** (.0088)
Δ HP * Δ UR	.0061** (.0009)	.0069** (.0008)	.0015 (.0012)	.0019 (.0016)
Δ HP * LTV	-.0001 (.0001)	-.0003** (.0001)	.0007** (.0001)	.0009** (.0001)
Δ HP * DTI	-.0000 (.0001)	.0001 (.0001)	.00010* (.00004)	.0001 (.0001)
Δ HP * FICO	-.0000 (.0000)	-.0000 (.0000)	-.00012** (.00002)	.0000 (.0000)
Δ UR * FICO	.0010** (.0001)	.0003** (.0001)	.0002 (.0001)	-.0000 (.0000)
FICO * DTI	.0000 (.0000)	-.000055** (.000017)	-.0000 (.0000)	-.00004** (.00001)
DTI * Δ UR	-.0008 (.0005)	.0003 (.0005)	-.0005 (.0003)	.0008 (.0006)
No. of monthly observations	10,796,387	821,020	10,796,387	821,020
No. of loans	501,317	41,132	501,317	41,132

Notes: Standard errors are clustered by state. * denotes significance at 5 percent. ** denotes significance at 1 percent. A negative value of a house-price change ($HP < 0$) is entered directly in the regression (not as an absolute value.)

Figure 6: Model-Generated Monthly Defaults and Prepayments (Per 100 Loans Originated) Under Various Assumptions

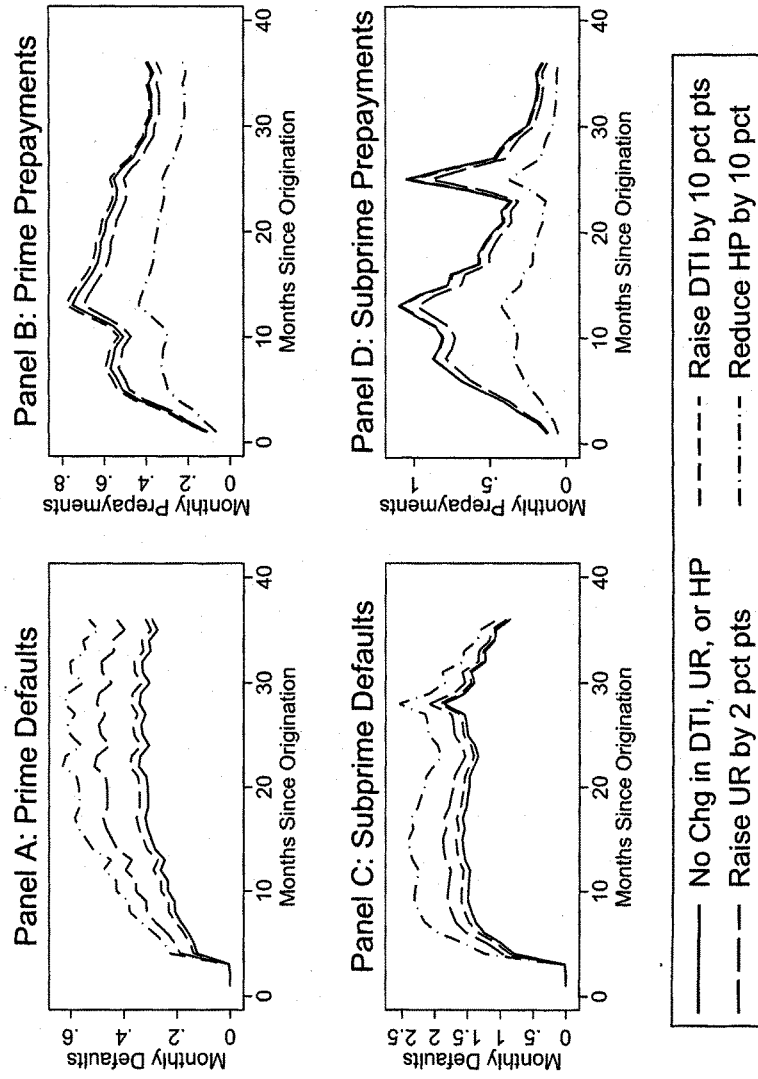


Figure 7: Roll Rates by Initial Delinquency Status

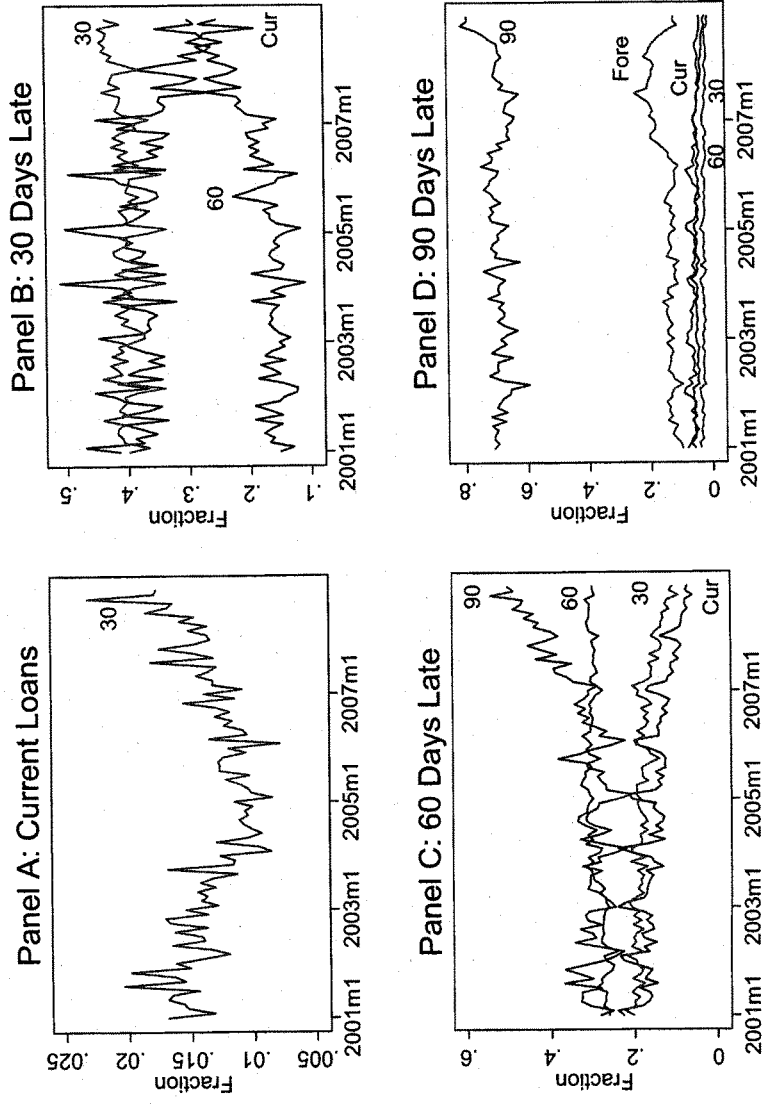


Table 6: Direct Defaults as a Share of All Defaults, by Year of Origination and Year of Default

Year of Origination	Year of Default						Total
	2003	2004	2005	2006	2007	2008	
Panel A: All States							
2003	11.4	10.8	15.3	14.1	18.0	28.1	16.4
2004		8.2	12.5	14.5	22.7	34.4	20.4
2005			11.2	15.8	31.4	44.6	32.1
2006				11.7	25.7	44.0	34.9
2007					25.5	39.7	37.4
2008						38.1	38.1
All Orig. Years	11.4	10.3	13.1	14.5	26.6	41.6	30.8
Panel B: AZ, CA, FL, & NV							
2003	9.4	5.0	5.4	8.7	20.9	41.0	16.8
2004		7.3	6.6	13.7	33.9	49.3	30.5
2005			5.0	18.1	43.9	57.7	46.2
2006				12.5	34.4	55.8	46.5
2007					31.3	53.9	50.6
2008						47.1	47.1
All Orig. Years	9.4	5.5	6.0	15.4	36.8	55.1	44.8
Panel C: 47 Remaining States							
2003	11.8	11.9	16.3	14.6	17.6	24.9	16.4
2004		8.4	13.4	14.7	19.9	27.3	17.8
2005			12.6	15.0	23.0	31.5	22.9
2006				11.3	19.8	31.6	25.0
2007					22.0	29.6	28.3
2008						34.5	34.5
All Orig. Years	11.8	11.2	14.1	14.3	20.7	30.4	22.7

Table 7: Modification Statistics by Type: 2007:Q1–2008:Q4

	# Loans Modified	Interest Rate Reductions		Principal Balance Reductions		Principal Balance Increases		Term Extensions	
		#	(% total)	#	(% total)	#	(% total)	#	(% total)
2007:Q1	10,940	600	5.3	700	6.2	8,660	76.4	1,380	12.2
2007:Q2	14,600	820	5.4	550	3.7	11,630	77.3	2,050	13.6
2007:Q3	17,720	770	4.1	810	4.3	15,170	81.2	1,940	10.4
2007:Q4	27,150	2,990	9.7	700	2.3	22,520	72.8	4,740	15.3
2008:Q1	36,230	6,010	13.8	900	2.1	32,100	73.8	4,500	10.3
2008:Q2	44,750	9,050	16.4	1,300	2.4	39,750	72.1	5,030	9.1
2008:Q3	62,190	16,280	20.3	940	1.2	56,940	70.9	6,110	7.6
2008:Q4	74,800	28,630	26.7	1,450	1.4	65,960	61.5	11,230	10.5

Notes: These statistics were computed using a 10 percent random sample of the LPS data. Quantities obtained from the data are multiplied by a factor of 10. The percentages are taken with respect to the total number of modifications, and *not* loans modified. Thus, there is double-counting in the sense that some loans received multiple types of modifications in a given quarter.

Table 8: Modification Statistics by Loan Holder

<i>Panel A - All Loan Types</i>												
	all loans outstanding				Modification % of 30 days delinquent or worse				60 days delinquent or worse			
	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2008:Q1	2008:Q2	2008:Q3	2008:Q4
GNMA	0.04	0.04	0.03	0.03	0.39	0.36	0.31	0.27	0.80	0.74	0.64	0.51
FNMA	0.10	0.06	0.05	0.04	2.32	1.30	0.88	0.61	4.87	2.51	1.58	1.03
FHLMC	0.05	0.05	0.16	0.23	1.95	1.75	4.72	5.26	4.56	3.74	9.06	9.30
Private Securitized	0.55	0.84	1.25	1.42	3.45	4.63	6.28	6.23	5.03	6.41	8.49	8.31
Portfolio	0.53	0.65	0.69	1.05	6.31	7.53	6.81	8.55	10.23	11.47	10.32	12.57
<i>Panel B - Subprime/Alt-A Loans (LPS Definition)</i>												
	all outstanding loans				Modification % of 30 days delinquent or worse				60 days delinquent or worse			
	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2008:Q1	2008:Q2	2008:Q3	2008:Q4
FNMA	0.80	0.42	0.37	0.19	3.42	1.70	1.32	0.56	6.01	3.05	2.24	0.87
FHLMC	0.23	0.12	2.48	1.70	1.30	0.56	9.39	5.35	2.92	1.18	17.86	8.68
Private Securitized	1.59	2.58	4.39	4.56	4.41	6.65	10.41	9.46	6.28	9.11	14.13	12.55
Portfolio	1.41	2.51	3.97	6.93	3.72	6.23	9.95	15.83	5.21	8.57	13.55	21.75

Figure 8: Kaplan-Meier Survival Estimates: Transition from Modification to Default

90-Days Delinquent

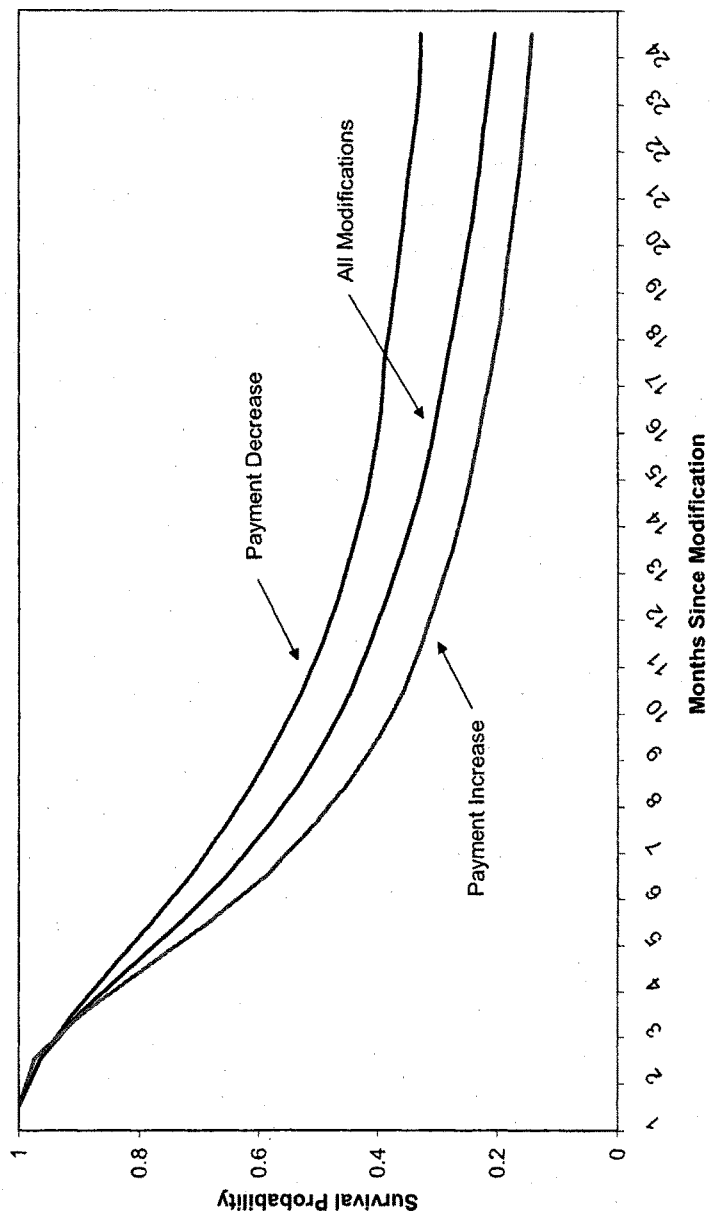


Figure 9: Kaplan-Meier Survival Estimates: Transition from Delinquency to Modification

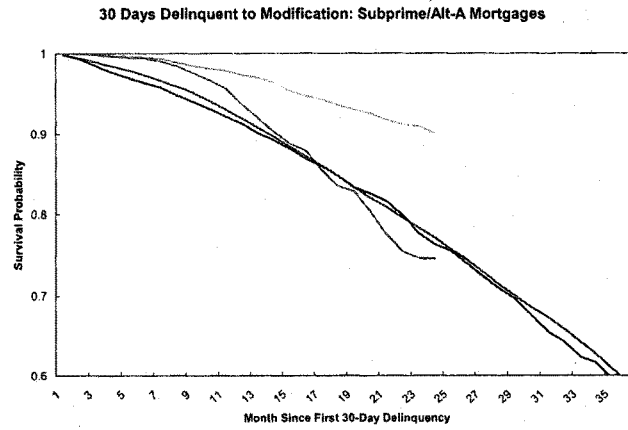
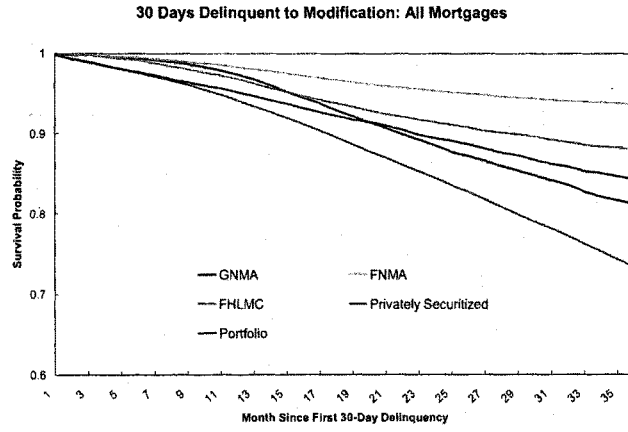
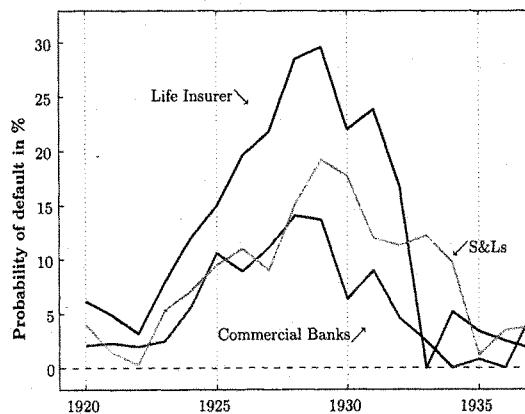


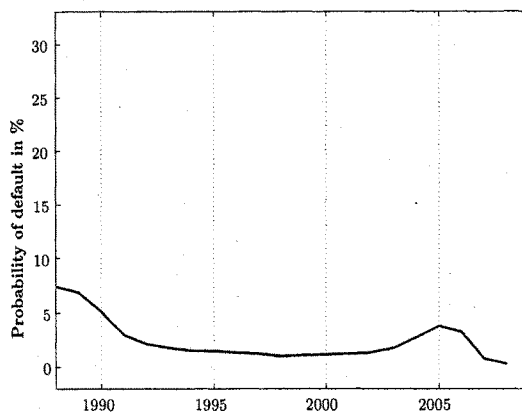
Figure 10: Default Probability by Year.

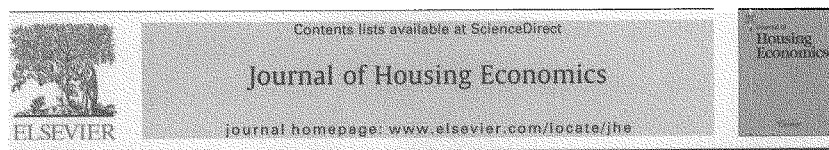
The top panel reports foreclosures on loans originated in that year. Loans may be purchase or refinance. Data comes from Morton (1956). The bottom panel reports foreclosures on homes purchased with mortgages in that year. For these data, we count a loan as foreclosed if there was a foreclosure on that loan or any subsequent mortgage to that owner. Thus the probabilities in the lower panel are an upper bound on the probabilities in the top panel. See Gerardi, Shapiro, and Willen (2007) for details.

Foreclosure probabilities between 1920 and 1947 by origination year



Foreclosure probabilities between 1989 and 2008 by origination year





Just the facts: An initial analysis of subprime's role in the housing crisis[☆]

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ABSTRACT

Using two large proprietary datasets from New England, this paper establishes some basic facts about the subprime crisis. First, while unaffordable interest-rate resets are often blamed for setting off this crisis, most subprime borrowers who defaulted did so well in advance of their reset dates. Defaults on subprime adjustable-rate mortgages are more sensitive to declining housing prices than are defaults on fixed-rate loans, however, and the data support a number of alternative explanations for this finding. Second, many borrowers with good credit scores took out subprime loans as the housing boom gathered steam. It is hard to construct a *prima facie* case that these borrowers were inappropriately steered into the subprime market, however, because the loans that these borrowers took out were too risky for prime treatment. Finally, 70% of Massachusetts homes recently lost to foreclosure were originally purchased with prime mortgages. But subprime refinancing is especially prevalent among owners who were likely to have extracted substantial amounts of equity before they defaulted.

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1. Introduction

Subprime mortgages lie at the center of recent turmoil in housing and credit markets. Unfortunately, many housing researchers have been prevented from performing formal analyses of the subprime market due to the difficulty of obtaining appropriate data. Proprietary, loan-level data used by Wall Street investment banks and hedge funds of-

ten cost more than \$100,000, placing these data out of reach for most housing researchers. Moreover, even these loan-level datasets sometimes paint an incomplete picture, because they do not link various mortgages to the same borrower over time. This paper presents some basic facts about the subprime market using two large, micro-level datasets. These data were purchased by the Federal Reserve Bank of Boston and have been used extensively in policy work. Though the datasets cover only Massachusetts (in one case) and southern New England (in another), we will argue that they are quite useful for understanding the subprime crisis in the nation as a whole.

Three sets of facts emerge from our analysis. The first concerns the relationship between the timing of interest-rate resets and the current surge in subprime defaults. The typical subprime loan was an adjustable-rate "hybrid," meaning that it had a fixed "teaser" interest rate during an initial 2- or 3-year period, after which the loan reset to a floating rate (usually around 6 percentage points above a short-term interbank lending rate). Many commentators have claimed that a wave of unaffordable resets sparked

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the current crisis. Yet the data show that most borrowers who defaulted on subprime adjustable-rate mortgages (ARMs) did so well in advance of their reset dates. Moreover, the data also show that the initial "teaser" rates were not artificially low; in fact, they were quite high. It is possible that some characteristics of subprime ARMs made foreclosures more likely, even though these foreclosures did not occur precisely at the reset dates.¹ In fact, we find that defaults among subprime ARMs are more sensitive to house price declines than defaults on subprime fixed-rate mortgages (FRMs). However, it is hard to know whether the higher sensitivity stems from features of the ARM contracts, or rather from the characteristics of borrowers who were likely to choose ARMs over FRMs.

A second set of facts concerns underwriting standards of subprime loans. Subprime lending began in the mid-1990s as a way for persons with less-than-perfect credit to purchase homes. Several commentators have noted, however, that the average credit score of subprime borrowers grew as the housing boom gathered steam. The commentators have interpreted this pattern as evidence that persons with good credit were "steered" into subprime loans by unscrupulous mortgage brokers. Our data confirm that persons with high credit scores were increasingly likely to take out subprime loans. Yet the data also show that these borrowers could not have obtained these same loans from prime lenders. The subprime loans taken out by "good" borrowers typically had high loan-to-value (LTV) or debt-to-income (DTI) ratios, or they lacked full documentation of borrower incomes and assets. These heightened risk characteristics would have made these loans unattractive to prime lenders, in spite of the borrowers' high credit scores. Of course, these higher risk characteristics also made the subprime loans very sensitive to the recent decline in housing prices, helping to explain high defaults among subprime mortgages.²

The third set of facts involves the importance of subprime refinancing to foreclosure. Our data show that slightly less than half (45.2%) of recently defaulted Massachusetts mortgages were subprime loans. This share is close to, though somewhat lower than, figures from national analyses. However, one of our datasets allows us to link mortgages taken out by the same owner on the same house. We are therefore able to analyze the purchase mortgage of each foreclosed home, even if the owner refinanced out of his purchase mortgage before defaulting. While ownerships that begin with subprime mortgages are much more likely to default than ownerships beginning with prime mortgages, less than one-

third of homes recently lost to foreclosure in Massachusetts were originally purchased with subprime loans. Somewhat surprisingly, many foreclosed homes were purchased before the early 2000s housing boom and had thus accumulated substantial equity. Though we cannot measure cash-out refinancing directly, we provide suggestive evidence that subprime loans were especially popular among homes that had appreciated in price but that were later lost to foreclosure, due in part to a large extraction of equity.

The paper is organized as follows. Section 2 describes the two main datasets used in our analysis. It also discusses alternative definitions of "subprime" and quantifies the extent of subprime defaults. Section 3 explores the role of interest-rate resets in subprime foreclosures, and compares the performance of subprime ARMs with that of subprime fixed-rate mortgages. Section 4 discusses changes in subprime underwriting standards and the effect that these standards may have had on foreclosure patterns in Massachusetts. Section 5 explores the role of subprime refinances in foreclosures, while Section 6 concludes with a discussion of a crucial outstanding question: whether higher subprime lending in the early 2000s put upward pressure on housing prices.

2. Background and data

2.1. The Warren Group's Registry of Deeds data

The most fundamental dataset in our research was supplied by The Warren Group, a private Boston firm that has been tracking real estate transactions in New England for more than a century. The Warren Group dataset is a standardized, electronic version of publicly available real estate transaction records filed at Massachusetts Registry of Deeds offices during the past 20 years. The dataset includes the universe of purchase mortgages, refinance mortgages, home equity loans, and purchase deeds transacted in Massachusetts from January 1987 through March 2008. Foreclosure deeds are available starting in 1989. So, for every house purchased in the state during the sample period, we know the location and price of the house, the size of all mortgages associated with the sale,³ and the identity of the mortgage lender, among other variables.

2.1.1. Sales and foreclosures

The Warren Group data allow us to paint a detailed picture of the Massachusetts housing market, both before and after the introduction of subprime lending in the mid-1990s. Fig. 1 presents Massachusetts sales and foreclosures by year, clearly illustrating the state's two foreclosure waves during the past two decades. The first foreclosure wave occurred in the early 1990s, when the combination of a severe recession and a significant downturn in the housing market resulted in a dramatic increase in foreclosures. In 2006 and 2007, we see evidence of the state's current foreclosure wave.

¹ For example, borrowers might have predicted that they could not have afforded the eventual interest rates after they reset, and defaulted in advance of that date.

² A natural question is whether the reduced quality of subprime loans is fully responsible for increased defaults among subprime loans originated at the height of the housing boom. Gerardi et al. (forthcoming) investigates this question with a nationwide dataset. They find that subprime loans originated at the end of the boom had worse risk characteristics than those originated earlier, a finding that is corroborated by the results of the current paper as well. But Gerardi et al. (forthcoming) also finds that these changes in risk characteristics are not large enough to explain the astronomical rise in default probabilities among the later vintages of subprime loans.

³ Specifically, we see second mortgages ("piggybacks") as well as any other mortgage secured by the home.

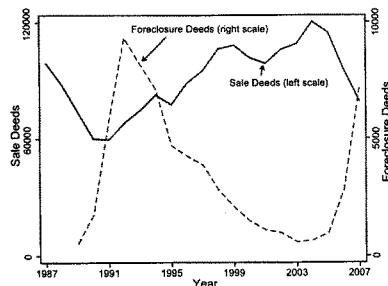


Fig. 1. Sales and foreclosures in Massachusetts, 1990–2007.

While the absolute number of current foreclosures is approaching early 1990s levels, there are some important qualitative differences across the two foreclosure waves. The early 1990s followed a burst of residential construction in Massachusetts, in which new condominiums were often used as investment vehicles (Jordan, 1992). When this building boom ended and house prices fell, many of these investment properties ended up in foreclosure. By contrast, residential construction was much more subdued in Massachusetts during the early 2000s boom. The condominium share of foreclosures has been replaced to some extent by foreclosures of multi-family properties, which were built some time ago and which are predominantly located in low-to-moderate income areas.⁴

Table 1 presents the importance of single-families, condos, and multi-families in the past two foreclosure waves, according to the Warren Group data, along with the share of 1990–2007 purchases attributable to each of the three dwelling types. The share of foreclosures attributable to condominiums has fallen from 33.7% in the earlier wave to only 13.3% recently. By contrast, the share accounted for by multi-families has risen from 20.4% to 28.4%. The bad news for current policymakers is that the negative external effects from multi-family foreclosures are generally more serious than from condo foreclosures. Generally, multi-families are owned by residents of one of the units, with the other residents paying rent. When the owner loses the home, the renters can also be evicted.⁵

⁴ Multi-family dwellings, meaning properties containing between two and four separate units, accounted for 23.0% of the total housing units in Massachusetts as of 2000 (U.S. Census Bureau, 2005). This percentage is the second highest in the nation (followed only by Rhode Island's 25.2%) and far exceeds the national average of 9.1%. The iconic multi-family dwelling in Massachusetts is the "triple-decker," which consists of three units, one of which is typically occupied by the owner while the other two are rented out.

⁵ Like the speculative condominiums of the early 1990s, purchases of multi-family dwellings in the early 2000s often had an "investment" quality to them, because multi-family purchasers sometimes qualified for purchase mortgages based on the rents they hoped to receive, even if the new owners planned to live in one of the units themselves. This strategy can turn out poorly if rental income is more volatile than the new owners had hoped.

Table 1
Shares of residence types in foreclosures and purchases.

	Single-family	Condominium	Multi-family
2006–2007 Foreclosures	58.3%	13.3%	28.4%
1991–1992 Foreclosures	45.9%	33.7%	20.4%
1990–2007 Purchases	68.8%	20.4%	10.8%

2.1.2. Prices

Our data also allow a careful measurement of housing prices, which have a close theoretical relationship to foreclosures. Standard models of housing finance predict that falling prices make foreclosures more likely by fostering negative equity, which occurs when the outstanding balance on a home mortgage exceeds the market price of the house. Even when the aggregate economy is doing well, individual homeowners often experience life events—such as illness, job loss, or divorce—which cause them to fall behind on their mortgages. When borrowers have positive equity, these adverse life events often prompt profitable sales, or, if the problems are temporary, cash-out refinances. But when equity is negative, borrowers facing adverse life events cannot retire their mortgages with sales at market prices, nor can they tide themselves over with cash-out refinances. Thus, after a sustained decline in housing prices that eliminates home equity, adverse life events often lead to foreclosures.⁶

In light of the theoretical link between prices and foreclosure, it is important to obtain an estimate of Massachusetts housing prices. Moreover, this estimate should encompass homes typically purchased with subprime mortgages and should not be contaminated by changes in the mix of houses being sold. Repeat-sales indexes, originally suggested by Case and Shiller (1987), attempt to solve problems engendered by a changing sales mix by aggregating price changes on individual homes between sales.⁷ The Office of Federal Housing Enterprise Oversight (OFHEO) uses the repeat-sales method when constructing its price index for Massachusetts, but this index may not accurately reflect price trends among subprime homes. Purchases that contribute to the OFHEO index must conform to securitization limits set by the government-sponsored housing enterprises, Fannie Mae and Freddie Mac. Because agency-conforming mortgages are generally prime mortgages, the use of a broader price index is important when studying subprime lending.

⁶ This line of thinking is akin to the "double trigger" theory of foreclosure, which holds that foreclosures occur when an owner has negative equity and suffers an adverse life event. We argue elsewhere (Foote et al., 2008) that while the double-trigger explanation essentially gets the facts right, it can be made more theoretically robust by recognizing the roles that credit-constraints and heterogeneity in time-discount rates play in explaining foreclosures at the individual level.

⁷ A drawback to our repeat sales measure is that it is impossible to know which houses have undergone major renovations in the Warren Group data, and which therefore should be excluded from the repeat sales calculations. We excluded any home that had risen in value by more than 50% for repeat sales within 1 year, and by more than 100% for repeat sales within 3 years, figuring that such a large price increase could only be explained by a renovation. In practice, the precise cutoff that we used to exclude renovations made little difference to our final results. See Appendix A of Gerardi et al. (2007) for details.

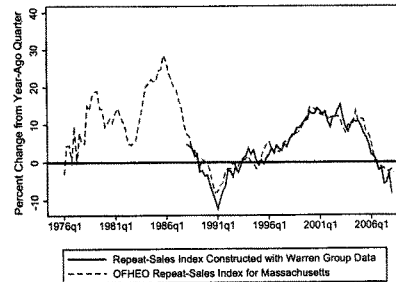


Fig. 2. Statewide repeat-sales index constructed with Warren Group data and OFHEO price index for Massachusetts.

Fortunately, the Warren Group data allow us to match individual homes across sales, so we are able to construct a repeat-sales index that uses all properties in the state. Fig. 2 graphs our repeat-sales price index along with the OFHEO index for Massachusetts. Gratifyingly, the two indexes are in close agreement during periods of overlap. Additionally, as is implied by theory, both indexes imply that periods of high foreclosures (as shown in Fig. 1) are also periods of low or negative price appreciation. Our index, however, shows larger price declines during the two housing downturns of the past two decades. This pattern suggests that homes financed with non-conforming mortgages suffered larger price declines during these downturns.⁸ More to the point of this paper, the pattern suggests that subprime properties were not spared the decline in housing prices during the past few years; if anything, these declines were more severe. Thus, the link between negative equity and foreclosure discussed above should also be applicable to the subprime market.

2.1.3. "Ownership experiences" and LTV ratios

In addition to matching individual homes across sales, we are also able to match individual mortgages for a single homeowner during the time he owned a specific house, a period that we term an *ownership experience*. By constructing ownership experiences, we can carry variables generated at the time of purchase through all of the periods that the owner lives in the home, even if he refinances out of the initial purchase mortgage. An example of such a variable is the homeowner's initial LTV ratio, which correlates with eventual foreclosure probabilities. Table 2 presents LTV ratios for the complete sample of Massachusetts ownership experiences, as well as for those ownerships that end in foreclosure. The first lesson from the table is that average purchase LTVs have risen over time, from 79% in 1990 to 84% in

⁸ We also compared our index to the S&P/Case-Shiller price index for Boston. This index includes homes purchased with both conforming and non-conforming mortgages, but only for the Boston area. The S&P/Case-Shiller price index also showed larger price declines during the housing downturns of the early 1990s and the mid-to-late 2000s.

Table 2
Initial loan-to-value ratios, by year of purchase.

	All ownerships			Ownerships that default		
	#	Mean	Median	#	Mean	Median
1990	44,545	0.79	0.80	2495	0.87	0.90
1991	45,436	0.80	0.80	1218	0.90	0.95
1992	53,807	0.81	0.80	913	0.91	0.95
1993	61,004	0.82	0.85	906	0.92	0.95
1994	66,568	0.83	0.88	931	0.92	0.95
1995	60,762	0.83	0.88	850	0.94	0.97
1996	69,718	0.83	0.88	831	0.94	0.98
1997	74,350	0.83	0.86	822	0.93	0.97
1998	85,947	0.83	0.85	715	0.92	0.95
1999	86,895	0.83	0.85	769	0.92	0.95
2000	78,045	0.82	0.85	776	0.92	0.95
2001	77,645	0.82	0.87	696	0.92	0.95
2002	81,337	0.82	0.85	823	0.92	0.95
2003	86,966	0.82	0.85	1072	0.92	0.95
2004	95,899	0.82	0.87	1975	0.94	0.98
2005	94,539	0.83	0.90	2291	0.95	1.00
2006	78,142	0.84	0.90	1291	0.96	1.00
2007	67,127	0.84	0.90	59	0.94	1.00

2007. (The increase is even greater if one tracks median LTV rather than mean LTV.) A second takeaway from Table 2 is the well-known regularity that high-LTV ownership experiences are more likely to end in default. Average LTVs among defaulting ownership experiences are generally 8–12 percentage points higher than the LTV for the typical ownership experience.

The ability to construct complete ownership experiences makes the Warren Group dataset uniquely valuable for housing research. However, the dataset does have some important shortcomings. The most significant is a lack of information on interest rates. Massachusetts law does not require interest rates on fixed-rate loans to be recorded at deed registries. For ARMs, interest rates are included in special riders to the main transaction records, but the Warren Group has not yet transcribed this information electronically (with some exceptions discussed below). Another disadvantage of the Warren Group dataset is that it does not tell us when any particular mortgage is paid off, or discharged. The lack of discharge information prevents us from calculating the amount of cash-out refinancing at various points.⁹ Finally, the Warren Group dataset does not include any demographic information about borrowers, such as income, race, or previous credit history.

2.2. LoanPerformance (LP) data

Most of our information on interest rates and other detailed mortgage characteristics comes from the First-

⁹ Obviously, if a new mortgage is used to pay off an old one, then the amount of cash left over for the homeowner will be much smaller than if the old mortgage remains on the books. Therefore, calculating the amount of equity taken out of the house with any degree of accuracy requires us to know when and if a particular mortgage is discharged. Discharges are officially registered at Massachusetts deeds offices and we are currently looking into ways of adding them to the Warren Group data. An obvious case where discharges can be inferred with the data we do have is when a house is sold, in which case all outstanding mortgages are discharged.

American LoanPerformance company (LP). This firm collects information on individual loans that have been packaged into non-agency, mortgage-backed securities (MBS) and sold to investors in the secondary mortgage market. We refer to two separate LP datasets in our research. The first is a loan-level dataset that the Boston Fed purchased from LP in mid-2007. This dataset covers Massachusetts, Connecticut, and Rhode Island from 1992 through August 2007.¹⁰ Elsewhere in this paper, we will refer to summary statistics generated by a nationwide LP dataset that was purchased by the Board of Governors of the Federal Reserve System in Washington, D.C., and used by research economists there.

The major strength of the LP dataset is its extensive loan-level information on interest rates and other lending terms. It also contains information regarding the type of MBS each loan was packaged into—subprime, Alt-A, or prime.¹¹ In addition, the LP dataset also includes information on borrowers. For approximately 97% of the loans in our sample we know the borrower's FICO score.¹² For 60% of the loans we know the DTI ratio, figured as the borrower's monthly debt payment divided by his monthly income,¹³ while for virtually every loan in our sample we know the combined LTV ratio implied by the size of the loan and the value of the house.¹⁴ A major shortcoming of the LP dataset is the inability to create complete ownership experiences by matching loans made to the same borrower on the same house. Also, the LP dataset has only limited information on borrowers. Like the Warren Group dataset, the LP dataset does not include demographic information such as race, education, or gender.

2.3. Defining the subprime market

A paper discussing facts about the subprime market obviously needs a definition of "subprime" lending, but there is no single way to define the subprime market. One description could be based on the characteristics of borrowers. A subprime borrower could be someone who

has missed a mortgage payment during the past year or two, who has filed for bankruptcy in the past few years, or who has a low FICO score for other reasons. However, as we will see, many borrowers with good credit scores also made use of the subprime market, especially at the height of the housing boom. Alternatively, a subprime definition could be based on lenders. Many lenders typically, but not exclusively, originated loans to subprime borrowers, generally with high fees and interest rates. Yet these same lenders also made loans to prime borrowers.¹⁵ Finally, we can construct a subprime designation using information on characteristics of the loans. For example, we could define a subprime loan to be a mortgage that was packaged into a subprime MBS.

The availability of different information in our two main datasets leads to different definitions of the subprime market. The Warren Group dataset does not contain mortgage interest rates or credit scores, so we use the identity of the lender to characterize individual mortgages as subprime or prime. Our list of subprime lenders comes from the Department of Housing and Urban Development (HUD), which has maintained a list of predominantly subprime lenders since 1993. HUD bases this list on characteristics of lenders' business models that are generally associated with subprime lending.¹⁶ By standardizing this list across years and matching it to the lender variable in the Warren Group dataset, we can designate loans in this dataset as subprime or prime. A drawback of this approach is that subprime lenders sometimes make prime loans. To get a sense of the misclassification that the use of the HUD list is likely to generate, we checked our subprime classification against interest rates in a small subsample of ARMs that the Warren Group had recorded electronically. The results were encouraging. Of the mortgages in the Warren Group data that were identified as subprime from the HUD list, and for which interest rate information is available, approximately 93% had an initial rate of at least 200 basis points above an equivalent prime mortgage rate, or had an associated margin of at least 350 basis points above the typical benchmark interest rate used for determining subprime rates.¹⁷

Table 3 presents the total share of subprime mortgages in the Warren Group data using the HUD-list definition. The table suggests that the subprime share in Massachusetts is comparable to, though somewhat lower than, the subprime

¹⁰ To be specific, 1992 was the first year in which a pool of securitized mortgages was included in the LoanPerformance dataset. However, the mortgage pools sometimes include mortgages that were originated well before the securitization process was initiated. Thus, there are mortgages in the dataset that were originated before 1992, but because of sample selection issues, we do not use any information from those mortgages.

¹¹ The Alt-A classification is for loans whose riskiness falls between that of the subprime and prime classifications. Because the LP data cover only non-agency securities, the prime loans included in the LP data are typically jumbo loans. Jumbo loans exceed the federally mandated limit for securitization by Freddie Mac or Fannie Mae.

¹² FICO is the acronym for Fair Isaac & Co., which developed a widely used score designed to evaluate creditworthiness. The dividing line that typically places a borrower in the subprime class is a FICO score of 620 or lower.

¹³ This calculation includes the amount of the monthly mortgage payment, as well as other types of debt, such as credit card debt, car loans, education loans, and medical loans. In the housing-finance literature, this debt-to-income ratio is typically referred to as the "back-end" debt-to-income ratio. The "front-end" ratio involves only the home mortgage debt itself.

¹⁴ The LTV ratio in the LP data includes second mortgages, but (unlike the Warren Group dataset) LP does not include home equity loans or home equity lines of credit. For purchases, the value of the house is assumed to be the purchase price, while for refinances, the appraised value of the house is used.

¹⁵ An example of such a firm is Countrywide.

¹⁶ Specifically, a lender makes the HUD list if most of its business is in refinancing rather than purchase loans, and if the lender does not sell a significant portion of its portfolio to the two government-sponsored housing agencies (Fannie Mae and Freddie Mac). Recently HUD has checked its subprime list against the designation of "high-cost" loans in a dataset generated by the Home Mortgage Disclosure Act, which began tracking high-cost loans in 2004. This exercise has found that the HUD lender list is in general agreement with the HMDA high-cost variable. The HUD list and supporting documentation is available at <http://www.huduser.org/datasets/manu.html>.

¹⁷ More extensive robustness checks for the subprime classification in the Warren Group dataset are found in Appendix B of Gerardi et al. (2007). A "margin" on a subprime adjustable-rate mortgage is the constant difference between a benchmark interest rate (typically 6-month LIBOR) and the "fully indexed" interest rate, which obtains when the subprime ARM is reset. We discuss the institutional details involved in the pricing of subprime adjustable-rate mortgages more extensively below.

Table 3
Subprime shares (in percent) for Massachusetts mortgages by origination year.

	1999	2000	2001	2002	2003	2004	2005	2006	2007
All mortgages	4.4	5.7	4.4	4.4	5.3	9.2	11.7	10.3	3.6
Purchase mortgages	2.5	2.5	3.0	4.0	7.0	10.1	14.8	13.1	3.1
By house type									
Single-family purchase	2.3	2.3	2.8	3.5	5.9	8.6	13.2	11.4	2.6
Condominium purchase	2.2	2.1	2.2	2.5	4.3	8.0	10.7	10.7	3.4
Multi-family purchase	4.2	4.6	6.4	9.4	18.0	26.4	32.6	28.6	5.8

share for the nation as a whole. Mayer and Pence (2008) construct a series of subprime shares using the HUD list and nationwide data collected as part of the Home Mortgage Disclosure Act (HMDA) for 1998–2005. They find that the subprime share of all originations fluctuates between about 8% and 12% from 1998 through 2003.¹⁸ In 2004 and 2005, the national subprime share rises sharply, reaching about 18% in those 2 years. Table 3 shows that this general pattern is also found in the Massachusetts data, though our series is about 5–7 percentage points lower than the national data. For national purchase mortgages, Mayer and Pence find a similar time-series pattern, with this share rising in 2004 and 2005 to about 15% and 18%, respectively. Our data also show a purchase-share peak in these years, though again the Massachusetts data are a few percentage points lower. The lower rows of Table 3 disaggregate the subprime share of purchase mortgages in the Warren Group data for each of the three types of residences. The table shows that subprime purchases were especially popular among multi-family homes at the height of the housing boom, with the subprime fraction of multi-family purchases reaching 32.6% in 2005. This high share is not surprising, because multi-family homes are typically located in low-to-moderate income areas and are often more costly (taking all housing units together) than the purchase of just one housing unit in a single-family home.¹⁹ The bottom line of this analysis is that subprime lending is likely to be somewhat less important in Massachusetts than for the nation as a whole, while the particular pattern of subprime lending is affected to some extent by the prevalence of multi-family homes in the state. But the time-series pattern of subprime lending in Massachusetts is qualitatively similar to that for the entire country.

In the LP data, creating the subprime loan designation is conceptually easier. Subprime mortgages are those that were securitized into a subprime MBS (as opposed to prime or Alt-A). No restriction is made on the FICO score of the borrower. Also note that, unlike the Warren Group dataset, the subprime definition is not based on the originator of the mortgage, but rather the type of security into which the mortgage was grouped in the secondary market.

Fig. 3 illustrates the evolution of borrower and loan characteristics among subprime loans in the LP dataset. Because

much of the discussion below will focus on differences between subprime ARMs and FRMs, we present data for these two types of loans separately. Panel A shows that average FICO scores generally improved over the sample period; we will have more to say on this topic below. Panel B shows that LTV ratios were generally rising during the housing boom, especially for ARMs. By 2006, the average LTV ratio for subprime ARMs was in excess of 90%, with the average LTV for FRMs very close to that level. Panel C shows that DTI ratios were in excess of 40% for both types of loans by the end of the sample period. Finally, the last panel shows that the fraction of fully documented loans declined for both types of loans after 2000, though this decline was more consistent among ARMs than FRMs. All in all, most of the risk characteristics of subprime loans deteriorated over the sample period, with the notable exception of FICO scores.

2.4. Quantifying subprime defaults

We next turn to the quantitative importance of subprime defaults, using the universe of Massachusetts mortgages in the Warren Group data. The first column of Table 4 shows the percentage of defaulted mortgages from 2006–2007 that were originated by subprime lenders. This fraction ranges from more than half for multi-family homes to slightly more than 40% for single-families and condos. Across all types of homes, the fraction is 45.2%, a number that is close to, but somewhat lower than, subprime fractions found in nationwide studies. For example, Nothaft (2008) found that around 52–56 percentage of defaulted mortgages during this period were subprime. The discrepancy of approximately 10 percentage points may reflect differences in the Massachusetts housing market relative to the rest of the country, or differences in the way that the two studies define subprime mortgages. Because the Warren Group data allows us to link mortgages within the same ownership experiences, we can also ask how many foreclosed homes were originally purchased with subprime mortgages. These fractions, reported in the second column of the table, range from a low of about one quarter for single-family homes to a high of 43% for multi-families. The overall share, across all three types of homes, is 30%.

One implication of Table 4 is that many prime purchasers refinanced into subprime loans before defaulting. This is seen by noting that the subprime share of defaulted mortgages in the first column is larger than the subprime shares among purchase mortgages of foreclosed homes in the second column. The last section of the paper investigates this type of refinancing activity in detail. A second takeaway from Table 4 is that subprime purchases default

¹⁸ The Mayer and Pence data quoted in this paragraph come from their Fig. 1b found on page 22.

¹⁹ For a borrower with a small downpayment, the purchase of an expensive multi-family property would require a mortgage with a high-LTV ratio. As we will discuss, such a mortgage may have been unattractive to prime lenders.

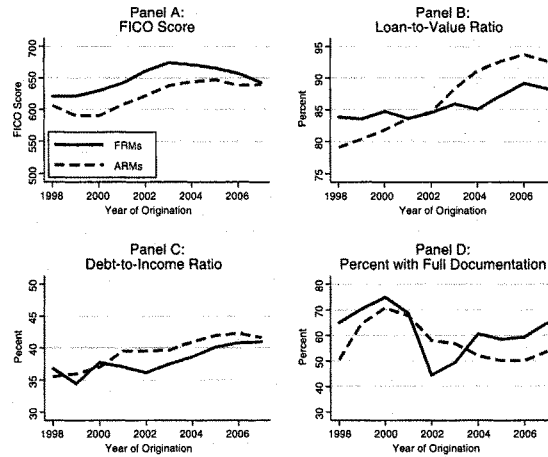


Fig. 3. Characteristics of subprime ARMs and FRMs.

more often than prime purchases. Although the share of subprime purchase mortgages peaked at slightly less than 15% (Table 3), about 30% of recently foreclosed homes were purchased with subprime mortgages (Table 4).

Fig. 4 explores foreclosure propensities of various homes in detail, by presenting cumulative default hazards disaggregated by subprime-purchase status, type of house and purchase year.²⁰ A comparison of the two rows in the figure reveals that subprime purchases are more likely to default, no matter what the type of house or purchase-year cohort. (Note the different vertical scales across the two rows.) For prime single-families and condos purchased in 2005–2006, the cumulative default hazard reached about 1.3% at the end of 2007. For the same types of homes purchased with subprime mortgages, the corresponding hazard was 11.9%. A large discrepancy in foreclosure rates also exists for multi-family homes. The cumulative hazard for multi-families purchased with subprime mortgages in 2005–2006 reached nearly 25% by the end of 2007. The corresponding hazard for prime multi-families was about 8%.

The next two sections of the paper evaluate some potential explanations for high subprime default probabilities related to interest rates and underwriting standards. But at this point, it is useful to point out that Fig. 4 is consistent with the theoretical link between falling prices and fore-

closures discussed earlier.²¹ The figure shows that homes purchased late in the housing boom are more likely to default than homes purchased earlier, and that this pattern is true for both prime and subprime purchases. One explanation for this pattern is that homes purchased early in the boom are more likely to have amassed positive equity before house prices fell, whether or not they were purchased with prime or subprime loans. Of course, the fact that falling prices played a role in defaults does not mean that other potential factors were unimportant for subprime loans. In the next section, we investigate the role of one such factor: interest-rate resets on subprime hybrid ARMs.

3. The role of subprime ARMs and interest-rate resets

Many of the policy proposals that were initially advanced to address the housing crisis involved interest-rate resets among subprime hybrid ARMs.²² This section

²⁰ A cumulative default hazard is a measure of how many foreclosures are likely to have occurred among a group of homes purchased in some year, as a function of how much time has elapsed since the purchases took place. The cumulative default hazard takes into account the fact that some homeownerships are "right-censored" with respect to foreclosure. That is, in every period, some homeownerships end in a sale rather than foreclosure, and therefore drop out of the pool of potential foreclosures for the next period. As a result, a cumulative default hazard is not strictly the probability that a given house purchased in some period will be foreclosed some time later.

²¹ Gerardi et al. (2007) estimate a formal duration model of default using the Warren Group data. The explanatory variables in their model include LTV ratio at purchase, type of residence, cumulative price appreciation since purchase, and subprime-purchase status. The paper finds a strong (negative) role for cumulative appreciation in defaults for both prime and subprime purchases. Consistent with Fig. 4, the paper also shows that subprime purchases are about six times more likely to default than prime purchases, all else equal.

²² In December 2007, the White House announced the voluntary Hope Now initiative, in which lenders agreed to suspend interest-rate resets for 5 years for borrowers who could afford their mortgages only at their initial interest rates. Resets are also a component of the government's new FHA Secure program, announced in August 2007. This program initially allowed borrowers who were delinquent on their mortgages to qualify for new FHA loans, but only if these delinquencies resulted from previous interest-rate resets. In April 2008, the program was extended to borrowers who had missed a limited number of payments either before or after their resets.

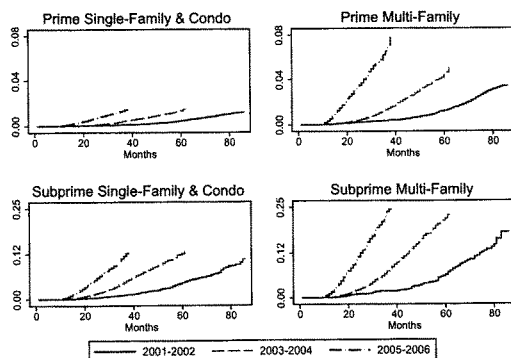


Fig. 4. Cumulative default hazards for Massachusetts homes purchased from 2001 to 2006, by type of residence and subprime-purchase status.

Table 4
Subprime shares among defaulted ownership experiences and mortgages, 2006–2007.

	Subprime fraction of defaulted mortgages	Fraction of defaulted ownerships purchased with subprime mortgages
Single-family	42.2%	24.3%
Condominium	40.1%	27.3%
Multi-family	53.3%	43.0%
All	45.2%	30.0%

describes the general lending model that gave rise to the hybrid ARM. We then assess the link between the timing of interest-rate resets on these mortgages and defaults. We conclude with a comparison of the sensitivity of ARMs and FRMs to declines in housing prices and a puzzle related to how these mortgages were priced.

3.1. The subprime business model

Proponents of the centrality of resets in the current crisis based their view on the following logic. Subprime hybrid ARMs offered borrowers extremely low “teaser” rates for some initial period (usually 2 or 3 years) but then these mortgages “exploded” to high rates thereafter. Lenders found such loans attractive because of the high post-reset interest rates. Borrowers found them attractive because of the teaser, but later regretted their decisions when they found themselves paying high post-reset interest rates. Is this an accurate description of the subprime lending model? No.

First, there was never something like a low “teaser” rate on the typical subprime ARM. Table 5 presents summary statistics from the Board of Governors’s LP dataset on “2/28” mortgages originated from 2004 to 2007. This type of 30-year mortgage is by far the most common type of subprime ARM. The “2” in the 2/28 designation indicates that the interest rate is fixed for the loan’s first 2 years. For the

Table 5
Interest rates for subprime 2/28 mortgages, by year of origination.

Year of origination	Initial (pre-reset) interest rate	1-year prime ARM rate	Margin of fully indexed (post-reset) rate over benchmark rate	Fully indexed interest rate
2004	7.3	3.9	6.1	11.3
2005	7.5	4.5	5.9	10.5
2006	8.3	5.5	6.1	9.1
2007	8.6	5.7	6.1	9.1

Note: The 2006 and 2007 cohorts of mortgages reset in 2008 and 2009. For these mortgages, the 6-month LIBOR 2 years after origination is assumed to be 3.0% (the April 2008 value) to allow comparison with other cohorts.

remaining 28 years, the interest rate adjusts every 6 months until the mortgage is paid off. Almost all 2/28s were fully amortized, meaning that the borrower repays some of the principal with every monthly payment. Table 5 shows that the initial interest rate for subprime 2/28s ranged from 7.3% in 2004 to 8.6% in 2007. These initial rates are not low; on the contrary, they are quite high. As the table shows, 2/28 borrowers paid rates that were about three full percentage points higher than rates on the closest prime equivalent, a 1-year prime ARM. In short, subprime lenders did not need to wait until the resets occurred in order to profit from these loans.

Second, the interest-rate adjustments at reset, while not trivial, were not explosive. The “fully indexed” rate on a subprime 2/28 mortgage—the rate paid after the initial interest rate expired—typically equaled a benchmark rate plus a fixed margin. Most often, the benchmark interest rate was the 6-month London Interbank Offered Rate (LIBOR), and the margin was about 6 percentage points. Table 5 illustrates the calculation, showing both the average margin and the average fully indexed rates. When the 2004 cohort of mortgages reset in 2006, the 6-month LIBOR was slightly higher than 5%, so a margin of a little more than 6% points generated fully indexed rates that

averaged about 11.5%. Similar numbers hold for the 2005 loans, which reset in 2007.

A comparison of the first and last columns of Table 5 shows that the fully indexed interest rates were about 3–4 percentage points higher than initial rates for mortgages originated in 2004 and 2005. This would lead to a monthly payment increase, or “payment shock,” of about 25%. While sizable, this payment shock is small compared to, say, payment shocks in the credit card market, where interest rates can easily increase by a factor of five when teaser rates expire. In addition, a simple comparison of pre- and post-reset interest rates on 2/28 mortgages typically overstates the payment shocks experienced by people who bought homes with subprime mortgages. During the height of the housing boom, many subprime purchasers also used second mortgages (“piggybacks”) when they bought their homes, because they did not make downpayments of at least 20%. These second mortgages had high interest rates and short amortization schedules, so they accounted for a disproportionate share of a borrower’s monthly house payment. Moreover, these mortgages were almost always fixed-rate loans, so they were not affected when the interest rate adjusted on the main subprime loan. The presence of second mortgages therefore limited the percentage increase in a borrower’s house payment that was caused by the interest-rate reset of the main 2/28 mortgage. Specifically, a reset on a 2/28 mortgage only affected about 60% of the typical borrower’s monthly payment.²³

Finally, subprime lenders anticipated that most borrowers would refinance their mortgages before or shortly after their interest-rate resets. Table 6 presents data on the disposition of subprime 2/28s in the Boston Fed’s LP dataset.²⁴ For the years 2001–2005, the disposition is measured as of 27 months after origination, which is 3 months past the reset date. The first row shows that only 22.3% of subprime 2/28s originated in 2001 were still active 3 months after the reset. About two-thirds of the original 2001 pool (66%) had already been refinanced, with the remainder either in foreclosure or seriously delinquent. The refinanced shares for the 2002 and 2003 mortgages are even higher, 74.1% and 74.6%, respectively. Clearly, most subprime borrowers did not spend much time paying on mortgages that had reached their reset dates. Lenders would have understood this and would not have relied on high post-reset payments to construct a profitable business model.

²³ Consider a borrower with a \$100,000 30-year first mortgage with an initial rate of 8.5% and a \$25,000 10-year second mortgage with a contract rate of 12%. The initial payment on the first mortgage is \$776 and on the second is \$358, making the pre-reset payment \$1134 a month. At reset, assume that the rate on the first mortgage jumps to 11%, so the payment on the first mortgage jumps by 22%, to \$952. Because the payment on the second lien stays the same (at \$358), the overall payment only rises to \$1,310, or 15%.

²⁴ Recall that this is a loan-level dataset covering Massachusetts, Rhode Island, and Connecticut.

Table 6
Disposition of subprime 2/28 mortgages in the Boston Fed’s LP dataset.

Year of origination	Percent active	Percent refinanced	Percent foreclosed	Percent 60–90 days delinquent	Total
<i>As of 27 months after origination</i>					
2001	22.3	66.0	8.4	3.3	100
2002	15.8	74.1	6.5	3.6	100
2003	15.5	74.6	6.2	3.7	100
2004	17.9	58.0	16.5	3.7	100
2005	23.4	53.5	20.2	3.0	100
<i>As of March 2008</i>					
2006	42.4	27.1	28.3	2.2	100
2007	65.5	12.3	21.5	0.7	100

3.2. Subprime foreclosures and the timing of interest-rate resets

As we move down the rows in Table 6 the increase in foreclosures among later vintages of mortgages becomes apparent. Data for the 2006 and 2007 2/28s reflects their status as of March 2008, not after 27 months, because mortgages made in these years have generally not been in existence for a full 27 months. Even with this shorter horizon, however, foreclosure rates for the 2006 and 2007 mortgages are much higher than those of other years. Fully 28.3% of 2/28s originated in 2006 are in foreclosure. The 2007 vintage is not far behind at 21.5%.

A closer look at the data shows little or no relationship subprime defaults and reset dates. Fig. 5 displays monthly default probabilities for three yearly vintages of subprime 2/28s, again from the Boston Fed’s LP dataset. Default probabilities typically rise rapidly until the loans are about 12 months old, then decline gradually thereafter. If mortgage resets were a direct cause of foreclosure—or at least an important precipitating factor—then we would expect to see spikes in default rates at or shortly after 24 months. Yet for the two vintages originated more than two years ago (2002 and 2005), no such spikes appear. Indeed, if a vertical line were not placed on the figure at 24 months, it would be difficult to notice anything special about this

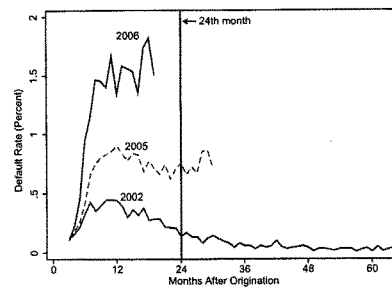


Fig. 5. Default probabilities for subprime 2/28 ARMs, by year of origination.

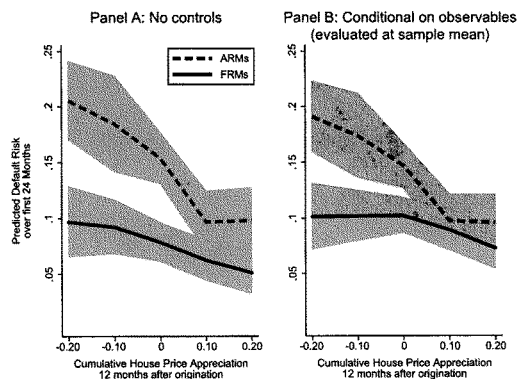


Fig. 6. Subprime foreclosures and cumulative house price changes: ARMs vs. FRMs.

month. The most salient feature of Fig. 5 is the large increase in default probabilities for the later vintages that took place *before* the reset occurred. For the 2006 vintage, default probabilities are about four times higher than the 2002 cohort, even though the 2006 loans had not yet reset at the time that the figure was created. The increase in defaults for the 2005 cohort is also substantial in its pre-reset period.

3.3. The effect of falling prices on subprime ARMs and FRMs

The previous results suggest that the timing of resets has little or no relationship to the timing of defaults. But this finding does not rule out the possibility that characteristics of subprime ARMs made them more likely to default. In particular, the data show that defaults among subprime ARMs were more sensitive to declines in housing prices than were defaults on subprime FRMs.

Using the Boston Fed's LP dataset, Fig. 6 graphs the estimated 24-month foreclosure probability of adjustable-rate and fixed-rate subprime mortgages, as a function of cumulative price appreciation during the first 12 months of the loan. In Panel A, no controls are included for risk characteristics of individual borrowers. By contrast, Panel B controls for FICO scores, LTVs, the presence of second mortgages, and documentation status. In both panels, the gray bars are standard-error bands. The figure shows that when house prices grow rapidly (at more than 10% per year), there is no significant difference in foreclosure rates between FRMs and ARMs, with or without controls for borrower and loan characteristics.²⁵ However, as house price growth decelerates and falls below 10%, differences do emerge. Moving from right to left in both panels, average default rates on ARMs rise much more rapidly as prices fall than do the default rates on FRMs. Once house price growth

²⁵ The standard error bars overlap, indicating that any difference may stem from statistical uncertainty surrounding the estimates.

becomes strongly negative, the standard error bands no longer overlap, suggesting a statistically significant difference in foreclosure propensities between the two types of loans. Note that controls for borrower and loan characteristics make some difference to the *average* gap between the two lines in each panel, suggesting that these characteristics do help predict the average level of foreclosures. However, the *differential sensitivity* of ARMs to falling prices is present with or without the controls.

There are number of reasons why subprime ARMs are more sensitive to falling prices. One is that ARM borrowers might have expected to refinance within the initial 2- or 3-year period of their mortgages. When house prices fell, these borrowers may have correctly surmised that their chances to refinance their loans had fallen. If these borrowers believed that they could not have afforded their fully indexed interest rates, then they may have simply defaulted well in advance of their reset dates. (Fixed-rate mortgages, by contrast, offer more flexibility in refinancing due to the lack of a specific reset date.) If this theory is correct, it implies that a specific feature of ARM contracts made these mortgages more sensitive to falling prices. But the differential sensitivities in Fig. 6 could also result from differences in borrowers likely to choose ARMs over FRMs. ARM borrowers may have had higher expectations for future price appreciation than FRM borrowers. Alternatively, ARM borrowers may have also been less "financially literate," with the implication that these borrowers were more likely to run into liquidity problems during periods of declining house prices than FRM borrowers.

3.4. A related puzzle on the pricing subprime of ARMs and FRMs

A related issue concerns how subprime ARMs and FRMs were priced in the market. We would expect the initial interest rate for a hybrid ARM to be much lower than the interest rate on an FRM, because the ARM borrower is taking on

Table 7
Initial interest rate differentials between fixed-rate and adjustable-rate subprime mortgages: 1998–2007.

	Interest rate differential: FRM rate less initial ARM rate
(1) Raw difference	–0.086 (0.042)
(2) Controlling for borrower's FICO score	0.141 (0.033)
(3) Controlling for borrower's FICO score, presence of second mortgage, documentation status, and LTVs on first and second mortgages	0.109 (0.038)
(4) Controls as in previous row, using 2005–2007 data only	0.163 (0.015)

Notes: Estimates are generated by ordinary least squares (OLS) regressions of initial subprime interest rates on a dummy that equals 1 if the loan is a fixed-rate loan (and other controls as noted). All regressions include quarterly dummies. FICO score controls in rows 2–4 are piece-wise linear controls. Standard errors are in parentheses. Rows 1–3 cluster the standard errors by quarter. Row 4 does not, because of the small number of quarters available.

interest-rate risk. In the data, however, initial rates on ARMs and FRMs are strikingly close. Table 7 presents interest-rate differentials on FRMs versus ARMs from regressions run on 1998–2007 data from the Boston Fed's LP dataset.²⁶ Row 1 shows that the typical interest rate on a fixed-rate loan appears lower than the typical initial ARM rate when we perform a simple comparison of raw averages. This difference may not be the true cost of using a fixed-rate product, however, given the systematic differences between borrowers that choose ARMs and those that choose FRMs. As we have seen, fixed-rate borrowers tend to have better FICO scores and lower LTVs than ARM borrowers, and they are also more likely to fully document their mortgage applications.

These good characteristics partially explain why FRM borrowers enjoyed relatively low interest rates. Row (2) controls for differences in borrower credit histories by adding a flexible control for borrower FICO scores in the regression. The interest-rate differential turns positive and equals about 14 basis points. While this estimate is statistically significant, it is small in magnitude.²⁷ In row (3), we add some additional controls, but the difference remains quantitatively small. Finally, row (4) uses data from 2005–2007 only, but the regression again implies a small difference in interest rates of slightly more than 16 basis points.

This small differential is difficult to explain. One possible interpretation is that ARM borrowers do not bother to demand a risk premium because they expect to refinance before their resets hit. Alternatively, ARM borrowers could be more likely to fold their closing costs into their mortgages, paying these costs with higher interest rates. If so, then the resulting increase in the ARM interest rate could mask a true rate differential between FRMs and ARMs that actual borrowers face in the market. Finally, financial literacy may also play a role. If ARM borrowers are unable to quantify the degree of interest-rate risk they take on with an adjustable-rate product, then these borrowers may not demand to be compensated for this risk with lower initial interest rates. Unfortunately, our data do not allow us to test these hypotheses directly, nor do they allow tests of theories to explain the differential default sensitivities

²⁶ The data for the table come from subprime first-lien mortgages used for home purchases only.

²⁷ A difference of 14 basis points is only 14 one-hundredths of a percentage point, so this implies an adjustable-rate mortgage with an 8% interest rate could be replaced with a fixed-rate mortgage with an 8.14% interest rate.

shown earlier in Fig. 6. We therefore leave these questions for future research.

4. The role of subprime underwriting standards

Differences in underwriting standards and in corresponding risk characteristics will obviously affect the performance of different types of mortgages. In popular accounts, the most-often mentioned risk characteristic of a subprime loan is the credit history of the borrower. While subprime lending originated as a way to serve borrowers with tarnished credit histories, the mature subprime mortgage market cannot be characterized along the single dimension of borrower credit quality. Subprime loans were riskier than prime loans for other reasons as well. In this section, we discuss how underwriting standards for subprime loans changed as the housing boom matured. We then explain how changing risk characteristics made subprime loans highly sensitive to declines in housing prices.

4.1. Explaining rising FICO scores among subprime borrowers

Fig. 7 investigates risk characteristics for all types of subprime borrowers (grouping ARMs and FRMs together), illustrating how the characteristics of different types of subprime borrowers changed over time. To set the stage, we can simply note that the average FICO score of subprime borrowers was rising. This fact is reflected in Panel A of Fig. 7; the higher line in this panel is the fraction of subprime borrowers that had a FICO score of 620 or higher. This fraction rises from slightly less than 40% in 1999 to around 70% by 2004. Increases in the fraction of high-FICO borrowers in subprime pools have also been found in other nationwide datasets (Gerardi et al., forthcoming; Brooks and Simon, 2007). These increases suggest that the quality of the subprime pool was actually getting better over time.

We saw in Fig. 3, however, that other risk characteristics of subprime loans deteriorated over the sample period, so that a plot of average credit scores presents an incomplete picture of the riskiness of subprime loans. The lower line in Panel A of Fig. 7 plots the fraction of subprime loans for which the borrower had a credit score of 620 or higher, the DTI ratio on the loan was 40% or less, the LTV ratio was 90% or less, and full documentation of the application was provided. This fraction begins at about 13% in 1999 and falls to around 5% by 2006. In contrast to the graph of bor-

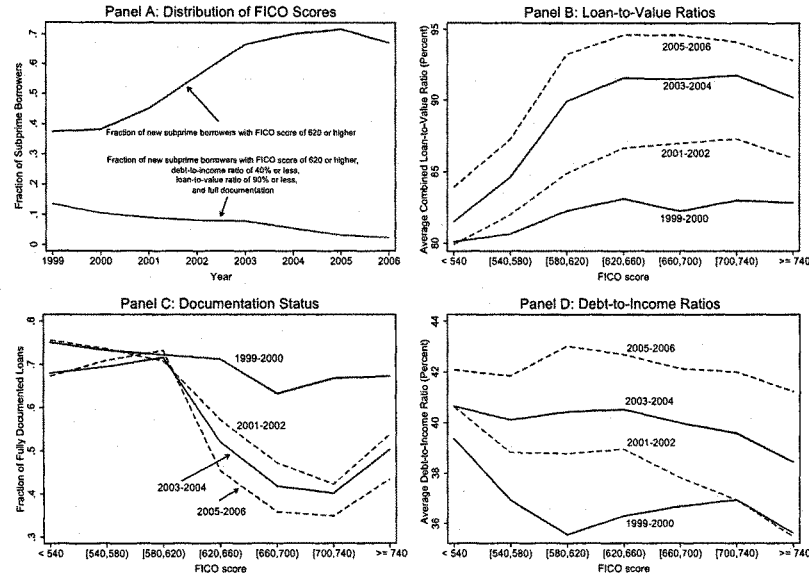


Fig. 7. Alternative measures of risk in the subprime pool. Figures are generated from all newly originated subprime mortgages in the Boston Fed's LP dataset, including both purchase and refinance loans.

rower credit scores, this more complete measure of subprime loan quality is getting worse over time.

The opposite movements of the two lines can be reconciled by asking why the share of high-FICO borrowers is rising over time. One reason typically offered for the presence of high-FICO borrowers in the subprime market is that they were inappropriately steered there by unscrupulous mortgage brokers in search of higher commissions. While this is a possibility, high-FICO borrowers will also show up in the subprime pool if they desire mortgages that are riskier than those offered by prime lenders.

Panel B of Fig. 7 illustrates this point by showing the evolution of average LTVs for different cohorts of subprime borrowers. The horizontal axis groups borrowers into seven categories based on their credit scores. Each line in the figure represents a 2-year cohort of subprime loans. For the earliest cohort (1999–2000), the average LTV is around 80% for borrowers in the lowest category, suggesting an average downpayment of 20%. The LTV is only slightly higher for borrowers in this cohort with the highest credit scores. As the years pass, however, the difference in LTVs across different FICO classes begins to grow. By 2005–2006, average LTVs for the lowest-score borrowers had risen to around 85%, but average LTVs for the highest-score borrowers had surged to near 95%.

A similar analysis for documentation status is shown in Panel C. In the earliest years of the sample, the fraction of fully documented loans made to the lowest-FICO borrowers was between 70 and 80%. The corresponding fraction for high-FICO borrowers was about the same. But in 2001, the fraction for high-FICO borrowers began to fall. By 2005–2006, the fraction of fully documented loans for high-FICO borrowers had declined all the way to 40%, even though the corresponding fraction for the low-FICO borrowers had changed only a little since the start of the sample period. Qualitatively, this pattern resembles that of the previous graph of LTVs; the riskiness of the entire subprime pool grew because of the behavior of the high-FICO borrowers.

Finally, Panel D displays the third indicator of loan risk, the DTI ratio. Early in the sample, DTIs for the lowest-FICO borrowers in the subprime pool were somewhat higher than those for the highest-FICO borrowers. The subsequent behavior of this characteristic is different than that of the previous two characteristics, in that DTIs deteriorated for borrowers of all FICO classes, not just the high-FICO borrowers. By the end of the housing boom, average DTIs for all borrowers exceeded 42%.

Taken together, the three risk characteristics—LTVs, documentation status, and DTIs—tell a consistent story. All of these indicators moved in the direction of greater

risk as the housing boom progressed and house prices moved higher. For LTVs and documentation status, most of this movement was caused by borrowers with high credit scores who were entering the subprime pool in larger numbers. In all likelihood, it would have been impossible for these borrowers to find prime lenders willing to make loans as risky as the subprime loans they eventually obtained. Prime lenders would have required larger downpayments, they would have insisted on lower DTI ratios, and they would have demanded better documentation of income and assets.

4.2. Implications

There are at least three important implications of these findings. First, from a policy perspective, they speak to the issue of whether some of the high-FICO borrowers were inappropriately steered into the subprime market. It is possible that little such coercion occurred. Mortgage brokers may have simply found subprime lenders that were willing to make the risky loans that high-FICO borrowers themselves had determined were appropriate, given the market prices of the homes that they wanted to buy. As prime borrowers would have frowned on these loans, the subprime market was the only option available. The evidence is not supportive of the view that borrowers were steered into the subprime market for loans they could have received more cheaply elsewhere. But it does not speak to the possibility that borrowers were steered into buying homes or borrowing amounts of money that required them to take subprime loans. In any case, the problem of “potentially prime” borrowers stuck in subprime loans is mitigated by the risk-based pricing models used by most subprime lenders. Using our LP data, we calculated the percentage of subprime loans for owner-occupied homes that had an LTV of 90% or below, that were fully documented, that had borrower FICO scores of 620 or higher, and had a DTI of 45% or less. About 9.6% of the subprime mortgages in the LP data met all of these criteria, so about 10% of the borrowers with outstanding subprime loans could have qualified for prime loans. We then asked whether these borrowers were paying the onerous terms typically associated with subprime loans. Of these borrowers, approximately 65% had fixed interest rates. Furthermore, the average initial interest rate for these loans was 6.7%, the median was 6.6%, and the 90th percentile rate was 7.9%. By contrast, only 29% of all subprime loans in the dataset were fixed-rate instruments, and the average interest rate calculated over all subprime loans was 7.7% (90th percentile was 9.4%). This calculation shows that the borrowers that can be identified as “potentially prime” already had much more favorable mortgage terms than the typical subprime borrower.

A second implication of our findings concerns claims by some commentators that the subprime crisis is proof that “some people should not own houses.” Implicit in this view is the notion that the subprime market is wholly characterized by irresponsible low-FICO borrowers who lack the financial or emotional wherewithal to remain current on mortgages. It is true that the subprime market originally specialized in serving borrowers with tarnished credit his-

tories. Yet we have seen that risky subprime loans were also made to borrowers with high FICO scores. Thus, blaming borrowers with low credit scores for the subprime mess is a vast oversimplification of the problem. Understanding why prime borrowers stretched themselves into risky loans available only in the subprime market would seem to be a more productive line of research.

A final implication concerns the debate over the whether the subprime crisis resulted from poor underwriting standards, which placed people in unaffordable mortgages, or from falling house prices, which brought about widespread negative equity and thus prevented profitable sales or refinances when borrowers suffered adverse life events. To us, this is an artificial debate. We learn from Figs. 3 and 7 that subprime LTV ratios rose during the housing boom. Because loans with high LTV ratios have small equity cushions, they are more likely to suffer from negative equity when house prices fall. Other panels of Figs. 3 and 7 showed that the prevalence of high DTI ratios and low-doc or no-doc loans rose in the subprime market over time. These are precisely the types of loans that are likely to cause borrower distress when adverse life events occur.²⁸ Thus, these loans will default more often when house prices fall. All in all, the right way to think about the subprime housing crisis is that both falling prices and relaxed underwriting standards were important. Looser underwriting standards created a class of loans that were highly sensitive to falling prices. When housing prices did fall, subprime loans therefore defaulted in greater numbers than prime loans. But, if prices had not fallen, we would not have seen nearly the number of subprime foreclosures that we did.²⁹

5. The role of subprime refinancing

In this section, we take a closer look at subprime refinancings. Table 1 showed that the subprime fraction of defaulted loans was larger than the subprime fraction of purchase mortgages of foreclosed homes. This discrepancy indicates that many prime purchasers refinanced into subprime loans before defaulting. A main motivation for refinancing is to liquify home equity in a cash-out refinancing. Though our data do not allow us to measure cash-outs directly, we can use the purchase date of homes to get a rough indication of how much equity was available to be cashed out. According to our state-wide repeat-sales index, average Massachusetts house prices increased by more than 60% from 1999 to early 2008. If we find that homes purchased in 1999 or before were eventually lost to foreclosure, it is likely that the owners refinanced at one or more points along the way in order to extract equity. Our data allow us to count the number of mortgages in each ownership experience to test this hypothesis.

²⁸ Higher DTI ratios increase the probability that a borrower suffering a decline in income or an increase in expenses will find his mortgage payment onerous. A lack of complete documentation acts as a “multiplier” on the effect of DTI, since the true DTI is likely to be higher than the DTI listed on the loan.

²⁹ See Gerardi et al. (2007) for some calculations along these lines.

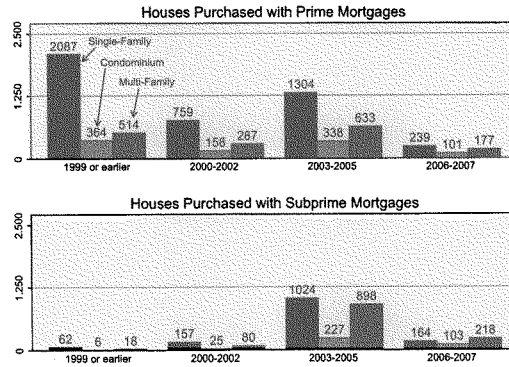


Fig. 8. 2006–2007 Massachusetts foreclosures by type of residence, purchase year, and subprime-purchase status.

In fact, the data do show that many of the prime purchases that were eventually lost to foreclosure were purchased in 1999 or earlier, so they were likely to have amassed substantial equity. Fig. 8 presents the absolute numbers of 2006–2007 Massachusetts foreclosures grouped by type of house, subprime-purchase status, and year of purchase. The top panel plots the data for prime purchases. Of the 4389 single-family foreclosures designated as prime purchases, almost half (2087) were purchased in 1999 or before. Across all types of homes, there were 6961 prime purchases foreclosed upon in 2006 and 2007. Of these, 2965 (42.6%) were purchased before 1999.

Fig. 8 also confirms our other findings. We saw in Fig. 4 that foreclosures are high among homes purchased at the height of the housing boom, presumably because these homes never had a chance to amass positive equity before prices started falling. As we would expect, Fig. 8 confirms that homes purchased in 2003–2005 are strongly represented in 2006–2007 foreclosures. Additionally, Fig. 8 illustrates the high rates of foreclosure among multi-family homes, particularly for multi-families purchased with subprime mortgages near the height

of the recent boom (2003–2005). The absolute number of subprime multi-family foreclosures from the 2003–2005 cohort (898) is close to the number of subprime single-family foreclosures in that cohort (1024), even though the multi-family purchases were far less common than purchases of single-family homes in this period.

We next look for evidence of refinancing activity among homes that had appreciated in price. Table 8 shows that foreclosed homes experienced higher refinancing activity than homes that were purchased at the same time, but that have not yet been foreclosed upon or sold. The first row of the table measures the total number of mortgages for homes purchased in 1999. Homes that were purchased in that year and foreclosed upon in 2007 averaged 5.1 mortgages during their entire ownership experiences. For homes purchased in 1999 that have not yet been foreclosed upon or sold, the average number of lifetime mortgages is only 3.8. A similar discrepancy is present for homes purchased in 2000 through 2003.

What role did subprime refinances play in these foreclosure patterns? Table 9 repeats this exercise but focuses only on the total number of subprime mortgages for various ownership experiences. The top row shows

Table 8
Average number of lifetime mortgages for Massachusetts ownership experiences, for homes purchased 1999–2007.

Year of purchase	Foreclosed ownership experiences, by year of foreclosure									Non-foreclosed ownership experiences
	1999	2000	2001	2002	2003	2004	2005	2006	2007	
1999	1.6	1.6	1.6	1.8	2.2	2.6	3.5	4.3	5.1	3.8
2000		1.5	1.4	1.6	1.8	2.1	3.0	4.1	4.9	4.1
2001			1.3	1.3	1.5	1.8	2.5	3.9	4.1	3.6
2002				1.6	1.4	1.5	2.2	3.0	3.7	3.1
2003					1.3	1.2	1.8	2.3	3.0	2.4
2004						1.1	1.6	2.0	2.4	2.2
2005							1.0	1.8	2.0	1.9
2006								1.8	1.8	1.7
2007									1.6	1.4

Note: Non-foreclosed ownership experiences in the last column correspond to ownerships that had not ended with a sale by the end of 2007.

Table 9
Average number of lifetime subprime mortgages for Massachusetts ownership experiences.

	Foreclosed Ownership Experiences, by Year of Foreclosure									Non-Foreclosed Ownership Experiences
	1999	2000	2001	2002	2003	2004	2005	2006	2007	
1999	0.2	0.1	0.1	0.3	0.4	0.5	1.2	1.2	1.6	0.2
2000		0.0	0.1	0.4	0.6	0.5	0.7	1.5	1.4	0.2
2001			0.2	0.2	0.4	0.5	0.7	1.3	1.2	0.2
2002				0.3	0.2	0.5	0.7	1.1	1.2	0.2
2003					0.3	0.3	0.8	1.0	1.1	0.2
2004						0.4	0.7	1.0	1.1	0.2
2005							0.0	1.0	1.1	0.3
2006								0.8	0.9	0.2
2007									0.1	0.0

Note: Non-foreclosed ownership experiences in the last column correspond to ownerships that had not ended with a sale by the end of 2007.

that homes that were purchased in 1999 and foreclosed upon in 2007 had an average of 1.6 subprime mortgages during their ownership experiences. The comparable number for homes purchased in 1999 that have not yet been foreclosed upon or sold is only 0.2. The inability to measure cash-out refinancing makes this analysis only suggestive. Yet the data are consistent with the view that subprime mortgages were extensively used to exact equity from homes that had appreciated in price, and that this extraction had an important impact on foreclosure patterns.

6. Conclusion and directions for future research

This paper has presented a number of facts about the subprime crisis which are at odds with oft-made claims. A simple model that claims a wave of subprime resets set off the crisis is hard to square with the facts, and it is hard to make a *prima facie* case that large numbers of subprime borrowers were inappropriately steered into their mortgages. Additionally, though subprime mortgages have proven especially fragile during the current housing downturn, prime mortgages have also been affected. Indeed, most of the homes lost to foreclosure in Massachusetts were purchased with prime mortgages, though many of their owners refinanced into subprime mortgages before defaulting.

These facts are consistent with the view that the widespread decline in housing prices is the proximate cause of the current housing crisis. They are also consistent with a claim that higher housing prices caused many high-FICO borrowers to turn to the subprime market in order to purchase increasingly expensive homes. Yet while high prices may have encouraged subprime lending, a crucial outstanding question is the degree of causality in the other direction, specifically, whether subprime lending put upward pressure on housing prices. This question lies beyond the scope of this paper. But there is some suggestive evidence that, at least in Massachusetts, higher housing prices were not caused by higher subprime lending. Fig. 9 shows that house prices started increasing in the Bay State well before subprime lending took off. Specifically, house prices were rising by more than 10% per year by the year 2000, when the subprime fraction of new purchases in the state was still quite small. In any

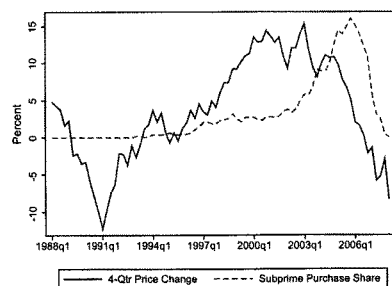
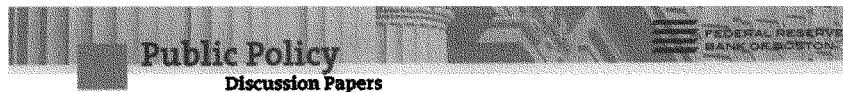


Fig. 9. House price appreciation and subprime-purchase lending in Massachusetts, 1988–2007.

case, figuring out the ultimate effect of subprime lending on house prices, and vice versa, is a difficult problem that will require innovative empirical approaches to answer.

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Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization

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Abstract:

We document the fact that servicers have been reluctant to renegotiate mortgages since the foreclosure crisis started in 2007, having performed payment-reducing modifications on only about 3 percent of seriously delinquent loans. We show that this reluctance does not result from securitization: servicers renegotiate similarly small fractions of loans that they hold in their portfolios. Our results are robust to different definitions of renegotiation, including the one most likely to be affected by securitization, and to different definitions of delinquency. Our results are strongest in subsamples in which unobserved heterogeneity between portfolio and securitized loans is likely to be small, and for subprime loans. We use a theoretical model to show that *redefault risk*, the possibility that a borrower will still default despite costly renegotiation, and *self-cure risk*, the possibility that a seriously delinquent borrower will become current without renegotiation, make renegotiation unattractive to investors.

JEL Classifications: D11, D12, G21

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1 Introduction

Many commentators have attributed the severity of the foreclosure crisis in the United States in the 2007–2009 period to the unwillingness of lenders to renegotiate mortgages, and, as a consequence, have placed renegotiation at the heart of the policy debate. Every major policy action to date has involved encouraging lenders, in one way or another, to renegotiate loan terms in order to reduce borrower debt loads. According to the Treasury-sponsored HopeNow initiative, in December of 2007 lenders were expected to prevent adjustable-rate mortgages from increasing to higher rates at the first reset of the mortgage.¹ “Hope For Homeowners,” enacted by Congress in July of 2008, envisioned that lenders would write off a substantial portion of the principal balance of mortgages for financially distressed households.² The Obama Administration’s Making Home Affordable Plan, announced in February of 2009, provided financial incentives to servicers to renegotiate loans on the condition that the lenders reduce the interest rate for a significant period of time.³

The appeal of renegotiation to policy makers is simple to understand. If a lender makes a concession to a borrower by, for example, reducing the principal balance on the loan, it can prevent a foreclosure. This is clearly a good outcome for the borrower, and possibly good for society as well. But the key to the appeal of renegotiation is the belief that it can also benefit the lender, as the lender loses money only if the reduction in the value of the loan exceeds the loss the lender would sustain in a foreclosure. In short, according to proponents, renegotiation of home mortgages is a type of public policy holy grail, in that it helps both borrowers and lenders at little or no cost to the government.⁴

In this paper, we explore the renegotiation of home mortgages using a dataset from Lender Processing Services (LPS), a large, detailed sample of residential mortgages. Our primary empirical analysis involves following borrowers over the year subsequent to their first serious delinquency and counting the frequency of renegotiation.⁵ Measuring renegotiation in the LPS data is a challenge because there is no field in the data that identifies whether or not a servicer has changed the terms of, or “modified,” the loan. We overcome this difficulty by developing an algorithm to identify modifications that we validate on an unrelated dataset that includes a modification flag.

We explore several different definitions of renegotiation in the data. Our first definition of “renegotiation” is concessionary modifications that serve to reduce a borrower’s monthly

¹Edmund L. Andrews, In Mortgage Plan, Lenders Set Terms, *New York Times*, Dec. 7, 2007.

²“Bush Signs Wide-Ranging Housing Bill Into Law,” *Wall Street Journal*, July 31, 2008.

³See “\$275 Billion Plan Seeks To Address Crisis In Housing,” *New York Times*, Feb. 18, 2009.

⁴See this discussion in Congressional Oversight Panel (2009), Zingales (2008), and Geanakoplos and Koniak (2008), as examples.

⁵Until 2008, the dataset was known as McDash.

payment. These may be reductions in the principal balance or interest rate, extensions of the term, or combinations of all three. This definition of renegotiation is a key focus of our analysis because there is a consensus among many market observers that concessionary modifications are the most, or possibly the only, effective way of preventing foreclosures. As the Congressional Oversight Panel (COP) for the Troubled Asset Recovery Program (TARP) has written, “Any foreclosure mitigation plan must be based on a method of modifying or refinancing distressed mortgages into affordable ones. Clear and sustainable affordability targets achieved through interest rate reductions, principal write-downs, and/or term extensions should be a central component of foreclosure mitigation.”⁶

Because the pooling and servicing agreements (PSAs), which govern the conduct of servicers when loans are securitized, often place limits on the number of modifications a servicer can perform, we broaden our definition of renegotiation to include any modification, regardless of whether it lowers the borrower’s payment. Modifications are often thought to always involve concessions to the borrower, but many, and in some subsets most, modifications involve the capitalization of arrears into the balance of the loan, and thus lead to increased payments.

Finally, we attempt to include in our definition of renegotiation the transactions whereby lenders allow borrowers to extinguish their liabilities by repaying less than the outstanding balance of the loan. These transactions are known as short payoffs, short sales, or deeds-in-lieu of foreclosure, depending on the structure. We measure this component of renegotiation by counting the number of seriously delinquent loans that the servicer reports as “paid off.”

No matter which definition of renegotiation we use, one message is quite clear: lenders rarely renegotiate. Fewer than 3 percent of the seriously delinquent borrowers in our sample received a concessionary modification in the year following the first serious delinquency. More borrowers received modifications under our broader definition, but the total still accounted for fewer than 8 percent of the seriously delinquent borrowers. And finally, fewer than 5 percent of all of our troubled borrowers repaid their mortgages, putting an upper bound on the number who could have repaid less than the principal balance of the loan. These numbers are small both in absolute terms, and relative to the approximately half of the sample for whom foreclosure proceedings were initiated, and the nearly 30 percent for whom they were also completed.

We next turn to the question of why renegotiation is so rare. If the logic described in the second paragraph is correct, lenders should find renegotiation attractive, even in the

⁶See the Congressional Oversight Panel (2009). This view is widely held and is the main focus of the Administration’s Making Home Affordable foreclosure prevention plan was to encourage servicers to modify loans to reduce monthly payments to 31 percent of income.

absence of government prodding. Yet, we observe very little renegotiation in the data. We address this apparent paradox.

The leading explanation attributes the reluctance of lenders to renegotiate to the process of securitization.

The complex webs that securitization weaves can be a trap and leave no one, not even those who own the loans, able effectively to save borrowers from foreclosure. With the loan sliced and tranced into so many separate interests, the different claimants with their antagonistic rights may find it difficult to provide borrowers with the necessary loan modifications, whether they want to or not. In the tranche warfare of securitization, unnecessary foreclosures are the collateral damage. (Eggert 2007)

More precise institutional evidence appears to confirm the role of securitization in impeding renegotiation. As mentioned in more detail below, PSAs do sometimes place global limits on the number of modifications a servicer can perform for a particular pool of mortgages. In addition, the rules by which servicers are reimbursed for expenses may provide a perverse incentive to foreclose rather than modify. Furthermore, because servicers do not internalize the losses on a securitized loan, they may not behave optimally. Another issue is the possibility that those investors whose claims are adversely affected by modification will take legal action. Finally, historically, SEC rules have stated that contacting a borrower who is fewer than 60-days delinquent constitutes an ongoing relationship with the borrower and jeopardizes the off-balance sheet status of the loan.

But some market observers express doubts about the renegotiation-limiting role of securitization. Hunt (2009) conducted an exhaustive review of a sample of PSAs and concluded, “it appears that large-scale modification programs may be undertaken without violating the plain terms of PSAs in most cases.” Although some servicers have expressed concern about lawsuits, of the more than 800 lawsuits filed by investors in subprime mortgages through the end of 2008, not one involved the right of a servicer to modify a loan.⁷ Even the Congressional Oversight Panel (2009), which did view securitization as a problem in general, conceded, “The specific dynamics of servicer incentives are not well understood.” Finally, the SEC ruled in 2008 that if default was “reasonably foreseeable,” then contact with a borrower prior to 60-day delinquency would not affect the accounting status of the loan.

Our empirical analysis provides strong evidence against the role of securitization in preventing renegotiation. The LPS dataset includes loans that are serviced for private securitization trusts that are not sponsored by any of the government sponsored enterprises

⁷Navigant report, Congressional Oversight Panel (2009).

(GSEs), so-called “private-label” loans, which are subject to all of the contract frictions described above. It also includes loans owned by servicers, so-called “portfolio” loans, which are immune to such problems. We compare renegotiation rates, controlling for observable characteristics of the loans. For our narrowest definition of renegotiation, payment-reducing modification, we find that the differences in the likelihood of renegotiation in the 12 months subsequent to the first 60-day delinquency between the two types of loans is neither economically nor statistically significant. When we consider the broader definition that includes any modification at all, which, as we mentioned above, we would expect to be most affected by securitization, the data even more strongly reject the role of securitization in preventing renegotiation. We also find that servicers are *more* likely to perform modifications, broadly defined, and to allow the borrower to prepay on a private-label loan than on a portfolio loan.

Our results are highly robust. One potential problem with the data is that there is unobserved heterogeneity in the characteristics of portfolio and private-label loans. To address this, we exploit subsets of the LPS data, in which servicers provide an exceptional amount of information about borrowers. When we exclude observations where the servicer failed to report whether the borrower fully documented income at origination, or what the debt-to-income ratio was at origination, our results become even stronger. When we focus only on loans for which the borrower fully documented income, we obtain results that are broadly consistent or, in some cases, stronger than the results for the full sample. Finally, we limit our sample to only subprime loans (as defined in LPS). These loans comprise only 7 percent of the LPS data, but they account for more than 40 percent of all serious delinquencies and almost 50 percent of the modifications that we identify in the data. The results that we obtain for the subprime sample are also consistent with our results for the full sample.

Another potential issue with our focus on 60-day delinquent loans is that portfolio lenders can contact borrowers at any time, whereas some securitization agreements forbid lenders from contacting borrowers until they are at least 60 days delinquent (two missed payments). When we shift our focus to 30-day delinquent borrowers (one missed payment), our results continue to show no meaningful difference between renegotiation of private-label and portfolio loans.

One other possibility is that our algorithm for identifying modifications is somehow missing a class of loss-mitigation actions taken by servicers. Forbearance agreements and repayment plans, for example, would not necessarily show up in our data. However, neither of these actions constitutes renegotiation in any classic sense, because the lender still expects the borrower to repay in full, including interest on any delayed payment. In addition, unlike

modifications, PSAs never place any limits on the use of forbearance agreements or repayment plans, so, *a priori*, we would have less reason to expect a difference in their use across private-label and portfolio loans. Finally, most successful forbearance agreements conclude with a modification to allow the borrower to repay the arrears incurred in forbearance. With all of that said, we test the proposition that servicers engage in other loss mitigation actions by looking at the “cure rate.” This is the percentage of loans that transition to current status after becoming 60-days delinquent. We find that in the full sample, private-label loans are less likely to cure, but that the gap, although statistically significant, is small — correcting for observable characteristics, we estimate a cure rate of around 30 percent for the typical portfolio loan and a cure rate of about 2 percentage points less for an otherwise equivalent private-label loan. However, for the subprime subsample, the subsample with information about documentation and debt-to-income (DTI) status, and the sample of fully documented loans, we find that private-label loans are significantly *more* likely to cure.

The policy debate has focused exclusively on the ways securitization impedes renegotiation and implicitly assumes that portfolio lenders face no institutional impediments, but this is not realistic. Portfolio lenders complain about accounting rules, including the need to identify modifications, even when the borrowers are current prior to the modification, as “troubled debt restructurings,” which leads to reduction of the amount of Tier II capital and increased scrutiny from investors and cumbersome accounting requirements. The shortage of qualified staff, an oft-heard complaint from borrowers seeking renegotiation, affects servicers of portfolio loans and private label loans equally. Finally, the interests of the managers of a loan portfolio are not necessarily any more likely to be aligned with their investors than are the interests of the trustees of a mortgage pool; many have attributed the catastrophic failures of financial institutions like AIG in 2008 to misaligned incentives of managers and shareholders.

Our results are consistent with the hypothesis that securitization does impede renegotiation but that a different set of impediments leads to similar problems with portfolio loans and generates our finding that there is no difference. However, the small differences would represent a remarkable coincidence.⁸ More importantly, the low overall levels of renegotiation mean that even if contract frictions cut the overall number of concessionary modifications in half, 94 percent of seriously delinquent borrowers would still fail to receive a concessionary modification. So the puzzle remains why so few loans are renegotiated.

If contract frictions are not a significant problem, then what is the explanation for

⁸Yet another possible explanation is that equal treatment provisions in PSAs force servicers to modify similar numbers of portfolio and private-label loans and that servicers are reluctant to modify portfolio loans in spite of the fact that they internalize the benefits because they must then modify private label loans for which they don't.

why lenders do not renegotiate with delinquent borrowers more often? We argue for a very mundane explanation: lenders expect to recover more from foreclosure than from a modified loan. This may seem surprising, given the large losses lenders typically incur in foreclosure, which include both the difference between the value of the loan and the collateral, and the substantial legal expenses associated with the conveyance. The problem is that renegotiation exposes lenders to two types of risks that can dramatically increase its cost. The first is what we will call “self-cure” risk. As we mentioned above, more than 30 percent of seriously delinquent borrowers “cure” without receiving a modification; if taken at face value, this means that, in expectation, 30 percent of the money spent on a given modification is wasted. The second cost comes from borrowers who redefault; our results show that a large fraction of borrowers who receive modifications end up back in serious delinquency within six months. For them, the lender has simply postponed foreclosure; in a world with rapidly falling house prices, the lender will now recover even less in foreclosure. In addition, a borrower who faces a high likelihood of eventually losing the home will do little or nothing to maintain the house or may even contribute to its deterioration, again reducing the expected recovery by the lender.

In Section 4 of the paper, we formalize the basic intuition of the investor renegotiation decision, with a simple model. We show that higher cure rates, higher redefault rates, higher expectations of house price depreciation, and a higher discount rate all make renegotiation less attractive to the investor. Thus, one cannot evaluate a modification by simply comparing the reduction in the interest rate on the loan or in the principal balance with the expected loss in foreclosure. One must take into account both the redefault *and* the self-cure risks, something that most proponents of modification fail to do.⁹

To our knowledge, this paper is the first to estimate directly the likelihood of renegotiation of private-label and portfolio-held loans. Piskorski, Seru, and Vig (2009) address the question of the effects of securitization on renegotiation, but rather than directly identifying renegotiation, they run “black-box” foreclosure regressions using LPS data and argue that observed differences in foreclosure rates *imply* differences in renegotiation activity. Our results contradict this interpretation. For renegotiation to explain the differences in foreclosure rates, there would have to be large errors in our algorithm for identifying renegotiation, and those errors would have to be significantly biased toward portfolio loans, a possibility that is particularly problematic given that the renegotiations we focus on are precisely the type that PSAs supposedly prevent. In addition, most of the loan histories in the LPS

⁹Many proponents of aggressive modification take into account redefault risk, and the MHA plan did address it by providing some insurance against further house price declines to investors who modified loans. However, none of the main proponents ever mentions self-cure risk, even though it is well-known in the industry, see: <http://www.calculatedriskblog.com/2008/09/loan-modifications-aneecdotes-and-data.html>.

sample are right-censored, meaning that the borrowers have neither lost their homes nor paid off their mortgages when the data end, making it impossible to equate the absence of a foreclosure with successful renegotiation. By contrast, a “cure” is a necessary condition for renegotiation, and thus the differences we report in cure rates across portfolio and private-label loans that are neither large nor of consistent sign contradict the claim that securitization is a major obstacle to renegotiation.

The implications of our research for policy are three-fold. First, “safe harbor” provisions, which shelter servicers from investor lawsuits, are unlikely to affect the number of modifications and should have little effect. Second, and more broadly, the number of “preventable foreclosures” may be far fewer than many believe.

Finally, we point out that while our model shows why investors may not want to perform modifications, that does not necessarily imply that modifications may not be socially optimal. One key input to our theoretical model is the discount rate, and it is possible that investors, especially in a time when liquidity is highly valued, may be less patient than society as a whole, and therefore foreclose when society would prefer renegotiation. Large financial incentives to investors or even to borrowers to continue payment could mitigate this problem.

1.1 Related Literature and Existing Evidence

Our research draws on existing literature in several different fields. First, there has been substantial interest in the question of renegotiation of home mortgages among real estate economists, both prior to, and as a result of the current crisis. Riddiough and Wyatt (1994a), Riddiough and Wyatt (1994b), and Ambrose and Capone (1996) addressed informational issues that inhibit efficient renegotiation. We draw extensively on this research in Section 4. Springer and Waller (1993), in an early example, explores patterns in the use of forbearance as a loss mitigation tool. Capone (1996) and Cutts and Green (2005) both discuss the institutional issues, with the former study providing historical evidence and focusing on issues in the mid-1990s, and the latter study discussing innovations since then.

The start of the subprime crisis in 2007 led to a resurgence of interest in the topic among real estate economists and aroused new interest from other fields, in particular, the field of law. In real estate, Quercia, Ding, and Ratcliffe (2009), Cutts and Merrill (2008), Stegman, Quercia, Ratcliffe, Ding, Davis, Li, Ernst, Aurand, and Van Zandt (2007), and Mason (2007), all discuss issues with contemporary loss mitigation approaches. Legal researchers, White (2008) and White (2009), for example, have addressed empirical questions about the frequency and characteristics of loan modifications, closely related to the analysis in this

paper. In addition, they have also looked at issues related to the restrictions imposed by contracts (Hunt 2009 and Gelpert and Levitin 2009) and the interactions among foreclosure, renegotiation, and personal bankruptcy (Levitin 2009a and Levitin 2009b).

More broadly, real estate economists have explored the factors that lead delinquent mortgages to transition to foreclosure or to cure, one of which is renegotiation. Pre-crisis papers include Ambrose and Capone (1998), Ambrose, Buttner Jr, and Capone (1997), Ambrose and Capone (2000), Lauria, Baxter, and Bordelon (2004), Danis and Pennington-Cross (2005), Pennington-Cross (2009), and Pennington-Cross and Ho (2006). Mulherin and Muller (1987) discusses conflicts between mortgage insurers and owners that may lead servicers to induce or postpone foreclosure inefficiently. In light of the crisis, Piskorski, Seru, and Vig (2009) and Cordell, Dynan, Lehnert, Liang, and Mauskopf (2008a) have revisited the question.

The issue of dispersed ownership and debt renegotiation has received a fair amount of attention in the corporate finance literature. Gan and Mayer (2006), for example, focus on commercial mortgages, and find that servicers delay liquidation of delinquent mortgages when they are also the holders of the equity tranche of the deal. This suggests that participating in the losses due to liquidation may alleviate some of the agency problems posed by the separation of ownership and servicing pointed out before. However, it may also lead to conflicts of interest between holders of different tranches. In their setting, Gan and Mayer (2006) find that the servicers' behavior is consistent with asset substitution, as servicers seek to benefit from the option-like payoff of their position. Also, the contractual restrictions imposed by PSAs (discussed above) and standard economic arguments on the effects of dispersed ownership of debt (as in Bolton and Scharfstein 1996 and Asquith, Gertner, and Scharfstein 1994) further reduce the incentives of servicers to modify mortgages.

2 Data

We use a dataset constructed by LPS. This is a loan-level dataset that covers approximately 60 percent of the U.S. mortgage market and contains detailed information on the characteristics of both purchase-money mortgages and mortgages used to refinance existing debt.¹⁰ This dataset is especially useful in the context of this paper, as it includes both securitized mortgages and loans held in portfolio.¹¹ The LPS data specifically denote whether a mort-

¹⁰We use a 10 percent random sample of the LPS data when estimating all of our empirical models. The dataset is simply too big to use in its entirety from a computational standpoint. However, we have checked the robustness of our results to using different sample sizes, and we do not find substantial differences.

¹¹For a more detailed discussion of the LPS data, we direct the reader to Foote, Gerardi, Goette, and Willen (2009).

gage is held in portfolio, or securitized by a non-agency, private institution.¹² If institutional constraints are restricting the modification process for private-label, securitized loans, we would expect to see relatively few modifications among them, as compared to portfolio loans. Unfortunately, our LPS sample does not include direct information regarding loan modifications.¹³ However, LPS does provide monthly updates to loan terms, so it is possible to identify loan modifications indirectly (and imperfectly). Table 1 shows two examples of modifications in the data. In the first example, the servicer cuts the interest rate, capitalizes arrears into the balance of the loan, and extends the term of the loan to 40 years. In the second example, the servicer just capitalizes arrears into the balance of the loan. In both cases the loan is reported as “current” after the modification, whereas before it was 90+ days delinquent.

We denote a loan as being modified if there is a change in its terms that was not stipulated by the initial terms of the contract. Such modifications include interest-rate reductions, principal-balance reductions, and term extensions. We can also identify principal-balance and mortgage-payment *increases* that reflect the addition of arrears into the balance of a loan.¹⁴ We spell out our algorithm for identifying modifications in more detail in Appendix A.

There are two potential mistakes we can make in this exercise. First, we may falsely identify modifications (“false positives”) because of measurement error in the data (for example, a mistake in the updated balance or interest rate) or some endogenous behavior on the part of the borrower (for example, a borrower making extra principal payments). Second, we could miss modifications (“false negatives”) because our algorithm for finding modifications is incomplete. In order to test our algorithm, we use data from the Columbia files put together by Wells Fargo’s CTSLink service. This dataset includes a similar set of variables to those in the LPS dataset (on performance of the loans and characteristics of the borrower at origination) but is limited to private-label loans. These files do include,

¹²The LPS data also denote when a loan is securitized by a GSE (Government Sponsored Enterprise) such as Freddie Mac or Fannie Mae. We eliminate this class of loans, since the GSEs hold all credit risk, and thus are not subject to any modification restrictions.

¹³In a recent report, the Office of Thrift Supervision (OTS), in collaboration with the Office of the Comptroller of Currency (OCC), used data from LPS to analyze the outcomes of recent mortgage modification programs (OCC and OTS Mortgage Metrics Report, Third Quarter 2008). In this report, they had access to supplementary data from servicers that include the identification of loans in the LPS data that had been modified. We have not been able to obtain access to this data.

¹⁴One of the major types of loan modifications that we are largely unable to identify are interest rate freezes for subprime ARMs, which reset after two or three years. However, the reason that we cannot identify those freezes is because many are not binding; the fully-indexed rate is lower than the initial rate. These modifications will have no major effect on the current terms of the mortgage, so we do not view this as a major drawback.

however, explicit flags for modifications. This allows us to use the same algorithm described in Appendix A and compare the modifications we identify to the “true” modifications. Results are reported in Table 2. Overall our algorithm performs well, with 17 percent false negatives (that is, we do not identify around 17 percent of the “true” modifications) and around the same percentage of false positives (that is, approximately 17 percent of the modifications we identify are not flagged as modifications on the CTSLink data). By type of modification, our algorithm performs best for principal reductions, term increases, and fixed-rate mortgage reductions, and comparatively worse for ARM rate reductions and for principal increases.

2.1 Summary Statistics from the Data

Table 3 reports the number of modifications performed each quarter from the first quarter of 2007 through the final quarter of 2008, disaggregated by the type of modification. Each of the numbers is a multiple of 10 because we used a 10 percent random sample and scaled up the numbers we found. The first column of Table 3 simply reports the total number of loan modifications made. Not surprisingly, modifications have become more common as the housing market has weakened. There appear to be more than 7–8 times as many modifications performed in the fourth quarter of 2008 as in the first quarter of 2007. In addition to the rapid growth in loan modifications, the composition of modifications has changed over time. This can be seen in the remaining columns of Table 3, which list the incidence of modifications of different types.¹⁵

An interesting finding is that most modifications entailed *increases* in the principal balance of a mortgage. Such increases are likely due to the addition of arrears to the outstanding mortgage balance for delinquent borrowers, and these often increase the monthly mortgage payment by a nontrivial amount. While the absolute numbers of balance-increasing modifications are still rising, they are falling as a percentage of total modifications. In the last few quarters, interest-rate reductions, which necessarily involve a decrease in the monthly mortgage payment, have become more frequent, rising to more than 26 percent of all modifications performed in 2008:Q4. Table 3 provides further information regarding the behavior of monthly mortgage payments for loans that have undergone a modification. There are several notable patterns in this table. First, as of 2008:Q4, modifications that involved payment decreases were more common than those that involved payment increases. Furthermore, the

¹⁵In many cases a mortgage will experience multiple types of modifications at the same time. For example, we see cases in the data in which the interest rate is decreased and at the same time the term of the loan is extended. Thus, the percentages in Table 3 are not calculated with respect to the number of loans modified, but rather with respect to the number of modifications performed.

average and median magnitude of payment decreases has recently increased in our sample. From 2007:Q1 to 2008:Q2, the median payment decrease ranged from approximately 10 percent to 14 percent, but then increased to approximately 20 percent and 22 percent in 2008:Q3 and 2008:Q4, respectively. Based on the logic from our simple framework above, it is likely that these will have more success than modifications involving increases in the payment and/or balance.

Another interesting observation from Table 3 is that the incidence of principal reductions is quite low in our data. This is likely due to two factors. First, the LPS dataset under-represents the subprime mortgage market.¹⁶ A few servicers that focus almost exclusively on subprime mortgages have recently begun modification programs that involve principal reduction.¹⁷ In addition, from a theoretical perspective, principal reduction plans suffer from the severe incomplete-information problem noted earlier. Balance reductions are appealing to both borrowers in danger of default and those who are not. In a recent paper, we argued that to avoid such moral hazard concerns, lenders have a strong incentive to only provide modifications to those borrowers who are most likely to default.¹⁸ Table 3 contains summary statistics regarding the characteristics at origination of both the sample of modified mortgages and the sample of all loans in the LPS dataset. The patterns that emerge from the table are consistent with such an argument. We discuss this point in more detail below. The sample of modified mortgages is characterized by substantially lower credit scores, higher loan-to-value (ltv) ratios, and slightly higher debt-to-income ratios. The discrepancy in ltv ratios may be underestimated, as the percentage of mortgages with an ltv ratio of exactly 80 percent is significantly higher in the modification sample than in the full sample. As we argued above, this likely implies a larger fraction of highly leveraged loans, for which the second liens are not observable in the data. In addition, the modification sample includes a higher fraction of mortgages with non-traditional amortization schedules, such as interest-only loans, option ARMS, hybrid ARMs, and subprime loans.

In Table 4 we compare the size of payment decrease and payment increase modifications for loans held in private-label trusts and loans held in portfolio. The results are somewhat mixed, as the size (as a percentage of the original payment) of the median payment decrease due to modification is larger for private-label loans in the first three quarters of 2008, but smaller in the final quarter. We see a similar pattern for the median payment increase due

¹⁶The majority of subprime mortgages are securitized by non-agency firms, and the LPS dataset includes approximately 35 percent of mortgages securitized by non-agency corporations.

¹⁷According to an October report by Credit Suisse, Ocwen Loan Servicing, LLC and Litton Loan Servicing LP were the only subprime servicers that had performed a nontrivial number of principal reduction modifications. Neither of these servicers contributes to the LPS dataset.

¹⁸See Foote, Gerardi, and Willen (2008) for a more detailed discussion.

to modification, while the differences are small for the mean and median payment increase.

3 Differences in Modification Behavior

In this section, we directly address the question of whether the incidence of modification is impeded by the process of securitization. We show evidence that private-label loans and portfolio loans perform similarly, both unconditionally and when observable differences between securitized and portfolio-held loans are controlled for, using both a logit model with a 12-month horizon and a Cox proportional hazard model that takes into account the problem of right censoring in the data.

To make sure that our results are robust to the type of modification performed, we use several different definitions of modification in this section. Our first measure is the number of concessionary modifications, which we define as reductions in the interest rate, reductions in the principal balance, extensions of the term, or combinations of all three. Any or a combination of these serves to reduce a borrower's monthly mortgage payment. We use this as our primary definition of modification in our analysis, as there is a consensus among most market observers that concessionary modifications are the most, or perhaps the only, effective way of preventing foreclosures. Because pooling and servicing agreements, which govern the conduct of servicers when loans are securitized, often limit modifications that change *any* of the contract terms (not just those that result in payment decreases), we broaden our definition of renegotiation to include any modification, regardless of whether it lowers the borrower's payment. As we discussed above, many, and in some subsets, most modifications, involve the capitalization of arrears into the balance of the loan and thus lead to increased payments. Finally, we attempt to include in our measure of renegotiation the number of times that lenders allow borrowers to extinguish their liabilities by repaying less than the outstanding balance of the loan. These transactions are known as short payoffs, short sales, or deeds-in-lieu of foreclosure, depending on the structure. We do this by counting the number of seriously delinquent loans that the servicer reports as paid off, and including these observations in our definition of modification.

Before turning to the regressions, however, it is instructive to look at the unconditional frequencies of modifications in the data. Panel A of Table 5 shows the unconditional frequencies for each type of investor. The first takeaway from the table is the extremely low percentages of modifications for *both* types of mortgages. Only 3 percent of 60-day delinquent loans received concessionary modifications in the 12 months following the first serious delinquency, and only 8.5 percent of the delinquent loans received *any* type of modification in the same period. These are extremely low levels of modifications, and they suggest that

even if there are contract frictions that are preventing modifications in securitized trusts, the economic effects are small. The second takeaway from the table is that the unconditional differences between portfolio loans and private-label loans are very small in absolute terms. There is a difference of approximately 0.6 percentage points and 0.3 percentage points for concessionary modifications and all modifications, respectively. These are very small differences, and they suggest that contract frictions do not play an important role in inhibiting the renegotiation process for loans in securitized trusts. However, these are unconditional statistics, and it is possible that once observable differences in the characteristics of each type of loan and borrower are accounted for, the results may change.¹⁹ Thus, we now estimate differences in modification behavior while controlling for observable loan and borrower characteristics. These characteristics include the contract interest rate at origination; the credit score of the borrower at origination; the loan-to-value ratio of the mortgage (not including second or third liens) at origination²⁰; the logarithm of the nominal dollar amount of loan; an indicator of whether the purpose of the loan was a refinance of a previous mortgage or a home purchase; an indicator of whether the loan was considered to be subprime²¹; a measure of the amount of equity in the property at the time of delinquency, specified as a percentage of the original loan balance and updated by state-level house price indexes calculated by the Federal Housing Finance Agency (FHFA)²² (and an indicator for a borrower who is in a position of negative equity at the time of delinquency, where the value of the mortgage exceeds the value of the home); and the unemployment rate of the county in which the borrower resides, calculated by the Bureau of Labor Services (BLS).²³ We also include, but do not show because of space considerations, a set of cohort dummies that control for the quarter when the mortgage was originated, information regarding the amortization schedule of the mortgage (interest-only or negative amortization, including mortgages commonly referred to as option ARMs), an indicator for whether the size of the mortgage is greater than the GSE conforming loan limits, an indicator for whether the

¹⁹For example, if private-label loans are significantly riskier, and thus better candidates for modification on average, then the unconditional difference will significantly understate things.

²⁰Because of the lack of information on second liens in the LPS data and the prevalence of second mortgages as a way to avoid paying mortgage insurance, we include an indicator variable if the ltv ratio is exactly equal to 80 percent. These are the borrowers who likely took out second mortgages, as the requirement for mortgage insurance occurs at ltv ratios above 80 percent. Our experience with other, more complete datasets also confirms that many of these borrowers are likely to have second mortgages that bring the cumulative ltv ratio up to 100 percent.

²¹This definition of subprime comes from the mortgage servicers that contribute to the LPS dataset.

²²House prices are measured at the state level using the FHFA index. We also tried using Case-Shiller metropolitan area house price indexes and found no substantive differences. We chose to use the OFHEO prices for our primary specifications because of their greater sample coverage.

²³Equity and periods of unemployment are very important determinants of a borrower's decision to default, and thus should also be important factors in the modification decision.

house is a primary residence, an indicator for adjustable rate mortgages that contain a reset provision (so-called “hybrid ARMs”), and, finally, an indicator for a borrower who does not use the corresponding property as a principal residence (this includes both properties used strictly for investment purposes, and vacation homes).

3.1 Canonical Specification Results

Panel B of Table 5 displays the estimated marginal effects from a set of logit models for the three different types of modification definitions. The dependent variable is 1 if a 60-day delinquent loan is modified at any point in the 12 months following the first delinquency. The first column considers payment-reducing (concessionary) modifications, the second column includes both payment-reducing and payment-increasing modifications, and the third column contains all modifications considered before, as well as prepayments. In all regressions, the group of portfolio-held loans is omitted from the estimation and is thus assumed to be the reference group. We cluster the standard errors at the zip code level to account for the fact that loans in the same geographical area are likely to suffer correlated (unobserved) shocks.

According to the estimates in the first column, private-label loans were approximately 0.3 percentage points less likely to receive concessionary modifications than loans held in portfolio. This estimate is economically small but statistically significant at the 10 percent level. When we consider all modifications the point estimate flips sign and becomes 0.2 percentage points (statistically insignificant), while for the third specification, private-label loans were actually 0.9 percentage points more likely to receive concessionary modifications (statistically significant). As discussed above, all of these specifications include a number of additional loan characteristics that are important in the underwriting process and, thus, likely to play an important role in the modification decision. The first observation to make regarding the results reported in Panel B is that the difference between the incidence of modification for portfolio-held loans and private-label loans becomes even smaller when these variables are controlled for in the estimation. The results also imply that loans with higher credit scores were modified less, loans with higher *ltv* ratios were modified less, larger loans were modified more, and loans with more equity at the time of delinquency were modified less. We find a sizeable difference in terms of the frequency of modification for both refinances and subprime loans. Conditional on being 60-days delinquent, subprime loans were modified about 2 percentage points more than prime loans. We estimate a model separately for subprime loans in Table 6.

Censoring is an important issue for any sample of mortgages, as there are currently

many delinquent loans that are, or will soon be, good candidates for modification, as the housing market continues to decline. For this reason, we estimate a Cox proportional hazard model of the transition from serious delinquency to modification. The Cox model is very common in the survival analysis literature, and it has the advantage of being both flexible in terms of functional form considerations, as the baseline hazard function can be treated as an incidental parameter, and easy to estimate in terms of computational considerations. The results, expressed as hazard ratios, are reported in Panel C. A hazard ratio less than 1 indicates that private-label loans were less likely to receive a modification compared to portfolio loans, while a ratio greater than 1 signifies the opposite. The estimates are consistent with what we report for the logits in the previous panel. Private-label loans were less likely to receive concessionary modifications, but this coefficient estimate is statistically insignificant. For the our other two modification definitions the sign flips, but again the result is not statistically significant. All three specifications include the same covariates that were included in the logit models.

3.2 Subsample Results

Table 6 contains further logit estimation results for various subsamples of interest to see if there are different probabilities than in the full sample. Since the subprime indicator seems to be such a powerful predictor of modification conditional on serious delinquency in Table 5, we report the estimated marginal effects for only the sample of subprime loans in the second column of Table 6. The subprime sample also has the advantage that the agencies (Fannie Mae and Freddie Mac) were unlikely to be the marginal investor for this type of loans, so it is less likely that the portfolio and private-label samples differ significantly on unobservable characteristics. In the third column, we report results from the sample of LPS mortgages for which the borrower had a FICO score of less than 620, since automated underwriting systems generally instruct lenders to engage in increased scrutiny for such loans because of increased default risk. In the fourth and fifth columns, we focus on samples of loans that we believe contain the most information regarding the borrowers, in order to try to minimize the amount of unobservable heterogeneity that could potentially be biasing the results. In the fourth column, we focus on the sample of loans for which both the DTI ratio and the documentation status contain non-missing values, while the fifth column contains results for only the loans that were fully documented (in terms of income and assets) at origination. Panel A contains both unconditional means and estimated marginal effects for concessionary modifications, while Panel B contains results for the broader definition that also includes non-concessionary modifications.

The results are largely consistent with those contained in Table 5. We redisplay the results from the full sample in the first column of Table 6 for ease of comparison. The difference in modification frequency between private-label and portfolio-held, subprime mortgages for 60-day delinquent loans is small, and not statistically different from zero for both definitions of modification. Using a FICO cutoff of 620 as an alternative definition of subprime does not seem to make much difference. The unconditional means are smaller (for both types of loans) compared to the LPS subprime sample, as the LPS definition includes most of the loans with a FICO less than 620, but also some loans with higher associated FICOs. However, the marginal effects of private-label loans estimated from the logit models are quite similar to those from the LPS subprime sample, as they are economically small, and not statistically significant. Finally, we also find small and largely insignificant results for the last two subsamples, displayed in the fourth and fifth columns of Table 6. Although, it is worth pointing out that we do find a statistically significant, positive estimate of private-label loans for the broad definition of modification (Panel B).

3.3 Alternative Delinquency Definition

As an additional robustness check, we broaden our definition of delinquency and focus on modifications performed on loans subsequent to their first 30-day delinquency, which corresponds to one missed mortgage payment. While waiting until a borrower becomes seriously delinquent (defined as 60-days) to renegotiate is common practice in the servicing industry, there are no direct contractual stipulations (to our knowledge) that restrict a servicer from modifying the loan of a borrower who is 30-days delinquent. Thus, in Table 7 we repeat our analysis of Tables 5 and 6, but condition on 30-days delinquency rather than 60-days. The table contains three panels of estimation results, one for each of our modification definitions, and all of the subsamples described considered in Table 6. The unconditional means, logit marginal effects, and Cox hazard ratios are all reported for each combination of subsample and modification definition.

The results are very similar to those from the analysis of 60-day delinquent loans. According to the full sample and subprime sample logit models, portfolio loans received slightly more concessionary modifications, and the differences (0.3 and 0.5 percentage points respectively) are statistically significant at conventional levels. However, according to the subprime sample and full documentation sample Cox models, private-label loans actually received more concessionary modifications, although those differences are also small.²⁴ The results

²⁴The logit marginal effects correspond to percentage point differences, while the Cox hazard ratios correspond to percent differences. If one expresses the logit marginal effects as a percent change of the unconditional means, those percent changes are very similar in magnitude to the Cox results.

for our second modification definition are similar, although we find more evidence of statistically significant, positive differences between the incidence of portfolio and private-level modifications. The samples of portfolio loans with non-missing information for DTI and documentation status were modified more often than the corresponding sample of private-label loans, but the magnitudes are still relatively small (10 to 20 percent difference from the unconditional mean). Finally, in Panel C, we see strong evidence for both the logit and Cox specifications, that delinquent private-label loans prepayed more often than portfolio loans. The differences are statistically significant for every one of the subsamples.

3.4 Redefault Probabilities and Cure Rates

In the previous subsections, we showed that there is little difference in the frequency of mortgage loan modifications between servicers of loans held in a private trust versus loans held in portfolio. There are two potential reasons that may explain the failure of those exercises to pick up important differences in servicer behavior that may truly exist. First, it may be that contract frictions in securitization trusts do not result in substantial differences in the frequency of modifications (the extensive margin) but do result in significant differences in the intensive margin, with respect to the types of modifications performed, the extent to which contract terms are modified, and, more broadly, the care or effort expended in each modification by private-label servicers compared to that expended by portfolio servicers. Second, there may be a type of renegotiation that our algorithm does not identify, but that is used to a large extent in loss mitigation efforts and used differently by servicers of private-label loans than by servicers of portfolio loans. For example, forms of forbearance, which are often called repayment plans in the industry, would not be picked up by our algorithm.²⁵ In this subsection, we use the LPS data to attempt to address these possibilities.

We perform two separate empirical exercises to address each of these concerns in turn. First, we compare redefault rates of private-label modified loans with those of portfolio modified loans. We define redefault as a loan that is 60 days delinquent or more, in foreclosure process or already foreclosed and now owned by the lender (REO for “real-estate-owned”) six months after the time of the modification. If there are important differences in the manner by which servicers of private-label loans modify mortgages relative to the foreclosure procedures of servicers of portfolio loans, then we would expect to see significant differences in the subsequent performance of modified loans.

Second, to address the possibility that our algorithm misses an important aspect of

²⁵However, as we argued above, PSAs do not contain restrictions on repayment plans, because they do not involve changing the terms of the mortgage. Thus, we would argue that differences in forbearance behavior that might exist could not be the result of contract frictions in securitization trusts.

renegotiation, we compare the cure rates of seriously delinquent, private-label loans to those of seriously delinquent portfolio loans. The idea behind this exercise is that any appreciable difference in servicer renegotiation behavior will manifest itself in differences in cure rates. It is important to stress however, that differences in servicer renegotiation behavior are only one potential explanation for differences that may exist in cure rates. To put this idea in the terms of logical reasoning, differences in cure rates are a necessary condition for significant differences in renegotiation behavior, but they are not a sufficient condition.

Table 8 contains the results of the redefault analysis. The first observation to note from the table is that the unconditional probability that a modified mortgage redefaults in this six-month period is very large, at about 20–40 percent for payment-reducing modifications (Panel A), and 40–50 percent for all modifications (Panel B). We argue below that the high level of redefault rates could explain why we observe so few modifications — very often they do not lead to successful outcomes even as little as six months after the modification. The second observation to note is that there is no statistically significant difference between the redefault rates of private-label loans and those of portfolio loans, once the observable characteristics of the mortgages are taken into account (this is valid for all of the subsamples). These results, combined with the statistics displayed in Table 4 suggest that there are no substantial differences in either the type of modification employed or in the care/effort expended by the two types of servicers.

Table 9 shows the results of logit models for the probability that a seriously delinquent loan subsequently cures. Our definition of a cure is that the loan is either current, 30-days delinquent, or prepaid after 12 months following the first 60-day delinquency. The first important point to make is that the unconditional cure probabilities are large (around 30 percent). Given that the unconditional modification probability is about 8 percent, this means that many loans cure without any intervention on the part of servicers. The second important observation to note in this table is that the cure probabilities for portfolio loans and private-label loans are quite similar. The unconditional cure probability is smaller by about 4.4 percentage points for private-label loans in the whole sample, but that is reduced to only 2.2 percentage points (statistically significant) when we control for observable characteristics of the loans and borrowers. We also include results for the subsamples of interest in columns 2–5. For each of the subsamples the sign of the difference actually reverses, as private-label loans were *more* likely to cure (the marginal effects are statistically significant, with the exception of the *FICO* < 620 sample). This is an important robustness check, as we argued above that unobserved heterogeneity is likely to be less of a problem in the subsamples (especially for the non-missing documentation status and DTI ratios sample and the full documentation sample). Thus, the change in the sign of the differences in

cure rates between private-label servicers and portfolio servicers suggests that unobserved heterogeneity between the two loan types plays an important role.

4 Understanding the Empirical Results

If securitization does not block renegotiation, then why is it so rare? In this section, we build a simple model of the renegotiation decision, which, in a stylized way, mirrors the net present value (NPV) calculation that servicers are supposed to perform when deciding whether to offer a borrower a modification. We show that servicer uncertainty about whether the borrower will redefault even after successful renegotiation or uncertainty about whether the borrower will cure without renegotiation can dramatically affect the NPV calculation, ruining what a naive observer might think of as a “win-win” deal for the borrower and lender. While many proponents of modification are aware of the former problem, “redefault risk,” none seem to be aware of the latter problem, which we call “self-cure risk.”

In addition to the model, we also provide institutional evidence in this section that supports our arguments and findings above. This includes evidence of low modification frequencies in previous housing busts, well before the advent of securitization trusts; the equal treatment provision statements contained in the PSAs, which direct the servicer to behave as if it was in fact the investor of the mortgage-backed security and thus the owner of the mortgages; and finally, the absence of lawsuits to date directed at servicers by investors in mortgage-backed securities, which one would expect to find if modifications were unambiguously better than foreclosures from an NPV calculation.

4.1 A Simple Model of Loss Mitigation

We consider a simple model of a lender’s decision to modify a delinquent loan.²⁶ There are three periods: $t = 0, 1, 2$. The borrower owes a mortgage payment of size m at time 1 and is due to repay the loan balance M in period 2. The mortgage is collateralized by a house, which is worth P_1 and P_2 in periods 1 and 2, respectively. In period 0, the lender has to make a decision to either modify the loan, or do nothing. If the lender fails to modify the loan, then, with probability α_0 , the borrower will default in period 1, and the lender will foreclose and recover $P_1 - \lambda$, where λ is the cost of foreclosing on the property. If the borrower does not default next period, then the lender receives the periodic payment m in period 1, and the borrower repays the loan in full in period 2. The value to the lender of

²⁶Our model shares some basic similarities with the approach in Ambrose and Capone (1996), who also identify a role for self-cure risk in assessing the profitability of a loss mitigation action.

the loan without modification equals the present discounted value of the cash flow:

$$\alpha_0 * \min[(P_1 - \lambda), M] + (1 - \alpha_0)[m + (1/R)M], \quad (1)$$

where we ignore discounting for the first period because there is no income in period 0. If the lender modifies the loan, then we assume that the borrower makes a reduced periodic payment m^* in period 1 with certainty, but then either defaults with probability α_1 or repays a modified amount M^* in period 2. The value to the lender of the modified loan is:

$$m^* + (1/R)\alpha_1 * \min[(P_2 - \lambda), M^*] + (1 - \alpha_1)(1/R)M^*. \quad (2)$$

Taking the difference between expressions (2) and (1) yields the following proposition:

Proposition 1 *Modification makes sense if:*

$$\begin{aligned} & (\alpha_0 - \alpha_1)[m^* + \frac{1}{R}M^* - \min[(P_1 - \lambda), M]] \\ & \quad - (1 - \alpha_0)[m + \frac{1}{R}M - (m^* + \frac{1}{R}M^*)] \\ & \quad + \alpha_1[m^* + \frac{1}{R}\min[(P_2 - \lambda), M^*] - \min[(P_1 - \lambda), M]] > 0. \quad (3) \end{aligned}$$

To interpret equation (3), divide the population of borrowers into three groups. The first group, with mass of $\alpha_0 - \alpha_1$ are borrowers who will repay in full with a modification but who will default otherwise. For this group, the investor gains the difference between the present value of the modified repayment $m^* + \frac{1}{R}M^*$ and the recovery given foreclosure, $\min[(P_1 - \lambda), M]$. The second group, with mass $1 - \alpha_0$, includes borrowers who will repay whether or not they receive a modification. For this group, the investor loses the difference between full repayment and the modified repayment. Gerardi and Willen (2009) refer to the first two terms as Type I error and Type II error, respectively, in analogy with the statistical concepts. In this context, Type I error corresponds to the cost of not renegotiating loans that need modifying, while Type II error corresponds to the cost of modifying loans that would be repaid in the absence of assistance. The third term, with mass α_1 , includes borrowers who will default regardless of whether they receive a modification. For these borrowers, modification yields a periodic payment, but postpones foreclosure. Whether this is good or bad for the lender depends on the evolution of house prices and the rate at which the lender discounts the cash flow.

To illustrate the implications of the model, we compute some simple comparative statics. All else being equal, an increase in α_0 makes modification more attractive to the investor, while an increase in α_1 makes modification less attractive. Intuitively, a higher α_0 means

higher Type I error and lower Type II error, and a higher α_1 implies higher Type II error. Since, in general, one would think that α_0 and α_1 would move in the same direction across borrowers, it is useful to note that an increase the gap, $\alpha_0 - \alpha_1$, makes modification more attractive.

We make three points about the model. First, when looking at the data, it is not sufficient to show that one would recover more from a modified loan than from foreclosure *ex post*, to prove that modification is *ex ante* optimal. To prove that a modification makes sense from the perspective of the lender, one must show that the Type I error, the value of the modified loans that would have defaulted, exceeds the Type II error, the value of the modified loans that would have paid off in the absence of modification. White (2009), among many others, focuses entirely on Type I error:

The average loss for the 21,000 first mortgages liquidated in November was \$145,000, representing an average loss of 55 percent of the amount due. Losses on second lien mortgages were close to 100 percent. In comparison, for the modified loans with some amount of principal or interest written off, the average loss recognized was \$23,610. This seven-to-one difference between foreclosure losses and modification write-offs is striking, and lies at the heart of the failure of the voluntary mortgage modification program. At a minimum, there is room for servicers to be more generous in writing down debt for the loans they are modifying, while still recovering far more than from foreclosures in the depressed real estate market of late 2008. I will consider some of the reasons for this apparently irrational behavior in a later section.²⁷

To see why this is wrong, take an extreme example with $\alpha_1 = 0$. In that case, the gain to modifications equals

$$\alpha_0[m^* + \frac{1}{R}M^* - \min[(P_1 - \lambda), M]] - (1 - \alpha_0)[m + \frac{1}{R}M - (m^* + \frac{1}{R}M^*)]. \quad (4)$$

With α_0 sufficiently low, modification will not make sense. To be clear, our criticism of White (2009) and others has nothing to do with the possibility that the modified loan will default, as we have assumed here that the modified loan will pay off in full.

The second point here is that both the rate at which lenders discount future payoffs and the evolution of prices affect the gains to modification. For mass $(1 - \alpha_1)$ of the borrowers, modification will simply delay foreclosure. In that case, the lender will get some extra income from any mortgage payments the borrower makes before redefaulting, but the lender has to wait longer to obtain the final payout and will get less if prices continue to fall.

²⁷White (2009), p. 14–15

The third point is that the lender's information set plays a crucial role here, and one could argue that it should only contain information outside the control of the borrower. This would limit the set to the origination characteristics of the loan, prices, and interest rates. Employment status, income, and marital status all present problems, although they can be partially overcome—as in the case of unemployment insurance. Delinquency status, which seems a natural candidate, is a difficult issue. On one hand, a borrower has virtually complete control over it. On the other hand, it is a costly signal, as a 60-day delinquency does adversely affect one's credit history and future access to credit markets. Thus, when considering ways to design a profitable modification program, which implies attempting to maximize α_0 and minimize α_1 , a lender must restrict its information set to a relatively small set of variables that are contemporaneously exogenous to the borrower.

4.2 Institutional Evidence

While the results from Section 3 may be surprising to market commentators who believe that contract frictions inherent in securitization trusts are preventing large-scale modification efforts in mortgage markets, we argue in this section that both historical evidence and evidence from securitization contracts actually support our findings.

First, we look at history. If securitization, or more precisely private-label securitization, inhibits renegotiation, then we would expect that renegotiation would have been common in the 1990s, when there was little private-label securitization, or in the 1970s, when securitization itself was rare. But, the historical evidence we have does not bear that out. In 1975, Touche Ross surveyed loss mitigation activities at savings and loans and found, "Lenders... were unwilling to either modify loans through extended terms or refinancing to a lower rate."²⁸ In the 1990s, a report commissioned by Congress to study foreclosure alternatives, said, "Along with loan modifications, long-term forbearance/repayment plans are the most under utilized foreclosure avoidance tools currently available to the industry."²⁹

Second, many observers have focused on institutional factors that inhibit loan modification when the loan is securitized, but other factors may play a similar role for portfolio lenders as well. In particular, accounting rules force lenders to take writedowns at the time of the modification (reducing Tier II capital), to identify modified loans as troubled debt restructurings (under FAS 15), and also to impose burdensome reporting requirements on modified loans including loan-specific allowances for potential losses (under FAS 114). Additionally, payments made by borrowers for loans that are subject to "troubled debt re-

²⁸Capone (1996), p. 20–21.

²⁹Capone (1996), p. x.

structurings” are recognized only as principal repayments and generate to interest income until the bank can demonstrate that a borrower is “performing.” All of the above accounting requirements potentially make modifications costly for a bank. Downey Financial, for example, attempted to refinance current borrowers out of risky option ARMs into safer, fixed-rate instruments and argued that the change should not affect their balance sheet because the borrowers had never missed payments. However, their accountants viewed the refinancings as “troubled debt restructurings,” and forced the firm to restate the share of nonperforming assets for November 2007 to 5.77 percent from 3.65 percent.³⁰

If modifications were truly in the best financial interest of investors in mortgage-backed-securities (MBS) as many commentators have alleged, we would expect to see concern on their part regarding the low levels of modifications performed to date. But, according to Cordell, Dynan, Lehnert, Liang, and Mauskopf (2008b), who interviewed a number of MBS investors, they (the investors) are not concerned that servicers are foreclosing on many more mortgages than they are modifying. Thus, there does not seem to be much concern by market participants that either incentives or contract frictions are inhibiting servicers from performing loan modifications. The evidence in the literature seems to suggest a small role for contract frictions in the context of renegotiation. In a 2007 study of a small sample of PSAs, Credit Suisse found that fewer than 10 percent of the contracts ruled out modifications completely, while approximately 40 percent allowed modifications, but with quantity restrictions,³¹ and the rest, about half, contained no restrictions on renegotiation behavior. Hunt (2009) also analyzed a sample of subprime PSAs and concluded that outright modification bans were extremely rare. A 2008 report by the COP analyzed a number of securitized mortgage pools with quantity restrictions and concluded that none of the restrictions were binding. In terms of incentive issues, Hunt (2009) found that most of the contracts in his sample explicitly instructed the mortgage servicer to behave as if it were the owner of the pool of the loans:

The most common rules [in making modifications] are that the servicer must follow generally applicable servicing standards, service the loans in the interest of the certificate holders and/or the trust, and service the loans as it would service loans held for its own portfolio. Notably, these conditions taken together can be read as attempting to cause the loans to be serviced as if they had not been securitized. (p. 8, insertion added)

³⁰<http://www.housingwire.com/2008/01/14/downey-financial-accounting-rules-suck/>

³¹The quantity restrictions often took the form of a limit (usually 5 percent) on the percentage of mortgages in the pool that could be modified without requesting permission from the trustee.

5 Conclusion

There is widespread concern that an inefficiently low number of mortgages have been modified during the current crisis, and that this has led to excessive foreclosure levels, leaving both families and investors worse off. We use a large dataset that accounts for approximately 60 percent of mortgages in the United States originated between 2005 and 2007, to shed more light on the determinants of mortgage modification, with a special focus on the claim that delinquent loans have different probabilities of renegotiation depending on whether they are securitized by private institutions or held in a servicer's portfolio. By comparing the relative frequency of renegotiation between private-label and portfolio mortgages, we are able to shed light on the question of whether institutional frictions in the secondary mortgage market are inhibiting the modification process from taking place.

Our first finding is that renegotiation in mortgage markets during this period was indeed rare. In our full sample of data, approximately 3 percent of the seriously delinquent borrowers received a concessionary modification in the year following their first serious delinquency, while fewer than 8 percent received any type of modification. These numbers are extremely low, considering that foreclosure proceedings were initiated on approximately half of the loans in the sample and completed for almost 30 percent of the sample. Our second finding is that a comparison of renegotiation rates for private-label loans and portfolio loans, while controlling for observable characteristics of loans and borrowers, yields economically small, and for the most part, statistically insignificant differences. This finding holds for a battery of robustness tests we consider, including various definitions of modification, numerous subsamples of the data, including subsamples for which we believe unobserved heterogeneity to be less of an issue, and consideration of potential differences along the intensive margin of renegotiation.

Since we conclude that contract frictions in securitization trusts are not a significant problem, we attempt to reconcile the conventional wisdom held by market commentators, that modifications are a win-win proposition from the standpoint of both borrowers and lenders, with the extraordinarily low levels of renegotiation that we find in the data. We argue that the data are not inconsistent with a situation in which, on average, lenders expect to recover more from foreclosure than from a modified loan. At face value, this assertion may seem implausible, since there are many estimates that suggest the average loss given foreclosure is much greater than the loss in value of a modified loan. However, we point out that renegotiation exposes lenders to two types of risks that are often overlooked by market observers and that can dramatically increase its cost. The first is "self-cure risk," which refers to the situation in which a lender renegotiates with a delinquent borrower who

does not need assistance. This group of borrowers is non-trivial according to our data, as we find that approximately 30 percent of seriously delinquent borrowers “cure” in our data without receiving a modification. The second cost comes from borrowers who default again after receiving a loan modification. We refer to this group as “redefaulters,” and our results show that a large fraction (between 30 and 45 percent) of borrowers who receive modifications, end up back in serious delinquency within six months. For this group, the lender has simply postponed foreclosure, and, if the housing market continues to decline, the lender will recover even less in foreclosure in the future.

We believe that our analysis has some important implications for policy. First, “safe harbor provisions,” which are designed to shelter servicers from investor lawsuits, are unlikely to have a material impact on the number of modifications and thus will not significantly decrease foreclosures. Second, and more generally, if the presence of self-cure risk and redefault risk do make renegotiation less appealing to investors, the number of easily “preventable” foreclosures may be far smaller than many commentators believe.

A Appendix: Identifying Modifications in the LPS Dataset

In this section we discuss in detail the assumptions that we used to identify modified loans in the LPS dataset. The LPS dataset is updated on a monthly basis, and the updated data include both new mortgages originated and a snapshot of the current terms and delinquency status of outstanding mortgages. Essentially, for a given mortgage, we compare the updated terms to the terms at origination, as well as the change in terms from the proceeding month, and if there is a material change over and above the changes stipulated in the mortgage contract, then we assume that the contract terms of the mortgage have been modified.

A.1 Interest Rate Reductions

We use a different set of rules to identify reduced interest rates for fixed-rate mortgages (FRM) and adjustable-rate mortgages (ARM). In principle, identifying a rate change for an FRM should be easy, since by definition the rate is fixed for the term of the mortgage. However, after a detailed inspection of the LPS data, it became apparent that some of the smaller rate fluctuations were likely due to measurement error rather than to an explicit modification. Thus, we adopt a slightly more complex criterion: The difference between the rate at origination and the current rate must be greater than 50 basis points; *and* the difference between the rate in the previous month and the current rate must be greater than 50 basis points; *and* either the mortgage must be 30-days delinquent with the loan currently in loss mitigation proceedings (as reported by the servicer) or the difference between the rate in the previous month and the current rate must be greater than 300 basis points (which allows for the possibility that a loan that is current could feasibly qualify for a modification).

Identifying interest rate reductions for ARMs is slightly more complicated, since by definition the interest rate is variable and can move both up and down. The LPS data contain the information necessary to figure out how much the interest rate should move from month to month. This rate is often referred to as the fully indexed rate, as it is normally specified as a fixed spread above a common nominal interest rate. The LPS dataset contains information regarding the initial rate, the appropriate index rate, and the spread between the index and the mortgage rate. In addition, the majority of ARMs are characterized by a period at the beginning of the contract in which the interest rate is held constant (these mortgages are often referred to as hybrid ARMs). At the end of this period, the interest rate adjusts (or resets) to a certain spread above an index rate and then subsequently adjusts at a specific frequency. The LPS dataset also contains information regarding the length of

the initial fixed period, enabling us to identify this period in the data and determine the point at which the interest rate should begin to adjust (we refer to this period as the reset date). Our criterion for identifying an interest rate reduction for an ARM is as follows: The difference between the rate at origination and the current rate must be greater than 50 basis points; *and* the difference between the rate in the previous month and the current rate must be greater than 50 basis points; *and* if the reset date has passed, then the difference between the fully-indexed rate and the current rate must be at least 100 basis points ; *and* either the mortgage must be 30-days delinquent with the loan currently in loss mitigation proceedings (as reported by the servicer) or the difference between the rate in the previous month and the current rate must be greater than 300 basis points (which allows for the possibility that a loan that is current could feasibly qualify for a modification). In addition, we allow for more modest month-to-month decreases in the interest rate (200 to 300 basis points) as long as there is also a positive change in the delinquency status of the loan (that is, the loan is reported to be less delinquent). Our inspection of the data suggests that the majority of modifications involve a resetting of the delinquency status back to current, or a minor delinquency, so conditioning on this change likely eliminates many false positives.

A.2 Term Extensions

In theory, it should be straightforward to identify term extensions in the LPS data, but it can be tricky to do so because of possible measurement error in the variable that measures the remaining maturity of each loan. We defined a term extension in the LPS dataset to be a case in which the loan was at least 30-days delinquent at some point and the number of years remaining increases by at least 20 months *or* the change in number of years remaining is greater than the difference between the original term of the loan and the remaining term (for example, if the original maturity is 360 months, and the loan has 350 months remaining, then the increase in length must be at least 10 months) and, finally, either the monthly payment decreases *or* the principal balance increases *or* the loan is in loss mitigation.

A.3 Principal Balance Reductions

A reduction in the remaining balance of a mortgage is perhaps the most difficult type of modification to identify because of the prevalence of “curtailment” or partial prepayment among mortgage borrowers. For example, it is common for borrowers to submit extra mortgage payments in order to pay down the loan at a faster rate. For this reason, we were forced to adopt strict criteria to limit the number of false positives. Our criterion for identifying a principal balance reduction is as follows: The month-to-month decrease in

the remaining principal balance must be at least -10 percent and cannot be more than -30 percent (the upper bound does not matter as much as the lower bound—we experimented with -40 percent and -50 percent, but did not find a substantial difference); the principal balance recorded in the previous month must be greater than \$25,000 (since we throw second liens out, and look only at mortgages originated after 2004, this cutoff does not bind often); the month-to-month payment change must be negative (there are only a few cases in which the principal balance is reduced without a corresponding decrease in the payment, but in these cases the term is extended, and thus is picked up in our code for identifying term extensions); and, finally, the mortgage must be either 30-days delinquent or currently in loss mitigation proceedings (as reported by the servicer).

A.4 Principal Balance Increases

For interest-only and fully-amortizing mortgages, identifying an increase in the principal balance due to the addition of arrears is relatively straightforward. It becomes trickier for mortgages that allow for negative amortization, as the principal balance is allowed to increase over the course of the contract, by definition. For interest-only and fully-amortizing mortgages our criterion is: The month-to-month principal balance must increase by at least 0.5 percent (to rule out measurement error in the data); the loan must have been at least 30-days delinquent at the time of the balance increase; and, finally, the month-to-month payment change must be positive unless there is also a corresponding increase in the term of the loan. For mortgages that allow for negative amortization, the criterion is similar, except that the balance increase must be at least 1 percent and there must be a positive change in the delinquency status of the loan.

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Table 1: Examples of modifications in the data.

Example 1: Servicer cuts interest rate, capitalizes arrears in the balance of the loan and extends term to 40 years.

Date	MBA Delinq. Stat.	Interest Rate	Monthly Payment	Outstanding Balance	Remaining Term in Months
2008m10	9	6.5	907	141,323	340
2008m11	9	6.5	907	141,323	339
2008m12	9	6.5	907	141,323	338
2009m1	C	4.5	660	146,686	479

Example 2: Servicer capitalizes arrears into the balance of the loan but otherwise leaves the loan unchanged.

Date	MBA Delinq. Stat.	Interest Rate	Monthly Payment	Outstanding Balance	Remaining Term in Months
2008m5	6	9.25	1,726	208,192	346
2008m6	9	9.25	1,726	208,192	346
2008m7	9	9.25	1,726	208,192	346
2008m8	C	9.25	1,815	218,316	341
2008m9	C	9.25	1,815	218,184	340

Table 2: Robustness of the modifications algorithm

False positives by type of modifications

	# of Modifications Using WF CTS Data	False Positives
FRM Rate Reduction	5,381	8.0%
ARM Rate Reduction	8,951	22.0%
Principal Reductions	470	1.9%
Principal Increases	13,010	12.8%
Term Increases	394	2.3%

Overall success of algorithm

	No Mod Using Our Algorithm	Mod Using Our Algorithm	Total
No Mod in WF Data	2,329,187	3,559	2,332,746
Mod in WF Data	3,627	17,514	21,141
Total	2,332,814	21,073	2,353,887

Notes: We test our algorithm on a dataset of securitized mortgages in which the trustee has identified modifications (data is from Wells Fargo Trustee Services). The lower panel shows that about 17.2% of our modifications are false positives, meaning that we identify modifications but the trustee does not and about 16.9% are false negatives, meaning that the trustee identifies a modification but we do not.

Table 3: Modification Statistics

(1) By Type of Modification: 2007:Q1–2008:Q4

	# Loans Modified	Interest Rate Reductions		Principal Balance Reductions		Principal Balance Increases		Term Extensions	
		#	(% total)	#	(% total)	#	(% total)	#	(% total)
2007:Q1	10,940	600	5.3	700	6.2	8,660	76.4	1,380	12.2
2007:Q2	14,600	820	5.4	550	3.7	11,630	77.3	2,050	13.6
2007:Q3	17,720	770	4.1	810	4.3	15,170	81.2	1,940	10.4
2007:Q4	27,150	2,990	9.7	700	2.3	22,520	72.8	4,740	15.3
2008:Q1	36,230	6,010	13.8	900	2.1	32,100	73.8	4,500	10.3
2008:Q2	44,750	9,050	16.4	1,300	2.4	39,750	72.1	5,030	9.1
2008:Q3	62,190	16,280	20.3	940	1.2	56,940	70.9	6,110	7.6
2008:Q4	74,800	28,630	26.7	1,450	1.4	65,960	61.5	11,230	10.5

(2) By Payment Change

	Payment Decreases						Payment Increases					
	#	mean Δ		median Δ		#	mean Δ		median Δ			
		\$	%	\$	%		\$	%	\$	%		
2007:Q1	2,080	-492	-13.2	-157	-10.0	5,020	106	6.7	62	4.4		
2007:Q2	2,060	-464	-12.7	-141	-9.6	7,710	120	7.0	63	4.4		
2007:Q3	2,470	-290	-12.9	-125	-9.7	10,380	110	6.7	60	4.3		
2007:Q4	5,600	-367	-15.3	-159	-11.7	14,540	100	5.9	59	3.9		
2008:Q1	11,500	-358	-14.0	-210	-13.2	18,720	108	6.5	62	4.3		
2008:Q2	18,660	-425	-16.1	-239	-14.1	20,770	124	7.4	69	4.1		
2008:Q3	31,770	-562	-21.5	-365	-20.2	26,400	124	6.3	63	3.6		
2008:Q4	48,000	-503	-22.9	-315	-21.7	22,520	104	6.0	53	3.6		

(3) Loan Characteristics of Modified Mortgages

	All Loans					Modifications				
	#	mean	p25	p50	p75	#	mean	p25	p50	p75
FICO (at origination)	1,892,777	706	660	713	762	17,533	622	580	621	662
LTV (at origination)	2,250,162	75	67	79	85	21,675	82	78	80	90
DTI (at origination)	1,346,093	37	28	38	45	13,945	41	35	41	47
Mortgage balance (at origination)	2,267,497	231K	121K	185K	288K	21K	234K	121K	186K	294K
% characterized as										
LTV = 80		14.4					21.7			
Subprime		6.8					47.4			
Fixed		71.2					39.7			
Hybrid ARM		7.7					26.2			
IO-ARM		11.3					13.1			
IO-Fixed		2.1					2.7			
Option-ARM		5.1					12.0			
Option-Fixed		0.3					1.4			
Owner		89.3					96.0			
Investor		7.1					2.6			
Vacation Home		3.7					1.1			
Purchase		51.9					49.0			
Low/no documentation		29.2					20.4			

Notes: These statistics were computed using a 10% random sample of the LPS data. Quantities obtained from the data are multiplied by a factor of 10. The percentages in panels (1) and (2) are taken with respect to the total number of modifications, and *not* loans modified. Thus, there is double-counting in the sense that some loans received multiple types of modifications in a given quarter.

Table 4: Modification Comparison by Payment Change

<i>Private-label Modifications</i>										
	Payment Decreases					Payment Increases				
	#	mean		median		#	mean		median	
		\$	%	\$	%		\$	%	\$	%
2007:Q1	106	-614	-14.42	-162	-10.85	239	121	6.02	76	3.37
2007:Q2	110	-505	-12.02	-222	-9.30	364	168	7.96	76	3.49
2007:Q3	128	-261	-11.82	-131	-8.42	558	145	7.52	75	3.65
2007:Q4	288	-313	-13.38	-163	-12.36	741	125	6.24	74	3.52
2008:Q1	634	-393	-16.12	-261	-15.65	938	133	6.76	79	4.08
2008:Q2	1,014	-540	-18.94	-334	-17.89	1,241	152	8.14	83	4.08
2008:Q3	1,778	-641	-22.01	-423	-19.95	1,805	137	6.22	70	3.31
2008:Q4	1,993	-565	-21.73	-367	-20.13	1,398	118	5.91	61	3.23
<i>Portfolio Modifications</i>										
	Payment Decreases					Payment Increases				
	#	mean		median		#	mean		median	
		\$	%	\$	%		\$	%	\$	%
2007:Q1	28	-759	-20.90	-428	-17.19	128	106	7.78	52	5.46
2007:Q2	19	-1172	-25.17	-656	-28.07	222	81	6.11	55	5.28
2007:Q3	31	-395	-17.13	-168	-15.29	255	71	6.13	43	5.37
2007:Q4	90	-474	-11.11	-90	-2.48	292	70	5.50	37	4.29
2008:Q1	187	-369	-10.00	-183	-8.08	331	80	6.59	33	3.97
2008:Q2	309	-304	-10.90	-117	-6.64	405	63	5.59	34	3.56
2008:Q3	376	-585	-25.19	-295	-17.85	359	105	7.04	39	4.26
2008:Q4	616	-794	-31.91	-384	-25.04	389	59	5.48	35	3.51

Table 5: Modifications (Main Sample)

Panel A: Unconditional Percentages			
	Concessionary Mods	All Mods	All Mods + Prepayments
Portfolio	0.032	0.087	0.147
Private-label	0.026	0.094	0.155

Panel B: Logit Regressions (12 month horizon)			
	Concessionary Mods	All Mods	All Mods + Prepayments
Private-label	-0.003	0.002	0.009
	-1.69	0.58	1.95
Initial Rate	0.001	-0.004	-0.007
	1.45	-5.7	-7.25
LTV Ratio	0	0	-0.002
	-0.24	-1.68	-11.14
LTV = 80	0	-0.014	-0.034
	-0.18	-6.25	-11.7
FICO	0	0	-0.002
	-0.02	-0.43	-4.62
FICO ²	0	0	0
	-0.39	-0.08	3.95
FICO < 620	0.002	0.029	0.034
	0.53	3.43	3.42
620 ≤ FICO < 680	0.005	0.017	0.024
	1.46	2.95	3.41
Log Original Amount	0.004	0.007	0.022
	3.12	2.96	7.47
Equity at Delinquency	-0.001	-0.003	0
	-0.4	-1.09	0
Negative Equity	-0.006	-0.022	-0.022
	-1.6	-3.17	-1.77
Unemployment	0	-0.002	-0.005
	-0.37	-3.13	-4.37
Refi	0.006	0.015	0.04
	4.14	5.98	11.67
Subprime	0.02	0.037	0.042
	9.32	11.71	10.87
Other Controls	Y	Y	Y
# Mortgages	66,541	66,541	66,541

Panel C: Duration Model			
	Concessionary Mods	All Mods	All Mods + Prepayments
Private-label	0.921	1.002	1.018
	-1.41	0.07	0.68
# Mortgages	87,343	87,343	87,343

Notes: Other controls include indicator variables for Jumbo, Option, Hybrid and Interest-Only mortgages, as well as for condos and multifamily homes. Panel B shows the marginal effects of logit regressions with a 12-month horizon, t-statistics shown below the coefficients. Standard errors are clustered at the zip code level. Panel C shows hazard ratio estimates from a Cox proportional hazards model.

Table 6: Modifications (Robustness tests with alternative samples)

Panel A: Concessionary Modifications					
	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.032	0.047	0.034	0.028	0.023
Private-label Mean	0.026	0.037	0.031	0.033	0.037
Marginal Effect (private-label)	-0.003 -1.69	-0.004 -0.94	-0.003 -0.77	0 -0.14	0.007 1.46
# Mortgages	66,541	33,719	27,639	25,543	18,097

Panel B: All Modifications					
	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.087	0.111	0.097	0.092	0.077
Private-label Mean	0.084	0.103	0.109	0.107	0.124
Marginal Effect (private-label)	0.002 0.58	0.004 0.61	0.007 1.06	0.006 0.97	0.025 2.94
# Mortgages	66,541	33,719	27,639	25,543	18,097

Notes: Portfolio and private-label means are unconditional probabilities of modification in each sample. Marginal effects are computed from logit models with a 12-month horizon that include all the controls in Table 5. Standard errors are clustered at the zip code level. t-statistics are reported below the marginal effects.

Table 7: Modifications Conditional on 30 Days Delinquency (Logits)

Panel A: Concessionary Mods					
	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.014	0.025	0.016	0.014	0.012
Private-label Mean	0.014	0.021	0.016	0.017	0.019
Marginal Effect (Logit)	-0.003 -2.72	-0.005 -2.31	-0.001 -0.55	-0.002 -1.57	0.001 0.37
Hazard Ratio (Cox)	1.03 0.59	1.147 1.83	1.027 0.31	0.969 -0.42	1.237 2.34
# Mortgages	120,558	51,285	43,550	47,993	34,403

Panel B: All Mods					
	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.038	0.056	0.051	0.042	0.052
Private-label Mean	0.042	0.055	0.051	0.047	0.035
Marginal effect (Logit)	-0.004 -2.39	-0.007 -1.79	-0.004 -1.22	-0.008 -3.16	-0.001 -0.2
Hazard Ratio (Cox)	1.043 1.42	0.951 -1.05	1.008 0.17	0.909 -2.23	1.065 1.21
# Mortgages	120,558	51,285	43,550	47,993	34,403

Panel C: All Mods + Prepayment					
	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.145	0.195	0.152	0.147	0.13
Private-label Mean	0.174	0.211	0.218	0.185	0.198
Marginal effect (Logit)	0.023 7.31	0.021 2.98	0.044 6.46	0.016 3.47	0.029 4.54
Hazard Ratio (Cox)	1.158 9.09	1.05 1.69	1.181 5.72	1.098 3.88	1.202 6.56
# Mortgages	120,558	51,285	43,550	47,993	34,403

Notes: Portfolio and private-label means are unconditional probabilities of modification in each sample. Marginal effects are computed from logit models with a 12-month horizon that include all the controls in Table 5. Hazard ratios are computed from Cox proportional hazard models with the same controls as in Table 5. *z*-statistics are shown below the coefficients, and *t*-statistics are reported below the marginal effects. Standard errors are clustered at the zip code level. Sample sizes refer to the logit regressions. The sample sizes for the Cox models are slightly larger.

Table 8: redefault Conditional on Modification

Panel A: Payment Reducing Mods					
	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.308	0.386	0.332	0.228	0.249
Private-label Mean	0.358	0.392	0.371	0.362	0.359
Marginal effect (Logit)	0.016 0.66	-0.001 -0.03	-0.015 -0.35	0.03 0.81	-0.004 -0.1
# Mortgages	4,626	2,514	1,562	1,475	1,135

Panel B: All Mods					
	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.393	0.53	0.444	0.404	0.403
Private-label Mean	0.449	0.5	0.501	0.482	0.482
Marginal effect (Logit)	0.008 0.58	-0.023 -0.84	-0.009 -0.38	-0.021 -0.97	-0.033 -1.24
# Mortgages	14,796	7,073	5,344	4,594	3,620

Notes: redefault is defined as loans that are 60 days delinquent, 90 days delinquent, in the process of foreclosure or in REO 6 months after the modification. Marginal Effects refer to the marginal effects of a logit model with a horizon of 6 months. t-statistics shown below the marginal effects. Standard errors are clustered at the zip code level.

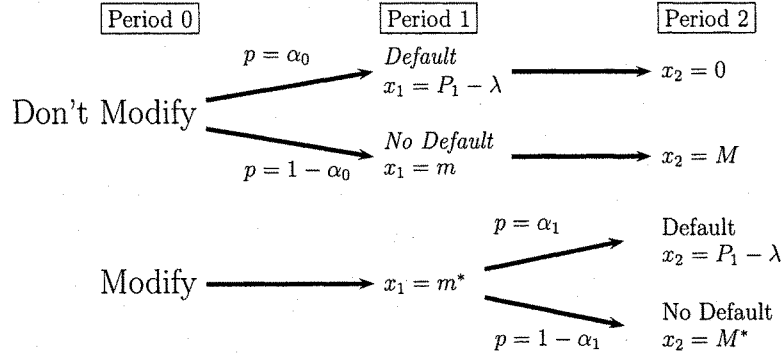
Table 9: Cure Conditional on 60 Days Delinquency

	All Loans	Subprime	<i>FICO</i> < 620	Non-missing Documentation and DTI	Fully Documented
Portfolio Mean	0.300	0.257	0.320	0.280	0.299
Private-label Mean	0.256	0.289	0.328	0.289	0.324
Marginal effect (Logit)	-0.022 -4.32	0.043 4.31	0.004 0.44	0.022 2.8	0.025 2.43
# Mortgages	66,451	33,719	27,639	25,543	18,097

Notes: The dependent variable ("Cure") is defined as a loan that is either current, 30 days delinquent, or prepaid 12 months after the first 60-day delinquency. Portfolio and Private-label means are unconditional probabilities of modification in each sample. Marginal effects are computed from logit models with a 12-month horizon that include all the controls in Table 5. Standard errors are clustered at the zip code level. t-statistics are reported below the marginal effects.

Figure 1:

(1) Model of loan modification



(2) Understanding the lender's gains from modification

Share of borrowers	$1 - \alpha_0$	$\alpha_0 - \alpha_1$	α_1
Description	Borrower always repays Lender loses because borrower would have paid in full	Modification effective Lender gains because modified payments worth more than foreclosure	Borrower never repays Foreclosure is delayed May or may not help lender
Net gain	$m^* + \frac{1}{R}M^* - (m + \frac{1}{R}M)$	$m^* + \frac{1}{R}M^* - (P_1 - \lambda)$	$m^* + \frac{1}{R}(P_2 - \lambda) - (P_1 - \lambda)$
Error	"Type II error" Costly assistance to borrowers who can pay	"Type I error" Don't help borrowers who would have defaulted	"Type III error" Lender loses if R is large or if $P_1 - P_2$ is big

PREPARED STATEMENT OF MARY COFFIN
EXECUTIVE VICE PRESIDENT, SERVICING DIVISION,
WELLS FARGO HOME MORTGAGE

JULY 16, 2009

Chairman Dodd, Ranking Member Shelby and Members of the Committee, I'm Mary Coffin, executive vice president of Wells Fargo Home Mortgage Servicing. Thank you for inviting me to speak today.

Throughout this historic public and private sector collaboration, Wells Fargo has considered it our leadership responsibility to champion solutions. We have played a key role in creating streamlined, unified modification programs to help customers in need.

A prime example of our work with the Administration is the new *Homeowner Affordability and Stability Plan*, which we fully support. Early indications are that the *Home Affordable Refinance Program* (HARP) and Home Affordable Modification Program (HAMP) are of great value, and will benefit a significant number of families.

In fact, we believe the Administration's goal to help as many as 7–9 million homeowners over the next few years is well within reach. In the first half of 2009, through lower rates, refinances and modifications, Wells Fargo alone has helped close to 1 million American homeowners.

We refinanced three-quarters of a million customers through HARP and standard programs. And, since our company represents approximately 20 percent of the market, we could estimate that close to 4 million Americans industry-wide have already refinanced into lower mortgage payments.

In these turbulent times, it is important to note that more than 90 percent of our borrowers remain current on their mortgage payments. To help those in need of assistance in the first half of this year, we have provided more than 200,000 trial and completed modifications, an increase of about 100 percent for the same period one year ago. Notably, last month, 83 percent of Wells Fargo's modifications resulted in a payment reduction which increases the probability customers will sustain these payments and, in turn, lowers re-default rates and foreclosures.

Acutely aware of the importance of speed, Wells Fargo worked with the government aggressively to develop and deliver HARP and HAMP. We did this in a way that was mindful of our responsibility to American taxpayers to execute solutions for those truly in need.

Speed of execution was complicated by the multiple versions of the program—each with unique contract requirements.

- On March 4, the Administration first announced the components of the *Homeowner Affordability and Stability Plan*.
- By April 6, we received the final HAMP guidelines from Fannie and Freddie, and began implementing this program for these customers.
- On April 13, we were the first to sign a HAMP contract for loans we service for private investors as well as for loans in our owned portfolio. Further details for this program were finalized by May 14, and we began offering it 9 days later.

Since January, we have been providing loan workouts to Wachovia option ARM customers who are struggling with their payments and, at the end of this month, we will add HAMP as yet another potential solution.

With this addition, we will have fully executed HAMP for almost all of our at-risk borrowers. It should be noted that the Administration has not yet made HAMP available for FHA, VA, and home equity borrowers.

Since we service one-third of the Nation's FHA loans, we're hopeful that the government will soon provide this program, as well as the second-lien program as it was initially described to us.

As of June 30, Wells Fargo was in the process of finalizing 52,000 *Home Affordable Modifications*. When working with all of our seriously delinquent borrowers, 30 percent are not eligible for HAMP because they have an FHA or VA loan and another 15 percent do not meet the basic program requirements. Of the remaining 55 percent, we are actively working with half, and the other half has not yet chosen to work with us.

For those borrowers who don't qualify for HAMP, we immediately seek to find another modification or alternate solution to avoid foreclosure. Before any home moves to foreclosure sale, we conduct a final quality review to ensure all options have been exhausted.

We understand this time has been frustrating for our at-risk customers and that they are anxious and in need of answers.

With the President's February 18 announcement that refinance and modification programs would be forthcoming, we began to experience a large increase in customer inquiries. Knowing this would occur, we anticipated the influx, and increased and trained team members to handle it. Yet, it has been challenging to meet customer expectations as the various program details were provided to us over a period of 90 days.

While we forecasted an increase in inquiries—even from customers current on their mortgage payments—our forecast turned out to be low. Historically, on a monthly basis, 5 to 10 percent of inquiries for loan workouts came from borrowers who were current. Since the announcement and the related increased focus on imminent default, that statistic has risen to nearly 40 percent. Of course, not everyone who calls qualifies for imminent default.

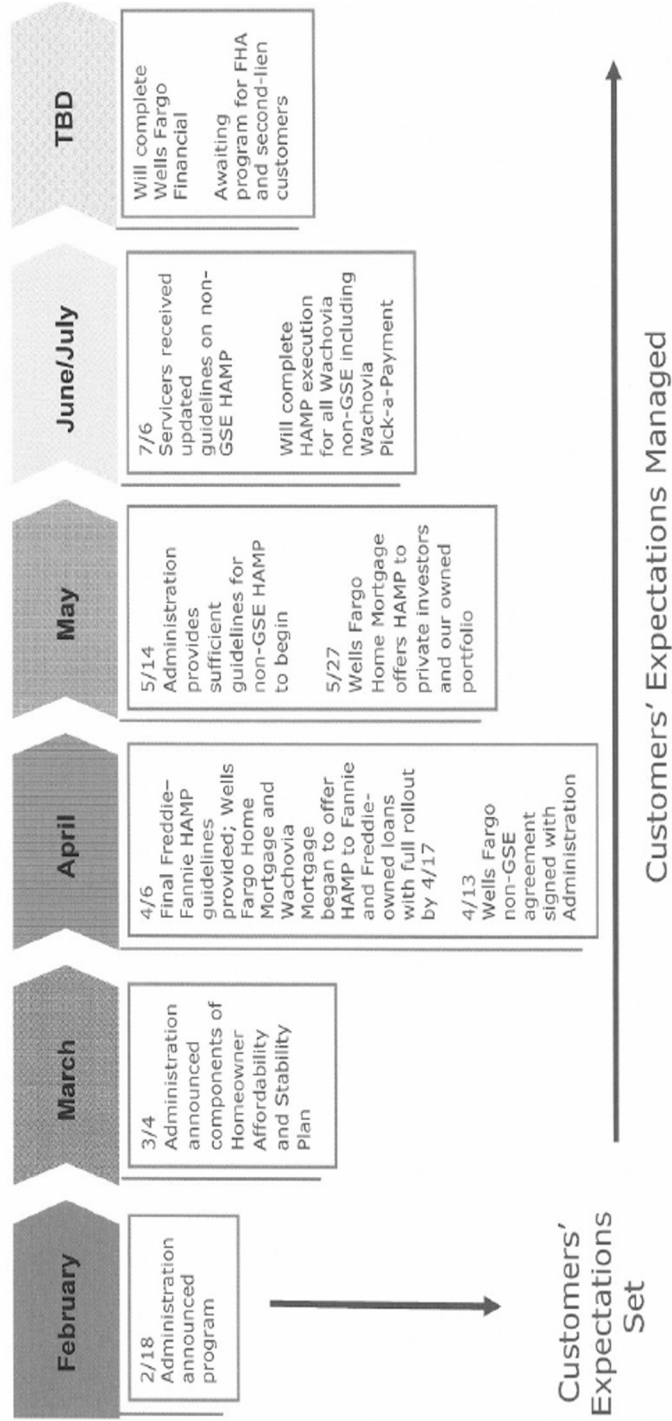
To manage this demand:

- we have implemented mandatory overtime;
- we have streamlined the receipt, imaging and processing of the required documents;
- we are upgrading systems to handle escrow requirements for home equity loans and lines; and
- most importantly, we have increased our trained staff by 54 percent over the first half of this year to 11,500 default team members—all of whom are U.S. based.

In conclusion, we can sincerely tell you we have been working very hard to responsibly execute these programs and fully support them. We will continue to work with the government, consumer counselors, non-profit agencies and others to reduce foreclosure, save homes, and quickly maintain, sell and donate foreclosed properties in order to stabilize our economy.

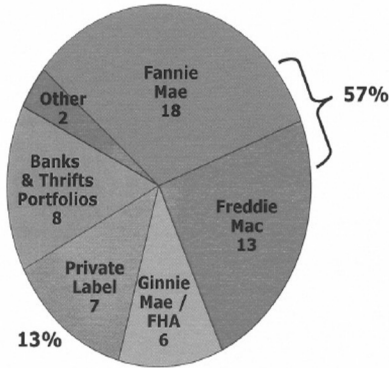
Our sincere thank you for all you've done to help us drive home retention by making the Nation aware of the options available to those in need. I'd be glad to answer any questions you may have.

Home Affordable Modification Program Timeline



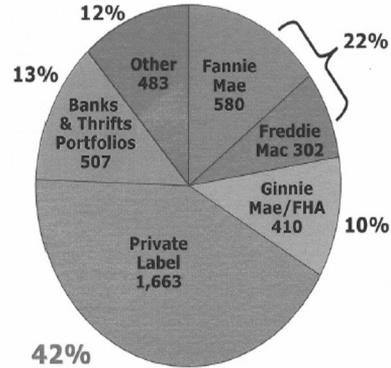
Q1 2009 Industry Seriously Delinquent Loans by Investor

Mortgages Outstanding
(millions)



Total: 54.5 million

Seriously Delinquent Mortgages
(thousands)



Total: 3.9 million

Source: FHFA, Freddie Mac

PREPARED STATEMENT OF CURTIS GLOVIER
MANAGING DIRECTOR, FORTRESS INVESTMENT GROUP,
ON BEHALF OF THE MORTGAGE INVESTORS GROUP COALITION
JULY 16, 2009

Mortgage Investors Coalition Testimony

Thank you for inviting me to testify today. My name is Curtis Glovier and I am a Managing Director at Fortress Investment Group. I am also a member of the Mortgage Investors Coalition, which was organized to develop investor consensus on current public policy initiatives and to provide policy makers with the mortgage investor's point of view. I am testifying today in my capacity as a member of the Mortgage Investors Coalition.

Allow me to start, Chairman Dodd, by commending you, Ranking Member Shelby and the other members of the Committee for your leadership for well over two years, going back to before the financial crisis, in trying to pursue every possible action to help keep Americans in their homes. We share your frustration with the slow pace of efforts to help homeowners get out of bad mortgages and into mortgages that will allow them to stay in their homes and build equity at the same time.

I also want to thank you particularly, Mr. Chairman, for co-authoring with Chairman Frank a letter last week highlighting the need to help families keep their homes and avoid foreclosure. We agree with your diagnosis of the Hope for Homeowners program ("HFH") and offer our support to assist American families' participation in this program, so they may be able to keep their homes and build equity. The discounted refinance program offered by HFH provides the best long term solution for the homeowner and for the recovery of the U.S. housing market.

My testimony today represents the views of the Mortgage Investors Coalition, as well those of other mortgage investors whose thoughts I have obtained through numerous conversations I have had in the course of my professional dealings and my participation in industry groups. The Mortgage Investors Coalition was formed in

April 2009 and currently has 11 member firms with about \$200 billion in total assets under management and over \$100 billion in current outstanding principal balance of investments in residential mortgage backed securities. In my testimony, I will briefly describe the composition of the mortgage market and some of the inherent conflicts that could be contributing to the difficulty in showing sufficient progress in stemming foreclosures.

Investors in private-label (non-Federal agency) mortgage-backed securities include asset managers, charitable institutions, endowments, foundations, hedge funds, insurance companies, investment banks, municipalities, mutual funds, pension funds, trusts, sovereign wealth funds, universities and others. Thus, many of the beneficiaries of these investments are ordinary American citizens—people with pensions, people with life insurance policies or mutual fund investments, and people who benefit from services provided by charities, universities, and state and local governments.

First, I'd like to briefly describe the residential mortgage market. The mortgage market consists of approximately \$11 trillion in outstanding mortgages. Of that \$11 trillion, \$5.4 trillion are held on the books of the GSE's as agency mortgage-backed securities (issued by one of the agencies) or in whole loan form. Another \$3.6 trillion are on the bank balance sheets as whole loans or securities in their portfolios, of which \$1.1 trillion are second liens (home equity loans/lines of credit or closed end second mortgages). Of the \$1.1 trillion outstanding second mortgages, only 3.7 percent of the total (or \$41 billion) is held in securitized form. The remaining \$1.8 trillion in first lien mortgages reside in private label mortgage-backed securities. The Residential Mortgage Backed Securities (RMBS) market has efficiently provided mortgage financing for millions of American families and has served as a means to extend credit throughout the American economy and the world. While the Federal government's actions to bolster Fannie Mae and Freddie Mac and to broaden the FHA's mandate have proven to be critical stopgap measures during the housing and economic crisis, a revival of the RMBS market and a return of private investors to that market is seen by many as a prerequisite to the recovery of the U.S. housing market and a return to normalcy in the capital markets. The Federal government cannot by itself provide the liquidity necessary to finance the national housing markets.

The process by which residential mortgage-backed securities are created begins when a borrower obtains a mortgage loan from a lender. After the loan is made, the loan is pooled together with other mortgage loans and placed into a trust. The trust is administered by a trustee and one or more servicers, who are the face of the trust to homeowners. Investors in the trust generally have no interaction with the homeowners, and also have extremely limited decision-making authority with respect to modifications, foreclosures and other servicing actions. Very often, the original lender, or its affiliate, acts as servicer once the loans are securitized. Loan servicing is relatively concentrated. Roughly 88 percent of subprime loans and 69 percent of all residential mortgage loans are serviced by 18 servicers, and 55 percent of all mortgages are owned by or serviced by the 4 largest banks.

Returning homeowners to a positive equity position provides significant opportunity and motivation for at-risk homeowners to remain in their homes and communities. A short refinancing under HFH solves both the affordability and negative equity problems plaguing homeowners at risk of foreclosure today. The program was created to reduce principal on the existing senior lien mortgage and to eliminate the existing subordinate second lien, which can prevent unnecessary foreclosures. The Mortgage Investor Coalition believes that a properly implemented Hope for Homeowners program will not only provide stability for homeowners, but will help stem the declines in the housing markets and provide certainty for the fixed income capital markets, which will bolster financial markets in general and promote increased lending and reinvestment in mortgages. We believe the program will prevent additional foreclosure inventory from adding to the overhang of bank owned properties in the residential real estate market, thereby helping to establish a floor for housing prices.

I would like to reiterate what we, the Mortgage Investors Coalition, have been stating—from Capitol Hill, to the Departments of Treasury and Housing and Urban Development, and with Community Housing Advocates. The best solution to our Nation's mortgage crisis is to significantly forgive principal on first and second lien mortgage debt in connection with the refinancing of the overextended homeowner into a new, low interest rate mortgage through the Hope for Homeowners program. The burden of solving the housing crisis should not fall squarely on the shoulders of any one stakeholder, and investors are willing to do our part by making a significant sacrifice in reducing mortgage principal.

Investors seek a sustainable mortgage restructuring program that works in the best interest of all parties and addresses the multiple factors that have contributed to homeowner re-defaults. The solutions that have been offered to date have been sub-optimal for the homeowner in that they fail to address the entire consumer debt burden, and overlook the pernicious effects of negative equity. Compared to a short refinance program such as HFH, a modification approach, such as the Making Home Affordable Program, has a notable shortcoming: by not addressing negative equity, homeowners are trapped in a mortgage that cannot be refinanced and a house that cannot be sold. When the program ends in five years, the interest rate on both the first and second mortgage will reset higher, the outstanding balance of the combined mortgage debt is likely to still exceed the value of the home, and there could be a meaningful risk of a re-default. The low prices of securities in the mortgage market today in part reflect the great uncertainty of future cash flows and values associated with such modified loans.

It is our understanding that the Committee would like to examine the reason more Hope for Homeowners refinancings have not occurred. The following is our analysis of what has happened since this Committee created and Congress passed the Helping Families Save Their Homes Act, modifying the Hope for Homeowners program.

While there are still operational hurdles to overcome in implementing a more effective program, the major impediment to the viability of the program is the volume of second mortgages or second liens outstanding. The second lien problem exists because many banks and their affiliated servicers offered additional forms of financing to consumers, such as home equity loans and second mortgages. As indicated earlier, while a small percentage of second mortgages were sold to investors, the vast majority remain on the balance sheets of our Nation's largest financial institutions. In fact, the four banks that service approximately 55 percent of mortgages held roughly \$441 billion of second liens on their balance sheets as of December 31, 2008. Banks have favored loan modification programs such as Making Home Affordable that defer the recognition of losses on the second lien portfolios. That program improves the cash flow available to the second mortgage at the expense of the first mortgage and defers the immediate loss that would be recognized in a foreclosure, short sale or short refinance. In these negative equity scenarios, the second lien would receive no proceeds in a foreclosure action; on the other hand, the modification program allows this uncollateralized obligation to remain outstanding and on the books of the financial institution as a performing asset, even though the homeowner has no equity in their home. The second lien is subordinate to the first lien and often has a higher interest rate. In the vast majority of cases, when a first mortgage is delinquent, so is the second lien. Our analysis of 44.1 million first lien loans from a primary credit bureau database indicated that of all second lien mortgages, only 3 percent are current with a corresponding first lien mortgage that is delinquent.

We believe the current accounting treatment of second liens on the banks' balance sheets makes them particularly unwilling to take this loss to complete a refinance, resulting in 1) unsuccessful modifications that are prone to quickly re-default and 2) more importantly, only a handful of Hope for Homeowners refinances. The ideal scenario for a borrower who owns a home that is worth less than its outstanding mortgage debt, referred to as being "underwater", is to refinance into a Hope for Homeowners mortgage. Such a refinancing would result in the Borrower having a new, affordable mortgage with an equity investment in his or her home and an incentive to stay in the home and build additional equity. In addition this homeowner could eventually sell the home in a normal market transaction as opposed to the selling into the current market of bank auctions and foreclosure sales.

As I previously explained, the refinancing of mortgages through Hope for Homeowners is the preferred solution for borrowers and investors in mortgage loans. Given that investors want more mortgage refinancings and an increased use of the Hope for Homeowners program, why can't investors just tell the servicers to refinance more loans?

Unfortunately, even though the loans backing the investments are held for the benefit of investors, the investors are limited in the influence they can exert over those who administer the trusts. The contracts governing the Administration of the trust that issued the mortgage-backed securities were generally written in a manner that creates various barriers to investor control. Thus, although investors want servicers to be more responsive to borrowers and to significantly increase the penetration of the Hope for Homeowners program, forcing that behavior on the servicers is extremely difficult.

What is the solution? It is an effort that will require participation and sacrifice by all interested parties to succeed. The government, financial institutions and in-

vestors all share an important stake in the recovery of the American homeowner and must contribute equitably to forge a healthier, more stable housing market, financial market and economy. The solution lies in providing positive equity and affordable payments for homeowners. Investors stand ready to make the sacrifice necessary to re-quitize the homeowners at risk of foreclosure.

The Congress and the Administration should be diligent in their prodding of bank-affiliated servicers to offer HFH refinancings. HUD and Treasury are actively working to reach out to all stakeholders, including the banks and servicers who hold second liens, to arrive at a solution that can lead to more refinancings under the Hope for Homeowners program. It is unclear at this point whether HUD and Treasury have made progress on the second lien issue. If necessary, additional capital could be allocated to this effort as TARP funds are repaid to the government. When the Emergency Economic Stability Act of 2008 first passed, a significant portion of the TARP money was to have been reserved for foreclosure avoidance. Government funds could be used to more aggressively compensate second lien holders as their investments are extinguished in the short refinance process of HFH.

Fundamentally, for this problem to be solved, everyone must share the burden. Solutions cannot be a windfall for certain stakeholders and terrible for others. We must get homeowners out of underwater mortgages and into mortgages that have positive equity and are properly underwritten, affordable, fair, and sustainable. Contributions must be made by all participants.

Based on all the available options, it seems the best solution is the Hope for Homeowners program. This means that investors like us will have to be prepared to take an immediate and substantial hit on the outstanding principal amount of the mortgage as loans are refinanced out of the securitization trust at a discount. It is necessary for borrowers to emerge from their underwater positions and begin to build positive equity for the housing market to recover. Given today's unprecedented economic conditions, mortgage investors stand ready to contribute to the re-quitization of homeowners by reducing principal on first lien mortgage debt to facilitate the refinancing of these loans into stable thirty-year, amortizing, fixed-rate government loans.

In creating the Hope for Homeowners program, Congress has created the framework for a successful solution to the housing crisis, and the funding necessary to provide sustainable mortgages for many American families at risk of losing their home to foreclosure. Mortgage Investors are prepared to make the appropriate contributions to preserve homeownership and call on the Committee to provide support in effectuating a workable program with the other stakeholders, including financial institutions that control the servicing and origination of residential mortgages.

Mr. Chairman, we thank you for the opportunity to testify today—and for your and your colleagues' efforts to help families not only achieve the American dream but also to keep their homes and avoid foreclosure during these turbulent times. We look forward to working with you to provide hope for homeowners and to doing our part to solve the housing and mortgage market crisis.

PREPARED STATEMENT OF ALLEN H. JONES

DEFAULT MANAGEMENT POLICY EXECUTIVE, BANK OF AMERICA

JULY 16, 2009

Good morning, Chairman Dodd, Ranking Member Shelby and Members of the Committee. I am Allen Jones, Bank of America's Default Management Policy Executive. Thank you for the opportunity to appear and update you on the efforts of Bank of America to help families avoid foreclosures wherever possible and stay in their homes.

Let me start by making two important points on which I will elaborate later in the testimony.

First, as you will recall Bank of America exited subprime lending nearly nine years ago. Upon acquiring Countrywide, we have taken the steps to ensure our combined company is a leader in traditional mortgage products. Our April launch of the Clarity Commitment—a clear and simple one page disclosure that accompanies every new and refinanced loan—is one demonstration of our focus on ensuring customers understand what loan they are getting and the associated costs.

Second, Bank of America has been at the forefront of government and industry efforts to develop loan modification programs as a way of avoiding foreclosures and helping financially distressed customers remain in their homes. We modified 230,000 mortgage loans in 2008, and we are pleased to report that in the first six

months of this year, modification offers have been accepted or rate relief has been provided for more than 150,000 customers.

In recent weeks, as the Administration's Making Home Affordable modification program guidelines have been completed and our systems have been converted, Making Home Affordable has become the centerpiece of Bank of America's overall home retention efforts. Already, approximately 80,000 Bank of America customers are in the trial modification period or are responding to modification offers we have extended under Making Home Affordable.

We have achieved this level of success by devoting substantial resources to this effort. Our Home Loans business has more than 7,400 associates dedicated to home retention. This team has nearly doubled since this time one year ago. They respond to an average of 80,000 customer calls a day—and more than 1.8 million calls a month. In addition to personnel, we have devoted substantial systems, training and other resources to our loan modification efforts.

Our country is slowly emerging from the worst economic crisis since the Great Depression, the impacts of which have been felt deeply by consumers because at its center has been the deterioration in value of an asset important to individual wealth and stability—the home. Home values in some areas of the country have depreciated to less than half their value at the market's peak, and unemployment continues to rise—recently hitting a 26 year high.

Against this backdrop, millions of families are struggling. As one of the country's leading mortgage lenders and servicers, Bank of America understands and fully appreciates its role in helping borrowers through these difficult economic times. We want to ensure that any borrower who has sufficient income and the intent to maintain homeownership has the ability to do so using any and all resources we have available.

With that introduction, let me describe more specifically how we are leveraging Making Home Affordable and other programs to help borrowers, and provide some suggestions for improvement.

Support for Administration's Foreclosure Relief Efforts

Bank of America supports the Obama Administration's Making Home Affordable refinance and loan modification programs for their potential to help millions of homeowners who otherwise may have faced certain foreclosure.

The program's focus on affordability of payment in the loan modification and refinance processes is consistent with the approach we have successfully developed for our customers, and we appreciate the opportunity we have had to work with the Administration in developing guidelines for its Making Home Affordable programs.

While our primary focus here today is loan modifications, it's important to recognize the benefits of the Making Home Affordable refinance program and its role in helping more Americans retain their homes.

Bank of America was one of the first lenders to process refinance applications through the Making Home Affordable program. We have taken more than 90,000 Making Home Affordable refinance applications (the majority of which have locked) and funded nearly 40,000 refinances since launching the program.

Responsiveness to borrowers. We understand the importance of responding promptly when our customers call, and providing clear, timely answers to their questions. As noted earlier, our home retention division responds to an average of 80,000 customer calls daily. We seek to answer calls from customers in 90 seconds or less—and in the second quarter we met that goal more than 80 percent of the time.

Making Home Affordable Modification Process. Our process for evaluating Making Home Affordable modifications generally works as follows: A customer is contacted through solicitation or offer letters or they contact us, and we perform an analysis of their financial situation, focusing primarily on their income and expenses and any hardships they may be suffering. In many cases, particularly where we have delegated authority from our investors to modify their loans, the customer can be pre-qualified for the Making Home Affordable program over the phone.

A pre-qualified customer receives a trial modification plan in the mail to execute and return within 30 days, along with supporting financial documentation and their first trial period payment. During the trial period, the customer's documentation is evaluated to ensure compliance with program guidelines. A customer who meets all program requirements, including timely making of all payments during this three or four month period, will receive a second agreement that must be signed and promptly returned to receive a final modification.

We continually strive to make our processes efficient and customer-friendly. We have established new processes for, among other things, verifying borrower income and expenses, managing trial modification periods, securing the payment of mort-

gage insurance pre-claims at the time of modification so as to enable more borrowers to qualify for modifications, and working with third party contractors engaged by the GSEs.

Delays in Foreclosure Sales. Bank of America customers will not lose their homes to foreclosure while their loans are being considered for a modification. The Bank places foreclosure sales on hold while it determines a customer's eligibility for its home retention programs.

Bank of America's Home Retention Operations

While the focus of today's hearing is on Making Home Affordable modification implementation, we also want to highlight our early leadership to address avoidable foreclosures. As the largest servicer in the United States, servicing one in five mortgages, or a total of 14 million loans, we understand our responsibility to help our customers sustain homeownership. Before the government's announcement of Making Home Affordable earlier this year, Bank of America had proactively put in place industry-leading assistance programs for distressed borrowers. We continue to leverage those programs to ensure that we consider every potential solution for our customers.

National Homeownership Retention Program. Shortly after acquiring Countrywide, Bank of America announced the creation of our National Homeownership Retention Program for nearly 400,000 borrowers with discontinued Countrywide subprime and pay option ARM products. Outreach under the program began in December 2008. Like Making Home Affordable, our National Homeownership Retention Program focuses on affordability and sustainability, while providing a streamlined loan modification process.

Hope for Homeowners. Bank of America believes the Hope for Homeowners program provides another useful tool for assisting borrowers. We have not been able to implement the program as we are still awaiting final guidance from the Department of Housing and Urban Development. The program, as originally rolled out, had a series of unique requirements which were very different from standard FHA programs, and presented serious implementation challenges for lenders. The Helping Families Save Their Homes Act signed into law by President Obama in May of 2009 includes helpful changes to Hope for Homeowners that are designed to make the program more consistent with standard FHA practices. We understand the Department of Housing and Urban Development is hard at work on developing final Hope for Homeowners guidance that will provide lenders with the tools they need to move forward and implement the program. It is important to note that once final guidelines are issued, it will still take lenders several months to implement the program.

Community Outreach and Partnerships. We have also devoted significant resources to community outreach. Since the beginning of this year, we have participated in more than 120 community outreach events in 26 states. We have reached more than 5,000 borrowers through these events, with about 50 percent of whom we had no prior contact in the last 60 days.

We have partnered with the National Council of La Raza, National Urban League, and the National Coalition for Asian Pacific American Community Development in the creation of the Alliance for Stabilizing Communities, and we provided \$2.5 million in funding to support this national coalition dedicated to assisting individuals facing foreclosure. The Alliance will hold 40 housing rescue fairs over the next two years in 24 communities hardest hit by the foreclosure crisis.

In addition, Bank of America partners with 440 HUD-approved non-profit counseling agencies. Empowering the counselors with knowledge about Bank of America Home Loans and the Making Home Affordable modification program is significant because counselors can educate borrowers and assist in the modification application process. This year, we have trained over 500 counselors in sessions across the United States.

Making Home Affordable Challenges and Improvements

Bank of America appreciates the opportunity we've had to work closely with members of the Administration in developing the Making Home Affordable program. We all understand there is still more work to be done on various aspects of the program to improve its success and the success of those homeowners that rely on it for assistance during these difficult economic times.

We would like to take this opportunity to offer some suggestions for improvement:

Announcement of Program Changes or Guidance. Communications by Treasury to servicers and at-risk homeowners regarding program features and effective dates could be improved. Advanced notification to loan servicers once new guidelines or program changes are determined (but before they become effective) would enable

servicers to establish early necessary systems and practices to better address customer inquiries. The current method of publicly announcing new guidelines or changes concurrently with their effective dates creates immediate demand with insufficient lead time for operational readiness. This can lead to negative customer experience and, ultimately, public backlash against the programs.

We also would suggest that new or revised guidelines not be issued until they have been reviewed with industry representatives and their details have been completed. For example, while we appreciate the spirit in which it was done, the issuance by Treasury of its brief and limited guidelines for the second lien and short sale programs months before their comprehensive rules have been finalized or even drafted has led to a great deal of confusion and delay in the industry and with the public.

Promoting uniform interpretations of program guidelines. Consistency in the creation and interpretation of program guidelines between Treasury and the GSEs, as well as consistent guidelines for Fannie Mae- and Freddie Mac-owned or securitized loans, also would reduce homeowner confusion and simplify servicers' ability to operationalize these programs as they evolve. Similarly, it is important to encourage states to limit modification-related legislation which may complicate participation in federal programs such as MHA. And there also should be consistency among the various federal regulators and agencies as to the options servicers should utilize and the process servicers should follow for implementing Making Home Affordable.

Requirement of complete documentation. One of the benefits of the MHA program is the trial modification period. Servicers can approve trial modifications almost instantly and use the trial period to collect the necessary documentation to complete the modification. One factor that slows down the process during the trial period is that many borrowers initially provide incomplete information. We hope to work with the Administration to address the challenges we are experiencing with some of the required documentation returned by customers by reinforcing through the media and other communications the importance of complete and accurate documentation. Servicers also should have some flexibility to determine the materiality of the incomplete response, such as whether we can accept an electronically filed tax return without a signature.

No program for the unemployed. As a general matter, we would welcome the opportunity to work with Treasury on a program that would offer short term relief while unemployed borrowers seek re-employment. This is already a significant population, and a growing need.

Customer Impacts

Despite problems in the economy, most of our customers continue to pay their mortgages on time; and less than 375,000 loans, or fewer than 3 percent of the 14 million loans in our servicing portfolio, face foreclosure. While foreclosures are a relatively small percentage of our portfolio, we recognize that the impact they have on our communities, neighborhoods and customers is significant. That is why we have exhausted and will continue to exhaust every possible avenue to help families stay in their homes.

Despite our best efforts, there are limits to what we can do. With unemployment at a 26-year high, even the most ambitious modification plan will not help when there is no income. Often the largest impediments to completing loan modifications are the changed circumstances of the borrower, such as unemployment, divorce, illness, or dissatisfaction with the property that may make a loan modification unattainable. We can only modify loans where the borrower has the ability and willingness to repay.

Our goal is to keep as many families in their homes as possible. Often we will succeed, but regardless, we believe every customer deserves to be treated with compassion and respect, and we work to provide a dignified process for everyone.

Bank of America Mortgage Lending Update

We strongly believe that long-term recovery in the economy and housing markets relies upon lenders responsibly and effectively providing loans to creditworthy borrowers. To that end, in April we launched Bank of America Home Loans, which is built on a brand promise to always be a responsible lender and help create successful homeowners.

At that time, we introduced several new tools in response to valuable customer feedback. One such tool—the Clarity Commitment—is a one-page summary of a borrower's loan terms in plain English. We have it in place on 95 percent of our products, and it has been very well received by our customers and community partners. Since we introduced it, already 400,000 customers have received this document with their loan papers.

We are making new mortgage loans available to eligible customers for buying homes and refinancing their current mortgage loans. On Friday, July 17, Bank of America will report second quarter earnings. In the first quarter of 2009, we generated:

More than \$85 billion in first mortgage production—representing more than 382,000 customers who purchased homes or saved money on the home they already own.

More than \$4 billion in home equity and reverse mortgage production, representing almost 23,000 customers.

One in four of these loans were to low- and moderate-income customers.

Conclusion

I want to thank you for the opportunity to describe our ongoing home retention efforts. We recognize there is still much more to be done. The ongoing economic crisis demands expedient, affordable loan modifications that help borrowers within the framework of our contractual obligations to investors.

This is a critically important undertaking that must be done right if we as a country are going to preserve the flow of mortgage credit to support sustainable homeownership and at the same time protect communities and neighborhoods from avoidable foreclosures. We look forward to working with Congress and the Administration to accomplish these goals. I would be happy to answer any questions you might have.

PREPARED STATEMENT OF DIANE E. THOMPSON
NATIONAL CONSUMER LAW CENTER, ALSO ON BEHALF OF
NATIONAL ASSOCIATION OF CONSUMER ADVOCATES

JULY 16, 2009

I. Introduction

Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for inviting me to testify today regarding the barriers encountered by homeowners attempting to access the Making Home Affordable program and the Hope for Homeowners program.

I am an attorney, currently of counsel to the National Consumer Law Center (NCLC).¹ In my work at NCLC I provide training and support to hundreds of attorneys representing homeowners from all across the country and consequently have heard many, many reports of the difficulties encountered by advocates and homeowners attempting to obtain sustainable loan modifications. For nearly 13 years prior to joining NCLC, I represented low-income homeowners at Land of Lincoln Legal Assistance Foundation in East St. Louis, Illinois. In that capacity, I became intimately familiar with the difficulties in arranging a loan modification, even when it was clearly in the investor's best interests.

I testify here today on behalf of the National Consumer Law Center's low-income clients. On a daily basis, NCLC provides legal and technical assistance on consumer law issues to legal services, government and private attorneys representing low-income consumers across the country. I also testify here today on behalf of the National Association of Consumer Advocates.²

We are facing in this country a foreclosure tsunami, which threatens to desta-

¹The **National Consumer Law Center, Inc.** (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending* (6th ed. 2007) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal with predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. This testimony was written by Alys Cohen, Staff Attorney, and Diane E. Thompson, Of Counsel, to NCLC.

²The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

We are facing in this country a foreclosure tsunami, which threatens to destabilize our entire economy, devastate entire communities, and destroy millions of families. Large-scale, sustainable modifications are widely recognized as an essential component of restoring economic health to our country and hope to our homeowners.

There are three major Federal programs designed to prevent foreclosures and preserve homeownership: Hope for Homeowners, the Making Home Affordable refinance program, and the Making Home Affordable modification program, or the Home Affordable Modification Program. My comments will focus on the modification prong of the Making Home Affordable program. Far more of the homeowners facing foreclosure are eligible for modification under the Home Affordable Modification Program than for refinance under either Hope for Homeowners or the refinance prong of Making Home Affordable. Recent changes to both programs should increase eligibility and may increase participation. Still, restrictions on both programs are likely to continue to limit their reach.

Both Hope for Homeowners and the refinance prong of Making Home Affordable are designed to offer some relief to homeowners who owe more than their homes are worth. This is an important goal and an essential component of any solution to the foreclosure crisis. As described in Chairman Dodd's letter of July 10, 2009, Hope for Homeowners, in particular, could play an important role in moving us forward by mandating principal reductions. We remain concerned, however, that neither program effectively eliminates negative equity. The refinance prong of Making Home Affordable permits the refinancing of excess debt and so may permit homeowners to lower interest rates. Absent market appreciation, however, it does not reduce the negative equity. Although Hope for Homeowners mandates principal reductions, many mortgage holders and servicers continue to be unwilling to agree to this write-down as the price for participation in the program, even with the possibility of an increased share in future appreciation.³ Nor is it clear that even the recent improvements to the Hope for Homeowners second lien program will be sufficient to remove second liens in any significant number.

The recent improvements to FHA and RHS are also beyond the scope of my testimony. We would like nonetheless to take this opportunity to congratulate Congress and the Administration on the important steps forward in these programs. In addition to improving Hope for Homeowners, S. 896 also increased the ability of homeowners with FHA and RHS loans to access partial claims, a special form of principal forbearance. This, too, is an important step to increase the long-term affordability of mortgages for many of our most vulnerable homeowners. Having negotiated partial claims with FHA servicers on behalf of low-income homeowners, I personally know how important the partial claim option can be to preserving homeownership. We at NCLC and NACA applaud Congress and the Administration for their efforts to expand the modification options available under the government-insured programs: FHA, RHS, and VA.

The Home Affordable Modification Program (HAMP) announced by President Obama's administration on March 4, 2009, is a laudable attempt to overcome long standing reluctance by servicers to perform large numbers of sustainable loan modifications. HAMP seeks to change the dynamic that leads servicers to refuse even loan modifications that would be in the investors' best interests by providing both servicers and investors with payments to support successful loan modifications. Several months into the Home Affordable Modification Program (HAMP), however, homeowners and their advocates report that the program is not providing a sufficient number of loan modifications to homeowners, the modifications offered often do not meet the guidelines of the program, and the program itself still presents serious barriers to mass loan modifications.

HAMP, despite its lofty goals, has not yet been able to contain the foreclosure tsunami. To date, implementation of the program by servicers has been slow and sporadic. The Administration's efforts to hold servicers accountable⁴ are a welcome and necessary step forward. Further steps to reform HAMP and ensure servicer compliance are needed if the program is to reach its goal of reducing foreclosures. Particularly problematic is the lack of any mechanism to ensure that homeowners are, when appropriate, offered a loan modification prior to foreclosure sale. A timeline should be set to evaluate whether HAMP, along with other existing programs, can

³The requirement that future appreciation be shared with HUD also reduces homeowners' investment in their property and may have adverse unintended consequences if homeowners respond to that reduced equity by defaulting.

⁴Renaë Merle, *White House Prods Banks: Letter Tells Chiefs To Start Backing Mortgage Relief*, Wash. Post, July 10, 2009, available at http://www.washingtonpost.com/wpdyn/content/article/2009/07/09/AR2009070902928.html?nav=rss_business.

sufficiently address foreclosures. If it becomes clear they can not, more stringent measures, as discussed below, should be adopted. The structure of the servicing industry makes it unlikely that existing measures will be adequate; currently available information confirms that prognosis.

A. Problems with Servicers' Implementation of HAMP Plague Homeowners Seeking Loan Modifications.

—Participating servicers violate the HAMP guidelines:

- Servicers still require waivers.
- Some participating servicers offer non-compliant loan modifications.
- Some participating servicers refuse to offer HAMP modifications.
- Servicers charge fees to homeowners for the modification.
- Servicers are continuing to initiate foreclosures and sell homes at foreclosure sales while the HAMP review is pending.

—Servicer staffing and training still lag behind what is needed.

- Homeowners and counselors report waits of months to hear back on review for a trial modification, followed by very short timeframes to return documents.
- Staff of participating servicers continue to display alarming ignorance of HAMP.
- Non-participating servicers continue to represent themselves as participating in HAMP.

—Lack of transparency and accountability is resulting in summary denials and other unreasonable acts by servicers.

B. Certain HAMP Policies Must Be Changed to Provide Sustainable Modifications and Save Communities.

—Transparency must be improved.

- The Net Present Value model for qualifying homeowners must be available to the public.
- The layers of documents governing HAMP, the guidelines, the Supplemental Directives, the various FAQ's, and the servicer contracts, should be consolidated, reconciled, and clarified.
- Participating subsidiaries must be clearly identified.

—Mechanisms for enforcement and compliance should be adopted.

- All foreclosure proceedings must be stopped upon the initiation of a HAMP review, not just at the point before sale.
- Homeowners should be provided with an independent review process when denied a loan modification.
- Homeowners should have access to an ombudsman to address complaints about the process.
- Denials based in part on a borrower's credit score should be accompanied by an adverse action notice under the Fair Credit Reporting Act.

—The HAMP guidelines should be adjusted to provide more meaningful relief to homeowners without reducing their existing rights.

- Homeowners need principal reductions, not forbearance.
- Homeowners suffering an involuntary drop in income should be eligible for a second HAMP loan modification.
- Homeowners in bankruptcy should be provided clear access to the HAMP program.
- Mortgages should remain assumable as between spouses, children, and other persons with a homestead interest in the property.
- Fair lending principles must be ensured throughout the HAMP process.
- HAMP application procedures should better recognize and lessen the impact of exigent circumstances.
- The trial modification program should be further formalized and clarified, such that homeowners receive assurances of the terms of the permanent modification and homeowners are not put into default on their loans if they are current at the onset of the trial modification.
- The final modification agreement should make clear that the homeowners do not waive any rights nor are required to reaffirm the debt in order to enter into the modification.

- The second lien program should be further developed to promote coordination with first lien modifications; servicers should be required to participate in both programs.

—Data collection and reporting should provide broad, detailed information in order to support the best HAMP outcomes.

II. Foreclosures Far Outweigh Loan Modifications.

Goldman Sachs estimates that, starting at the end of the last quarter of 2008 through 2014, 13 million foreclosures will be started.⁵ At the end of the first quarter of 2009, more than 2 million houses were in foreclosure.⁶ Over twelve percent of all mortgages had payments past due or were in foreclosure and over 7 percent were seriously delinquent—either in foreclosure or more than 3 months delinquent.⁷

These spiraling foreclosures weaken the entire economy and devastate the communities in which they are concentrated.⁸ Neighbors lose equity;⁹ crime increases;¹⁰ tax revenue shrinks.¹¹ Communities of color remain at the epicenter of the crisis;

⁵ Goldman Sachs Global ECS Research, *Home Prices and Credit Losses: Projections and Policy Options* (Jan. 13, 2009), at 16; see also Rod Dubitsky, Larry Yang, Stevan Stevanovic & Thomas Suehr, Credit Suisse Fixed Income Research, *Foreclosure Update: Over 8 Million Foreclosures Expected* 1 (Dec. 4, 2008) (predicting 9 million foreclosures for the period 2009–2012).

⁶ Mortgage Bankers' Ass'n, Nat'l Delinquency Survey Q109 at 4 (2009) (reporting that 3.85 percent of 44,979,733, or 1.7 million, mortgages serviced were in foreclosure). Roughly half of these were serviced by national banks or Federal thrifts. See Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 8 (June 2009), available at <http://files.ots.treas.gov/482047.pdf> (reporting that 884,389 foreclosures were in process by national banks and Federal thrifts at the end of the first quarter of 2009). The estimate of more than 2 million homes in foreclosure is achieved by extrapolating from the MBA numbers. The MBA survey only covers approximately 80 percent of the mortgage market. Thus, $(44979733 * 3.85\%) / 0.8 = 2.16$ million.

⁷ Mortgage Bankers' Ass'n, Nat'l Delinquency Survey Q109 at 4 (2009).

⁸ See, e.g., Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., Address at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), available at <http://www.Federalreserve.gov/newsevents/speech/bernanke20081204a.htm#f12>; Ira J. Goldstein, The Reinvestment Fund, Lost Values: A Study of Predatory Lending in Philadelphia, at 62/-63 (2007), available at www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf (discussing disastrous community impact left behind by failed subprime lenders).

⁹ See John P. Harding, Eric Rosenblatt, & Yao Vincent, The Contagion Effect of Foreclosed Properties (July 15, 2008), available at <http://ssrn.com/abstract=1160354>; Letter, Senator Dodd to Senator Reid (Jan. 22, 2008) (describing cycle of disinvestment, crime, falling property values and property tax collections resulting from foreclosures), available at http://dodd.senate.gov/multimedia/2008/012308_ReidLetter.pdf; Staff of the J. Economic Comm., 110th Cong., 1st Sess., The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here (2007), available at http://jec.senate.gov/index.cfm?FuseAction=Reports.Reports&ContentRecord_id=c6627bb2-7e9c-9af9-7ac7-32b94d398d27&Region_id=&Issue_id= (projecting foreclosed home owners will lose \$71 billion due to foreclosure crisis, neighbors will lose \$32 billion, and state and local governments will lose \$917 million in property tax revenue); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 Housing Pol'y Debate 57, 69, 75 (2006) ("for each additional conventional foreclosure within an eighth of a mile of a house, property value is expected to decrease by 1.136 percent"; estimating total impact in Chicago to be between \$598 million and \$1.39 billion); William C. Apgar, Mark Duda, & Rochelle Nawrocki Gorey, The Municipal Cost of Foreclosures: A Chicago Case Study (Hous. Fin. Policy Research Paper 2005), at 1, available at www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf; John P. Harding, Eric Rosenblatt, & Yao Vincent, The Contagion Effect of Foreclosed Properties (July 15, 2008), available at <http://ssrn.com/abstract=1160354>; Letter, Senator Dodd to Senator Reid (Jan. 22, 2008) (describing cycle of disinvestment, crime, falling property values and property tax collections resulting from foreclosures), available at http://dodd.senate.gov/multimedia/2008/012308_ReidLetter.pdf.

¹⁰ See, e.g., J.W. Elphinstone, *After Foreclosure, Crime Moves In*, Boston Globe, Nov. 18, 2007 (describing Atlanta neighborhood now plagued by house fires, prostitution, vandalism and burglaries); Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 Housing Stud. 851 (2006), available at www.prism.gatech.edu/di17/housingstudies.doc (calculating that for every 1 percent increase in the foreclosure rate in a census tract there is a corresponding 2 percent increase in the violent crime rate).

¹¹ See, e.g., Staff of the J. Economic Comm., 110th Cong., 1st Sess., The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here (2007), available at http://jec.senate.gov/index.cfm?FuseAction=Reports.Reports&ContentRecord_id=c6627bb2-7e9c-9af9-7ac7-32b94d398d27&Region_id=&Issue_id= (projecting foreclosed home owners will lose \$71 billion due to foreclosure crisis, neighbors will lose \$32 billion, and state and local governments will lose \$917 million in property tax revenue); William C. Apgar, Mark Duda, & Rochelle Nawrocki Gorey, The Municipal Cost of Foreclosures: A Chicago Case Study (Hous. Fin. Policy Research Paper), 2005, at 1, www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf.

targeted for subprime, abusive lending, they now suffer doubly from extraordinarily high rates of foreclosure and the assorted ills that come with foreclosure.¹²

Modifications have not made a dent in the burgeoning foreclosures. A recent paper in the Boston Federal Reserve Bank's Public Policy series found that less than 8 percent of all the loans 60 days or more delinquent were modified during 2007–2008¹³ Professor Alan White, in examining pools of securitized mortgages, found that the number of modifications varied dramatically by servicer, ranging from servicers who modified as many as 35 percent of the loans in foreclosure to as few as 0.28 percent of the loans in foreclosure in November 2008.¹⁴ Even at the high end of 35 percent of all mortgages in foreclosure, the modification rate is not enough to reduce the foreclosure rate to pre-crisis levels.¹⁵ HAMP has not yet improved the situation: although modifications increased during the first quarter of 2009, all data indicate that the number and rate of total modifications fell back during the second quarter.¹⁶

Worse, the modifications offered pre-HAMP (and presumably still by servicers not offering HAMP modifications) were overwhelmingly ones that increased the borrower's payment and principal balance. Only about 3 percent of the delinquent loans studied in Boston Federal Reserve Bank paper received modifications that reduced the payment.¹⁷ Professor White's data shows that, in the aggregate, modifications increase the principal balance.¹⁸ While the first quarter 2009 data from the OCC and OTS shows that a majority of the modifications (excluding short term payment plans or forbearance agreements) decreased the payment, most of those modifications also increased the principal balance by capitalizing arrears.¹⁹ Unsurprisingly, redefault rates on loan modifications remain high.²⁰

¹² See, e.g., Michael Powell & Janet Roberts, *Minorities Affected Most as New York Foreclosures Rise*, N.Y. Times, May 15, 2009; Mortgage Foreclosure Filings in Pennsylvania: A Study by the Reinvestment Fund for the Pennsylvania Department of Banking 36 (Mar. 2005), available at www.trfund.com/policy/pa_foreclosures.htm; Paul Calem, Kevin Gillen & Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, 29 J. Real Estate Fin. & Econ. 393 (2004); Ira Goldstein, *The Reinvestment Fund, Predatory Lending: An Approach to Identify and Understand Predatory Lending* (2002) (showing that areas within the city of Philadelphia that are predominately African American or Latino also tended to have higher concentrations of foreclosure sales and were more vulnerable to predatory lending); cf. AARP Pub. Pol'y Inst., *A First Look at Older Americans and the Mortgage Crisis 5* (2008), http://assets.aarp.org/rgcenter/econ/i9_mortgage.pdf (African Americans and Hispanics are foreclosed on at roughly three times the rate of white Americans).

¹³ Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization 35* (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09–4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

¹⁴ Alan M. White, *Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Modification Contracts*, Conn. L. Rev. 12–13 (forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1325534.

¹⁵ See Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., *Address at the Federal Reserve System Conference on Housing and Mortgage Markets* (Dec. 4, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm#f12> (noting that the number of foreclosures has more than doubled from pre-crisis levels).

¹⁶ See, e.g., Gretchen Morgenson, *Fair Game—So Many Foreclosures, So Little Logic*, N.Y. Times, July 4, 2009 (reporting that modifications peaked in February 2009 and have since declined while the number of foreclosures and delinquencies has continued to rise); California Reinvestment Coalition, *The Ongoing Chasm Between Words and Deeds: Abusive Practices Continue to Harm Families and Communities in California* (2009) (reporting observations by housing counselors that loan modifications declined in the second quarter); *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Alan M. White).

¹⁷ Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09–4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

¹⁸ Alan White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, Fordham Urb. L. J. 20 (forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538#

¹⁹ Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 5 (June 2009), available at <http://files.ots.treas.gov/482047.pdf>.

²⁰ Office of the Comptroller of the Currency & Office of Thrift Supervision, OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data, First Quarter 2009, at 6 (June 2009), available at <http://files.ots.treas.gov/482047.pdf>.

The official numbers available to date on the HAMP program reflect a modest start at best.²¹ The good news is that, on paper at least, 75 percent of all the loans in the country should be covered by HAMP.²² The bad news is that only 55,000 trial modifications have been offered and only 300,000 letters with information about trial modifications have been sent to homeowners. As the President acknowledges, foreclosures still outnumber modifications under the program.²³ The 300,000 letters containing information about trial modifications are obscured by the more than 2 million homeowners in foreclosure and the over 770,000 new foreclosure starts in the first quarter alone.²⁴

Servicers are still staffing up to deal with homeowners in distress.²⁵ Administration officials have admitted that the industry is not yet up to the task.²⁶ The progress servicers have made in hiring loan modification staff, although real, is not keeping up with the numbers of foreclosures filed by those same servicers.

We do not yet have any data on the characteristics or performance of the HAMP loan modifications. However, extensive reports from advocates around the country show that the quality of loan modifications offered too often does not comport with HAMP guidelines. Advocates for homeowners continue to report problems with implementation of the program.²⁷ Servicers are all too often refusing to do HAMP modifications, soliciting a waiver of homeowners' rights to a HAMP review, and structuring offered modifications in ways that violate HAMP. These violations may be harder to detect than the gross failure of servicers to date to process a meaningful number of modifications, but they will vitiate HAMP just as surely.

III. Servicers' Lack of Alignment with the Interests of Investors or Homeowners Contributes to the Failure to Do Loan Modifications.

As discussed above, despite widespread calls for more modifications, the number of modifications remains paltry compared to the number of foreclosures. And investors are losing mind-boggling large sums of money on foreclosures.²⁸ The available data suggests that investors lose ten times more on foreclosures than they do on modifications.²⁹

A. Servicers Have Different Interests Than Investors.

In attempting to make sense of this puzzle, we should remember that servicers are not investors. Investors hold the note, or a beneficial interest in it, and are, in general, entitled to repayment of the interest and principal. Servicers collect the payments from the homeowners on behalf of the investors. The bulk of their income comes from a percentage payment on the outstanding principal balance in the pool; the bulk of their net worth is tied to the value of the mortgage servicing rights they purchased. A servicer may or may not lose money—or lose it in the same amounts

²¹United States Department of the Treasury, Making Home Affordable Progress Report, May 14, 2009, available at <http://www.treas.gov/press/releases/docs/05142009ProgressReport.pdf>.

²²United States Department of the Treasury, Making Home Affordable Progress Report, May 14, 2009, available at <http://www.treas.gov/press/releases/docs/05142009ProgressReport.pdf>.

²³Tami Luhby, Obama mortgage plan needs work: Many borrowers are not getting help under president's modification or refinancing plan, CNN Money.com, July 8, 2009; Press Conference by the President, The White House, Office of the Press Secretary (June 23, 2009), available at http://www.whitehouse.gov/the_press_office/Press-Conference-by-the-President-6-23-09/ ("Our mortgage program has actually helped to modify mortgages for a lot of our people, but it hasn't been keeping pace with all the foreclosures that are taking place.")

²⁴Mortgage Bankers' Ass'n, Nat'l Delinquency Survey Q109 at 4 (2009) (reporting that 3.85 percent of 44,979,733 mortgages surveyed were in foreclosure in the first quarter and that 1.37 percent of mortgages surveyed had foreclosure starts in the first quarter; the MBA survey data covers 80 percent of the mortgage market, so the numbers are extrapolated by dividing the MBA numbers by 80 percent).

²⁵See, e.g., Peter S. Goodman, *Promised Help Is Elusive for Some Homeowners*, N.Y. Times, June 3, 2009.

²⁶Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 29, 2009 (quoting Michael Barr, Assistant Secretary for Financial Institutions at the Treasury Department: "They need to do a much better job on the basic management and operational side of their firms . . . What we've been pushing the servicers to do is improve their infrastructure to make sure their call centers are doing a better job. The level of training is not there yet.")

²⁷See, e.g., California Reinvestment Coalition, *The Ongoing Chasm Between Words and Deeds: Abusive Practices Continue to Harm Families and Communities in California* (2009); Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 29, 2009.

²⁸*Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Alan M. White) (65 percent loss severity rates on foreclosures in June 2009).

²⁹*Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Alan M. White).

or on the same scale—when an investor loses money. And it is servicers, not investors, who are making the day-to-day, on the ground, decisions as to whether or not to modify any given loan.

Servicers continue to receive most of their income from acting as largely automated pass-through accounting entities, whose mechanical actions are performed offshore or by personified computer systems.³⁰ Their entire business model is predicated on making money by skimming profits from what they are collecting: through a fixed percentage of the total loan pool, fees charged homeowners for default, interest income on the payments during the time the servicer holds them before they are turned over to the owners, and affiliated business arrangements. Servicers make their money largely through lucky or strategic investment decisions: purchases of the right pool of mortgage servicing rights and the correct interest hedging decisions. Performing large numbers of loan modifications would cost servicers upfront money in fixed overhead costs, including staffing and physical infrastructure.

B. Servicers' Business Model Involves As Little Service As Possible.

As with all businesses, servicers add more to their bottom line to the extent that they can cut costs.³¹ Servicers have cut costs by relying more on voicemail systems and less on people to assist homeowners, by refusing to respond to homeowners' inquires and by failing to resolve borrower disputes. Servicers sometimes actively discourage homeowners from attempting to resolve matters. As one attorney in Michigan attempting to arrange a short sale with Litton reports, the voice mail warns "If you leave more than one message, you will be put at the end of the list of people we call back." Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate.³² As a result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead homeowners are being pushed into short-term modifications and unaffordable repayment plans.

Creating affordable and sustainable loan modifications for distressed homeowners on a loan-by-loan basis is labor intensive.³³ Under many current pooling and servicing agreements, additional labor costs incurred by servicers engaged in this process are not compensated by the loan owner. By contrast, servicers' costs in pursuing a foreclosure are compensated. In a foreclosure, a servicer gets paid before an investor; in a loan modification, the investor will usually continue to get paid first. Under this cost and incentive structure, it is no surprise that servicers continue to push homeowners into less labor-intensive repayment plans, non-HAMP loan modifications, or foreclosure.

Post hoc reimbursement for individual loan modifications is not enough to induce servicers to change their existing business model. This business model—of fee-collecting and fee-skimming—has been extremely profitable. A change in the basic structure of the business model to active engagement with homeowners is unlikely to come by piecemeal tinkering with the incentive structure. Indeed, some of the attempts to adjust the incentive structure of servicers have resulted in confused and conflicting incentives, with servicers rewarded for some kinds of modifications, but not others,³⁴ or told both to proceed with a foreclosure and with a modification. Until recently, servicers received little if any explicit guidance on which modifications were appropriate and were largely left to their own devices in determining

³⁰ See, e.g., *In re Taylor*, 2009 WL 1885888 (Bankr.E.D.Pa. Apr 15, 2009).

³¹ See Joseph R. Mason, *Servicer Reporting Can Do More for Modification than Government Subsidies* 17 (Mar. 16, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331 (noting that "servicers' contribution to corporate profits is often . . . tied to their ability to keep operating costs low").

³² Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mausekopf, *The Incentives of Mortgage Servicers: Myths and Realities* 9–10 (Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs Working Paper No. 2008–46); State Foreclosure Prevention Working Group, *Analysis of Subprime Mortgage Servicing Performance*, Data Report No. 3 at 8 (2008), <http://www.csbs.org/Content/NavigationMenu/Home/SFPWGRpt3.pdf>; Preston DuFauchard, California Department of Corporations, *Loss Mitigation Survey Results* 4 (Dec. 11, 2007); cf. Aashish Marfatia, Moody's, U.S. Subprime Market Update November 2007 at 3 (2008) (expressing concern as to servicers' abilities to meet staffing needs).

³³ Joseph R. Mason, *Mortgage Loan Modification: Promises and Pitfalls* 7 (Oct. 3, 2007), available at papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.

³⁴ See, e.g., Ben S. Bernanke, Chairman, Bd. of Governors of the Federal Reserve System, *Speech at the Federal Reserve System Conference on Housing and Mortgage Markets: Housing, Mortgage Markets, and Foreclosures* (Dec. 4, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm> ("The rules under which servicers operate do not always provide them with clear guidance or the appropriate incentives to undertake economically sensible modifications.")

what modifications to make.³⁵ In the face of an entrenched and successful business model, fragmented oversight, and weak, inconsistent, and post hoc incentives, servicers need powerful motivation to perform significant numbers of loan modifications. Servicers clearly have not yet received such powerful motivation.

Servicers may make a little money by making a loan modification, but it will definitely cost them something. On the other hand, failing to make a loan modification will not cost the servicer any significant amount out-of-pocket, whether the loan ends in foreclosure or cures on its own. Until servicers face large and significant costs for failing to make loan modifications, until servicers are actually at risk of losing money if they fail to make modifications, no incentive to make modifications will work. What is lacking in the system is not a carrot; what is lacking is a stick.³⁶ Servicers must be required to make modifications, where appropriate, and the penalties for failing to do so must be certain and substantial.

C. Servicers Maximize Income in Ways that Hurt Both Homeowners and Investors.

Servicers are designed to serve investors, not borrowers. Despite the important functions of mortgage servicers, homeowners have few market mechanisms to employ to ensure that their needs are met. Rather, in the interest of maximizing profits, servicers have engaged in a laundry list of bad behaviors, which have considerably exacerbated foreclosure rates, to the detriment of both investors and homeowners.³⁷

Most servicers derive the majority of their income based on a percentage of the outstanding loan principal balance.³⁸ For most pools, the servicer is entitled to take that compensation from the monthly collected payments, even before the highest-rated certificate holders are paid. The percentage is set in the PSA and can vary somewhat from pool to pool, but is generally 25 basis points for prime loans and 50 basis points for subprime loans.³⁹ This compensation may encourage servicers to refuse principal reductions and to seek capitalizations of arrearages and other modifications that increase the principal balance.

Servicers also receive fees paid by homeowners and the “float”—the interest earned on funds they are holding prior to their disbursement to the trust.⁴⁰ For many subprime servicers, late fees alone constitute a significant fraction of their total income and profit.⁴¹ Servicers thus have an incentive to push homeowners into late payments and keep them there: if the loan pays late, the servicer is more likely to profit than if the loan is brought and maintained current. Float income encourages servicers to delay turning over payments to investors for as long as possible.

For servicers, their most important asset is the value of their mortgage servicing rights. Whether or not the servicer made the correct speculative investment decision when it bought the mortgage servicing rights to a pool of mortgages does more to shape its profitability than any other single factor. A servicer’s performance has only a marginal impact on the performance of the loan pool; the way a servicer increases its net worth is not by doing a top-notch job of servicing distressed mortgages but by gambling on market trends. Servicers with thin margins may need to squeeze all they can out of increasing performance from delinquent loans; servicers with stronger pools are likely to be less invested in the performance of the loans

³⁵American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 1 (June 18, 2009), available at http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf.

³⁶See Helping Families Save Their Homes: The Role of Bankruptcy Law: Hearing Before the S. Comm. on the Judiciary, 110th Cong., 2nd Sess. (Nov. 19, 2008), available http://judiciary.senate.gov/hearings/testimony.cfm?renderforprint=1&id=3598&wit_id=4083 (statement of Russ Feingold, Member, Sen. Comm. on the Judiciary) (“One thing that I think is not well understood is that because of the complex structure of these securitized mortgages that are at the root of the financial calamity the Nation finds itself in, voluntary programs to readjust mortgages may simply be doomed to failure.”).

³⁷See National Consumer Law Center, Foreclosures, Ch. 6 (2d ed. 2007 & Supp.) (describing the most common mortgage servicing abuses).

³⁸See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K), at 3 (Mar. 17, 2008) (typically receive 50 basis points annually on the total outstanding principal balance of the pool).

³⁹Anthony Pennington-Cross & Giang Ho, Loan Servicer Heterogeneity & The Termination of Subprime Mortgages 2 (Fed. Res. Bank of St. Louis Working Paper No. 2006-024A); 26 NCLC Reports, Follow the Money: How Servicers get Paid May/June 2008.

⁴⁰See generally *In re Stewart*, 391 B.R. 327, 336 (Bankr.E.D.La. 2008) (overviewing servicer compensation).

⁴¹See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K), at 3 (Mar. 17, 2008); Kurt Eggert, Limiting Abuse and Opportunism by Mortgage Servicers, 15 Housing Pol’y Debate 753, 758 (2004).

they manage.⁴² This dynamic leaves many servicers indifferent to the performance of the loans they service and unmotivated to hire and train the staff needed to improve performance.

D. The Possibility of Cure Does Not Explain Servicers' Failure to Make Loan Modifications in the Current Market.

A recent paper co-authored by my fellow panelist this morning, Paul Willen, confirms that extremely few loan modifications are being done and, in an attempt to solve the puzzle, propounds an economic model to explain the dearth of loan modifications.⁴³ Under the terms of that economic model, investors recover more if a borrower brings the loan current or refinances than if the lender modifies the loan. This is a commonsense and unobjectionable observation. Both the FDIC Loan Mod-in-a-Box NPV test and the HAMP NPV test build in the likelihood of cure in determining whether a loan modification or foreclosure is the more profitable path for investors.

In more normal times, it is surely rational for a servicer to spare itself the time and expense of modifying a loan in favor of the possibility of cure. In normal times, when cure rates exceeded foreclosure rates, an investor would have little objection to the wait-and-see-approach.⁴⁴ However, this model cannot explain the failure to perform loan modifications when we observe real world conditions: dropping cure rates, due in part to the restricted ability to refinance, even for homeowners with high credit scores;⁴⁵ homes so deeply underwater that investors lose 65 percent of the mortgage debt on average in foreclosure;⁴⁶ and a lack of other, more attractive places, to invest funds. If we take the 30 percent cure rate documented for loans during 2007 and 2008 in the paper co-authored by Mr. Willen, assume, as the FDIC did in its NPV calculations, that 40 percent of all loan modifications will end in redefault, and assume loss severity ratios of 60 percent if the loan is foreclosed on immediately or 70 percent if it is foreclosed on after a redefault (to reflect the dropping home prices and potential loss of upkeep by a struggling homeowner), investors will still save money if loan modifications reduce the current present value of the loan by as much as 20 percent.⁴⁷

Mr. Willen and his co-authors suggest that the lack of outcry by investors against servicers demonstrates that servicers are acting in what the investors perceive as their best interest.⁴⁸ First, the premise that investors have been silent is not correct. Leading groups representing investors have urged more and deeper loan modi-

⁴² Vikas Bajaj & John Leland, *Modifying Mortgages Can Be Tricky*, N.Y. Times, Feb. 18, 2009 (reporting views of Credit Suisse analyst that “[s]maller companies . . . that are under more financial pressure and have more experience in dealing with higher-cost loans have been most aggressive in lowering payments” than larger companies, who offer weaker modifications).

⁴³ Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 35 (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09-4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>. In addition to the overall limitations of a theoretical economic model to explain the complex web of interacting motivations impacting the numbers of loan modifications, there appear to be some errors in the model, even as a theoretical exercise. For example, the model assumes that the value of the unmodified loan is the greater of the unpaid principal balance or the value of the home, after adjusting for the costs of the foreclosure. But, in fact, it should be the lesser of the two. A foreclosing lender cannot legally recover more than the unpaid principal balance and is practically unlikely to recover more than the net foreclosure value of the home. This error results in an overstatement of the value of foreclosure, particularly in a market where home prices are declining, and thus undervalues modifications.

⁴⁴ Alan White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports*, Fordham Urb. L. J. 17-18 (forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538#; see also Aashish Marfatia, Moody's, U.S. Subprime Market Update November 2007 at 5 (2008) (reporting that half of all active loans facing reset in the first three-quarters of 2007 refinanced; more than one-quarter of all remaining loans refinanced after reset); State Foreclosure Prevention Working Group, *Analysis of Subprime Mortgage Servicing Performance, Data Report No. 3 at 8* (2008), <http://www.csbs.org/Content/NavigationMenu/Home/SFPWGRReport3.pdf> (reporting that 23 percent of closed loss mitigation efforts in May 2008 were either refinancings or reinstatements in full by the borrower).

⁴⁵ David Streitfeld, *Tight Mortgage Rules Exclude Even Good Risks*, N.Y. Times, July 10, 2009.

⁴⁶ *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Alan M. White).

⁴⁷ These numbers are derived from an analysis by Professor Alan White. His comment on the study is Attachment E of this testimony.

⁴⁸ Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 24 (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09-4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

fications.⁴⁹ Second, to the extent that some investors have been silent, we cannot assume that their silence means that they are happy with servicers' actions. Given the lack of effective control investors exercise over servicers, it would be wrong to construe that silence as agreement with servicers' decisions to decline modifications in favor of a chimerical cure. The large, private-label pools that contain most subprime loans are passive investment vehicles. Trustees, on behalf of the trust, can in exceptional cases fire a servicer, but this right is rarely invoked, usually only when the servicer is no longer able to pay the advances due on the borrowers' monthly payments.⁵⁰ Thus, although servicers are nominally accountable to investors, investors are, in most cases, no more powerful than borrowers to provide direction to a servicer.⁵¹

The work of Mr. Willen and his co-authors is an important contribution to understanding the nature and quantity of the loan modifications performed. The study does not tell us why loan modifications are not being done, however. The study does not run actual net present value analyses on actual loans: many loans that it would not make sense to modify in a market with rising home prices, easy refinancing, and plentiful alternative investment channels do make sense, purely from the standpoint of financial return to investors, to modify in today's economic market. The paper presents no hard data on whether or not servicers, in this climate, are serving the best interests of investors in refusing to modify loans. Servicers, moreover, may have different incentives than investors, and it is not clear that servicers do always make loan modification based upon the best interests of the trust as a whole.

What we know from this study is that servicers are not making modifications. We believe that more modifications could be made that would serve the interests of both investors and homeowners, as well as the national economy. As Professor Alan White noted in his testimony last week before a House subcommittee,⁵² and as the authors acknowledge,⁵³ there may be compelling public policy reasons to increase the number of modifications. Foreclosures impose high costs on families, neighbors, extended communities, and ultimately our economy at large.⁵⁴ It would be shortsighted indeed to fail to act.

IV. HAMP Design and Implementation Present Substantial Barriers to High Volume, High Quality Loan Modifications

HAMP offers real hope for increasing both the quantity and the quality of loan modifications made. By mandating a take-one, take-all policy, requiring servicers of GSE loans to modify loans, and standardizing the loan modification process, HAMP should increase the total number of modifications. By mandating affordable payments, limiting the fees charged, and permitting principal reductions, HAMP will increase the quality of the loan modifications offered.

HAMP is a significant step forward from previous loan modification programs. Yet the program has significant limitations both in design and implementation. HAMP's ability to guarantee an increase in sustainable modifications is dependent on voluntary servicer participation in the program. Several large servicers are still not participating, and the patchwork coverage is confusing to homeowners and their advocates alike.

More seriously, homeowners have no leverage to obtain a HAMP loan modification from even a participating servicer. It is unclear if the Administration's compliance efforts will be able to detect and remedy servicer noncompliance. Similarly, whether

⁴⁹ See, e.g., American Securitization Forum, Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans 2 (June 2007).

⁵⁰ Indeed, PSAs usually allow a trustee to increase its monitoring of a servicer only in the case of a narrowly circumscribed list of triggering events, primarily financial defaults. Michael Laidlaw, Stephanie Whited, Mary Kelsch, Fitch Ratings, U.S. Residential Mortgage Servicer Bankruptcies, Defaults, Terminations, and Transfers 2 (2007).

⁵¹ See, e.g., Joseph R. Mason, Servicer Reporting Can Do More for Modification than Government Subsidies 14 (Mar. 16, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331 ("The point is, the investor has to completely trust the servicer to act in their behalf, often in substantially unverifiable dimensions.")

⁵² *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Alan M. White).

⁵³ Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* 8 (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 09-4, July 6, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf>.

⁵⁴ Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., Address at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), available at <http://www.Federalreserve.gov/newsevents/speech/bernanke20081204a.htm#f12>.

or not HAMP's equalization of the incentives between principal and interest rate reductions will be enough to boost the number of modifications that reduce principal remains to be seen. Since loan modifications with principal reductions appear to have the lowest redefault rates,⁵⁵ HAMP's long-term success may be contingent on increasing the number of loan modifications with principal reductions and its great weakness in ensuring sustainable modifications may be its failure to mandate principal reductions.

A. Problems with Servicers' Implementation of HAMP Plague Homeowners Seeking Loan Modifications.

Servicers' compliance with HAMP is, at best, erratic. There is widespread violation of the HAMP guidelines across many servicers. The lack of compliance arises in part from obvious and persistent short falls in staffing and training. Yet some of the violations of HAMP are embodied in form documents, perhaps reflecting a more conscious attempt to evade the HAMP requirements. Lack of transparency prevents homeowners from identifying violations. Lack of accountability prevents homeowners from obtaining any redress when violations are identified.

1. Participating servicers violate existing HAMP guidelines.

Waivers of claims and defenses are still being required by servicers.

The HAMP rollout language prohibits waivers of legal rights. Yet servicers still are seeking waivers from homeowners or an admission of default.⁵⁶ We have learned of many instances in which servicers require homeowners to waive all claims and defenses in order to obtain a loan modification or even a loan modification review. Servicers also have asked homeowners to waive their right to a HAMP loan modification review in favor of a non-HAMP loan modification.⁵⁷ Not only does this violate HAMP rules but it demonstrates bad faith. Some servicers also are requiring homeowners to sign a waiver that states that any HAMP loan modification will be suspended if the homeowner subsequently files for bankruptcy.⁵⁸ These are form documents and thus unlikely to represent a random mistake by a line-level employee.

Some participating servicers offer non-compliant loan modifications.

All homeowners who request a HAMP review are entitled to one. Homeowners may elect a non-HAMP modification, but that should be the borrower's choice, informed by disclosure of all modification options.

Nonetheless, some servicers have told homeowners that they are providing a HAMP modification, only to provide documents that do not comport with the HAMP guidelines. These loan modifications are usually significantly less sustainable than a HAMP modification would be and often have higher costs. In addition to the waiver issue discussed above, advocates have been told that homeowners must pay large advance fees before a modification will be considered, homeowners have been required to complete hefty repayment plans before a review is conducted, and homeowners have been offered, as HAMP modifications, modifications limited to 5 years, with no limitation on interest rate increases after that time. Aurora, for example, represented to one advocate that it does not have the "right documents," although they have been publicly available for months, and so instead offered the borrowers old forms that contain waivers and are otherwise not HAMP compliant. Select Portfolio Servicing has insisted that a New York borrower make payments at a 44 percent debt-to-income ratio instead of the 31 percent mandated by HAMP.

Some participating servicers refuse to offer HAMP modifications.

The HAMP servicer contracts require that participating servicers review all homeowners in default for HAMP eligibility and that any borrower who requests a HAMP review be granted one, even if the borrower is not yet in default. Homeowners not yet in default but who are at imminent risk of default are eligible for a HAMP modi-

⁵⁵ See, e.g., Roberto G. Quercia, Lei Ding, Janneke Ratcliffe, *Loan Modifications and Redefault Risk: An Examination of Short-Term Impact* (Center for Community Capital, March 2009), available at http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf.

⁵⁶ See Attachment A, Ocwen Loan Servicing Loan Modification Agreement dated June 1, 2009 (seeking waiver of all legal rights by homeowner) Attachment B, Aurora Loan Services "workout agreement" dated May 20, 2009 (seeking homeowner admission of default and stating that the trial payments will not remove the homeowner from delinquency).

⁵⁷ See, e.g., Attachment C (Chase Agreement seeking to obtain waiver of homeowner's right to a HAMP loan modification in favor of a non-HAMP loan modification offered prior to March 4, 2009).

⁵⁸ See, e.g., Attachment D (WaMu HAMP trial plan agreement requiring waiver of HAMP loan modification if homeowner later enters bankruptcy).

fication. Servicers may only refuse to perform a HAMP review if the pooling and servicing agreement (PSA) forbids modification. In that case, servicers are still expected to use all reasonable efforts to obtain an exception to the PSA.

Staff at some participating servicers routinely refuse to do HAMP loan modifications.⁵⁹ For example, in a New York case, the employee stated that the investor did not permit loan modifications, yet refused to produce a copy of the PSA or even identify the investor, much less attempt to obtain a release from the restrictions as required by HAMP. One California advocate pursuing a HAMP modification for a loan serviced by Wells Fargo was told repeatedly that the holder did not do modifications. After protracted discovery, the servicer identified the holder as Wells Fargo Home Mortgage. Wells Fargo Home Mortgage, of course, is owned by Wells Fargo Bank, a participating servicer under HAMP. In another case, a Select Portfolio Servicing representative said that the PSA prevented a HAMP modification, but could not provide the PSA due to “system errors.” Other times servicers tell homeowners that they are not participating or that they are only participating for GSE loans. Bank of America has told homeowners in both Pennsylvania and Florida that it is only modifying loans that are owned by the GSEs.⁶⁰ Bank of America is a participating servicer under HAMP and therefore required to evaluate all loans for modification under HAMP. Some servicers have asserted that loans held by the GSEs require a higher debt-to-income ratio than HAMP, despite the implementation of nearly identical programs by both Fannie Mae and Freddie Mac. Advocates in both Ohio and Florida have been driven to file court documents to compel Wells Fargo to do a HAMP review and stay foreclosure proceedings, after Wells Fargo failed to complete a HAMP review.⁶¹

HAMP may even be causing a drop off in loan modifications. Loan modifications rose through the first quarter of the year, but fell after HAMP’s roll out in March.⁶² Bank of America informed an advocate that future HAMP modifications are put on hold while Treasury reviews Bank of America’s version of the Net Present Value calculation. Other advocates and homeowners have been told more generally that their servicer is participating but that the servicer does not yet have a program to evaluate homeowners for HAMP. Ocwen, for example, told an advocate on July 1 that it did not know when it would be rolling out its HAMP modifications. Ocwen signed a contract as a participating servicer on April 16, two and a half months earlier. One Brooklyn, New York advocate was told that the investor was not allowing any modifications because they were waiting for the Federal Government to act. In the meantime, of course, foreclosures continue.

Servicers charge fees to homeowners for the modification.

HAMP forbids any upfront payments as a precondition to review or trial modification. Several homeowners have reported being told by various servicers that they must make payments before being considered for HAMP.⁶³ Sometimes these payments take the form of a special forbearance agreement or lump-sum payment of arrearages; other times it is less clear what the payment is for.

A Bank of America loss mitigation representative informed a Pennsylvania homeowner’s counsel that if the homeowners paid \$2,200.00 to Bank of America, then Bank of America would “consider” a loan modification. America’s Servicing Company, a division of Wells Fargo Home Mortgage, told a New York borrower that only upon completion of a 3-month repayment plan, followed by a balloon payment of \$18,000, could the borrower be considered for HAMP. Select Portfolio Servicing representatives demanded a payment in the amount of the original mortgage payment

⁵⁹ See, e.g., *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Irwin Trauss) (Saxon Mortgage “simply reject[s] homeowners for consideration under HAMP, for no reason that is in any way connected with the program requirements, with no notice of any kind to the homeowner or to her counsel.”).

⁶⁰ See, e.g., *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Irwin Trauss).

⁶¹ Motion to Set Aside the Judgment, Modify the Loan, and Dismiss the Foreclosure, U.S. Bank National Ass’n as Trustee HEAT 2006–1 v. Pitman, No. 2008–CV–337 (Greene County, Ohio, 2009); Motion to Stay/Abate, Deutsche Bank Nat’l Trust Company, as Trustee for HIS Asset Securitization Trust 2007–HE1 v. Hoyne, No. 42–2009–CA–002178 (Marion County, Fla., 2009).

⁶² Gretchen Morgenson, *Fair Game—So Many Foreclosures, So Little Logic*, N.Y. Times, July 4, 2009.

⁶³ See, e.g., Attachment A, Ocwen Loan Servicing Loan Modification Agreement dated June 1, 2009.

in order to enter the trial period agreement in order to demonstrate the borrower's "good faith."

Servicers are continuing to initiate foreclosures and sell homes at foreclosure sales while the HAMP review is pending.

HAMP requires that no foreclosures be initiated and no foreclosure sales be completed during a HAMP review, although existing foreclosure actions may be pursued to the point of sale. Reports from around the country indicate that servicers are routinely placing homeowners into foreclosure during a HAMP review and, far worse, selling the home at foreclosure while the homeowner is waiting on the outcome of the HAMP review.

Servicers often negotiate loan modifications on a separate track from the personnel pursuing foreclosure. This structure results in homeowners being placed in foreclosure, and being subject to a foreclosure sale, while HAMP review is occurring.

2. Servicer staffing and training still lag behind what is needed.

Homeowners encounter numerous bureaucratic barriers in attempting to negotiate a loan modification.

Homeowners' loan files are routinely lost.⁶⁴ Counselors report waits of months to hear back on review for a trial modification. In one case, Select Portfolio Services advised counsel for a New York borrower on three separate occasions over 6 weeks that the necessary broker price opinion had been canceled due to "system errors" and a new request would have to be submitted. A Florida homeowner had his HAMP trial modification canceled by Citimortgage for non-compliance, despite having submitted all required documents and payments as required, only to receive a HAMP solicitation letter the same day. His lawyer, in describing the situation to us, wrote, "It is driving the poor guy bananas."

To add insult to injury, homeowners are expected to return the documents within days of receipt. Homeowners in both New York and Florida have reported receiving the trial modification agreements the same day the servicer required their return. One Illinois homeowner received her trial modification agreement 3 days after she was required to return the agreement.

Staff of participating servicers continue to display alarming ignorance of HAMP.

Staff of participating servicers have told homeowners that HAMP does not exist. Several homeowners have reported being told to contact HUD since HAMP is a government program. HUD, of course, does not administer HAMP; participating servicers do. Bank of America apparently told the homeowners in one case that they were not eligible for HAMP because they were not in default.⁶⁵ This misinformation was given to the homeowner despite the fact that servicers are given an additional \$500 incentive payment for modifying a loan prior to default. In another case, Bank of America refused to modify a first lien position home equity line of credit, apparently under the belief that modifications of home equity lines of credit were banned as second liens, whether or not they actually were junior liens.

In one case, Select Portfolio Servicing (SPS) claimed that it could only take 80 percent of the applicants' gross income into consideration, regardless of HAMP guidelines and that the clients would have to reduce their debt obligations by \$300 to be considered for a modification. The representatives appeared to be operating under SPS's standard screening process for non-HAMP modifications and were not familiar with the HAMP standards. In the same case, another SPS representative claimed that the investor on the loan would only allow for payment modifications at 44 percent debt-to-income ratio, not the 31 percent mandated by HAMP. In many cases, it is not clear if staff are applying the net present value test or if they are applying it correctly.⁶⁶

A recent blurb from *Mortgage Servicing News Bulletin* captures the problem: "Confused About the Rescue Plan?"⁶⁷ Apparently many servicers are.

⁶⁴Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 28, 2009.

⁶⁵Freda R. Savana, *Some Banks Not With the Program*, Bucks County Courier Intelligencer, July 14, 2009.

⁶⁶See, e.g., *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. (2009) (testimony of Irwin Trauss) (discussing a case involving Wells Fargo).

⁶⁷Mortgage Servicing News Bull., July 14, 2009.

Non-participating servicers continue to represent themselves as participating in HAMP.

Some servicers give conflicting information on whether or not they participate in HAMP. American Home Mortgage Servicing, for example, conveyed on its website, automated answering service, and through its loan modification staff that it was a participating servicer under HAMP. Yet at least some of the loan modifications it offered were not HAMP-compliant, nor is it, as of July 13, 2009, listed as a participating servicer.

3. Lack of transparency is resulting in summary denials and other unreasonable acts by servicers.

Even when servicers do a HAMP review, they sometimes use the wrong numbers, which advocates are only able to uncover after a protracted battle. In one case involving a New York borrower, Select Portfolio Servicing representatives initially advised that the clients were ineligible for a HAMP loan modification, based on their budget. When asked for clarification about the grounds for this determination, SPS representatives claimed that the clients' expenses exceeded their income, making it impossible for them to afford their mortgage. Upon further discussion, it was revealed that SPS was using the clients' original mortgage payment as an input value for these calculations, rather than the proposed modified payment amount that would have made their mortgage affordable.

Some servicers are scrutinizing homeowner expenses and using back-end ratios as a basis for denying HAMP loan modifications. Back-end ratios, the ratio between all of the borrowers' fixed monthly obligations and income, should not disqualify a borrower under HAMP unless the reduced payment will cause the borrower severe financial hardship; instead, homeowners with back-end ratios above 55 percent are to be referred to HUD-certified housing counselors. In other cases, homeowners are turned down for loan modifications without any explanation.

Servicers refuse to provide the final payment amounts even when the borrower provides all verified information before the beginning of the trial modification period. In one case, 3 days after the servicer had supplied the borrower with the first set of trial modification documents and nearly 2 months after the borrower had submitted verified income information, the servicer increased the monthly payment amount, without any apparent justification.

The permanent modifications offered often include arrears that are undocumented and apparently overestimated. While HAMP permits arrearages and some fees to be capitalized, HAMP does not permit unpaid late fees to be capitalized. Given the widespread practice by servicers of padding fees in foreclosure or bankruptcy,⁶⁸ homeowners and their advocates have good reason to seek review of the legitimacy of the fees.

Some servicers claim they are doing a large volume of modifications for homeowners not eligible for HAMP, as well as many HAMP loan modifications. Whether or not the homeowners with the non-HAMP modifications were in fact eligible for HAMP is uncertain. As discussed above and exemplified in Attachment C, some servicers are requiring homeowners to waive their eligibility for a HAMP review in order to obtain any modification. The lack of public accountability makes it impossible to know how many of those reported as ineligible for HAMP were, in fact, ineligible, and how many were simply steered away from HAMP modifications.

In addition, determining whether or not any individual servicer is or is not participating is not trivial. As discussed above, some servicers represent themselves on their websites as participating, but fail to provide any HAMP review. As discussed below, confusion as to coverage of affiliated servicers is widespread.

B. Certain HAMP Policies Must Be Changed To Provide Sustainable Modifications and Save Communities.

1. Transparency must be improved.

The NPV model for qualifying homeowners must be available to the public.

A homeowner's qualification for a loan modification under HAMP is determined primarily through an analysis of the Net Present Value ("NPV") of a loan modification as compared to a foreclosure. The test measures whether the investor profits more from a loan modification or a foreclosure. Most investors require that servicers

⁶⁸ See, e.g., *In re Stewart*, 391 B.R. 327 (Bankr. E.D. La. 2008); *In re Sacko*, 394 B.R. 90 (Bankr. E.D. Pa. 2008); *In re Prevo*, 394 B.R. 847 (Bankr. S.D. Tex. 2008); *In re Porter*, 399 B.R. 113 (Bankr. D. N.H. 2008); Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 Tex. L. Rev 121 (2009).

perform some variant of this test prior to foreclosure.⁶⁹ The outcome of this analysis depends on inputs including the homeowner's income, FICO score, current default status, debt-to-income ratio, and property valuation, plus factors relating to future value of the property and likely price at resale. Participating servicers are required to apply this analysis to all homeowners who are 60 days delinquent and those at imminent risk of default. Homeowners and their advocates need access to the program to determine whether servicers have actually and accurately used the program in evaluating the homeowner's qualifications for a HAMP modification. Without access to the NPV analysis, homeowners are entirely reliant on the servicer's good faith.

The lack of NPV transparency makes servicer turndowns hard to counteract. NPV turndowns must be detailed and in writing, and based on a transparent process that conforms to HAMP guidelines.

The layers of documents governing HAMP, the guidelines, the Supplemental Directives, the various FAQ's, and the servicer contracts, should be consolidated, reconciled, and clarified.

Homeowners, their advocates, and servicers have no one source of guidance on HAMP. The initial guidelines differ slightly from the Supplemental Directives, and the FAQs provide different interpretations. All of this complicates compliance.

Participating subsidiaries must be clearly identified

Participating servicers may, but need not, require their subsidiaries to participate, so long as the subsidiary is a distinct legal entity. However, if the subsidiary is not a distinct legal entity, then the subsidiary must participate. The public list of participating servicers still does not make these distinctions clear. One example of the confusion is Wells Fargo. On financialstability.gov, Wells Fargo Bank is listed as a participating servicer. Wells Fargo Bank, N.A., is, according to the National Information Center maintained by the Federal Reserve, the parent company of Wells Fargo Home Mortgage. The contract posted on financialstability.gov variously represents the covered servicer as Wells Fargo Bank, N.A. (when giving the address for notices) and Wells Fargo Home Mortgage, a division of Wells Fargo Bank, N.A. (above the signature lines). Does this contract mean that both Wells Fargo Bank, N.A., and Wells Fargo Home Mortgage are covered? And is America's Servicing Company, a division of Wells Fargo Home Mortgage also covered? The answer to both questions appears to be yes but has not been uncontested. Asking homeowners and counselors to wade through these legal relationships invites confusion and frustration.⁷⁰

2. Mechanisms for enforcement and compliance should be adopted.

All foreclosure proceedings must be stopped upon the initiation of a HAMP review, not just at the point before sale.

While many servicers are placing homeowners in foreclosure and proceeding to sale in violation of HAMP guidelines (as described above), even compliance with the current rule is pushing homeowners into costlier loan modifications and tilting the scales toward foreclosure. In judicial foreclosure states, servicers are aggressively pursuing foreclosures while reviewing homeowners for loan modifications. As a result, homeowners are incurring thousands of dollars in foreclosure costs. Servicers either demand these payments upfront (an apparent violation of HAMP) or capitalize the costs without permitting any review by the homeowner. In either event, these costs make it harder to provide an affordable loan modification and the continuation of the foreclosure causes homeowners great stress. All foreclosure proceedings should be stayed while HAMP reviews occur. Staying the foreclosures during the pendency of a HAMP review would encourage servicers to expedite their HAMP reviews, rather than delaying them.

Homeowners should be provided with an independent review process when denied a loan modification.

It seems unlikely that all servicers will always accurately evaluate the qualifications of every homeowner who is eligible for HAMP. Homeowners who are wrongly denied must be afforded an independent review process to review and challenge the servicer's determination that the borrower does not qualify for HAMP.

⁶⁹ American Securitization Forum, *Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans* (June 2007), available at http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf.

⁷⁰ We understand and appreciate that the Treasury Department is working on this issue. As is apparent, providing full information to the public on participating servicers is essential.

Homeowners should have access to an ombudsman to address complaints about the process.

Homeowners currently have no resource for addressing complaints, whether with a servicer's failure to return phone calls or offer of a non-compliant modification. Any forum for addressing homeowners' complaints must adhere to timelines for addressing complaints and provide public accounting as to the nature of the disputes and their resolution.

Denials based in part on a borrower's credit score should be accompanied by an adverse action notice under the Fair Credit Reporting Act.

The Fair Credit Reporting Act requires that if an adverse action in the provision of credit is taken based in part on the borrower's credit score that the borrower be advised of that adverse action and of the credit score upon which the decision was based.⁷¹ The reason for that requirement is that credit scores often have errors, which a borrower may correct—but only if the borrower is aware of the error.

The Net Present Value test relies on credit scores to determine default and redefault rates. It is at least possible that those credit scores could result in the failure of the NPV test and the denial of a loan modification. Absent full transparency regarding the NPV calculation, homeowners are unlikely to know of the program's reliance on their FICO score or, if they do, whether or not their FICO score was the cause of their denial for a HAMP modification. An adverse action notice alerts homeowners to the possibility that an incorrect FICO score—which could be corrected—might be the reason their servicer denied a HAMP modification. Without an adverse action notice homeowners have little opportunity to address any potential problems.

3. The HAMP guidelines should be adjusted to provide more meaningful relief to homeowners without reducing their existing rights.

Homeowners need principal reductions, not forbearance.

Principal forgiveness is necessary to make loan modifications affordable for some homeowners. A significant fraction of homeowners owe more than their homes are worth.⁷² The need for principal reductions is especially acute—and justified—for those whose loans were not adequately underwritten and either 1) received Payment Option Adjustable Rate Mortgage loans that negatively amortize until as much as 125 percent of the original balance is owed; or 2) obtained loans that were based on inflated appraisals. As a matter of equity and commonsense, homeowners should not be trapped in debt peonage, unable to refinance or sell.

Practically, principal reductions may be key to the success of HAMP. Being “underwater” increases the risk of default, particularly when coupled with unaffordable payments.⁷³ Built into the HAMP NPV calculations is an assumption that default increases as a function of how far underwater the homeowner is. Existing data on loan modifications shows that loan modifications with principal reductions tend to perform better.⁷⁴ In order to bring down the redefault rate and make loan modifications financially viable for investors, principal reductions must be part of the package.

The Federal Reserve Board's loan modification program directly requires principal reductions for those homeowners most underwater. Under that program, principal reductions are mandated when the outstanding loan balance exceeds 125 percent of the home's current market value. Not incidentally, under the most recent revisions to the Making Home Affordable refinance program, once the mark-to-market loan-to-value ratio is 125 percent, a homeowner may refinance. Thus, once the loan value is reduced to 125 percent of current market valuation, there is, at least for some homeowners, the possibility of refinancing. While a loan-to-value ratio of 125 percent still leaves homeowners underwater and restricts their options, it gives them some hope, as it permits the possibility of refinancing or even sale, after several years of payments or subsequent to a market rebound. A reduction only to 125 per-

⁷¹ 15 U.S.C. § 1681m.

⁷² See Renae Merle & Dina ElBoghdady, *Administration Fills in Mortgage Rescue Details*, *Wash. Post*, Mar. 5, 2009 (reporting that one in five homeowners with a mortgage owe more on their mortgages than their home is worth).

⁷³ See, e.g., Kristopher Gerardi, Christopher L. Foote, & Paul S. Willen, *Negative Equity and Foreclosure: Theory and Evidence* (Fed. Reserve Bank of Boston Pub. Pol'y Paper No. 08–3, June 2008); Andrey Pavlov & Susan Wachter, *Aggressive Lending and Real Estate Markets* (Dec. 20, 2006), available at <http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf>.

⁷⁴ Roberto G. Quercia, Lei Ding, Janneke Ratcliffe, *Loan Modifications and Redefinition Risk: An Examination of Short-Term Impact* (Center for Community Capital, March 2009), available at http://www.ccc.unc.edu/documents/LM_March_%202009_final.pdf.

cent is still sufficiently harsh that it is likely to contain any moral hazard problems, yet it puts a finite bound on the homeowner's debt peonage.

HAMP permits principal reductions, but does not mandate them, not even in the most extreme cases. HAMP does require forbearance, but only as a method for reducing payments. While forbearance provides affordable payments, it prevents a homeowner from selling or refinancing to meet a needed expense, such as roof repair or college tuition, and sets both the homeowner and the loan modification up for future failure. For all of these reasons, the HAMP guidelines should be revised so that they at least conform to the Federal Reserve Board's loan modification program by reducing loan balances to 125 percent of the home's current market value.

Homeowners suffering an involuntary drop in income should be eligible for a second HAMP loan modification.

Even after a loan modification is done successfully and is performing, homeowners may still become disabled, lose their jobs, or suffer the death of a spouse. These subsequent, unpredictable events, outside the control of the homeowner, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership. Foreclosing on homes where homeowners have suffered an involuntary drop in income without evaluating the feasibility of a further HAMP modification is punitive to homeowners already suffering a loss and does not serve the interests of investors.

Some servicers provide modifications upon re-default as part of their loss mitigation program. This approach should be standard and mandated, and should include continued eligibility for HAMP modifications rather than only specific servicer or investor programs.

Homeowners in bankruptcy should be provided clear access to the HAMP program.

As a result of the HAMP guidelines providing servicer discretion on whether to provide homeowners in bankruptcy access to HAMP modifications, homeowners generally are being denied such modifications. In at least one instance, a servicer is reported to have refused a modification on the basis of a former bankruptcy, a clear violation of the HAMP guidance. The HAMP guidelines should provide clear guidance on instances where a loan modification should be provided to homeowners in bankruptcy. The HAMP guidelines should explicitly provide that servicers must consider a homeowner seeking a modification for HAMP even if the homeowner is a debtor in a pending bankruptcy proceeding.

Some servicers have explained their reluctance to do loan modifications in bankruptcy by citing a fear of violating the automatic stay in bankruptcy. Neither the automatic stay nor the discharge order should be a bar to offering an otherwise eligible homeowner a loan modification. HUD, in recent guidance to FHA servicers, has explicitly recognized that offering a loan modification does not violate the automatic stay or a discharge order.⁷⁵

Servicers should be required, upon receipt of notice of a bankruptcy filing, to send information to the homeowner's counsel indicating that a loan modification under HAMP may be available. Upon request by the homeowner and working through homeowner's counsel, servicers should offer appropriate loan modifications in accordance with the HAMP guidelines prior to discharge or dismissal, or at any time during the pendency of a chapter 13 bankruptcy, without requiring relief from the automatic stay, and, in the case of a chapter 7 bankruptcy, without requiring reaffirmation of the debt. The bankruptcy trustee should be copied on all such communications. All loan modifications offered in pending chapter 13 cases should be approved by the Bankruptcy Court prior to final execution, unless the Court determines that such approval is not needed. If the homeowner is not represented by counsel, information relating to the availability of a loan modification under HAMP should be provided to the homeowner with a copy to the bankruptcy trustee. The communication should not imply that it is in any way an attempt to collect a debt.

Two changes to the modification rules should also be made to facilitate access for homeowners in bankruptcy. First, the payment rules should take into account the fact that payments may be passed through the bankruptcy trustee, rather than directly from homeowner to servicer. Supplemental Directive 09-03 requires that the servicer receive a payment by the end of the first month that the trial plan is in effect. If the servicer does not receive the payment, the trial modification is terminated and the homeowner is disqualified from a permanent modification under HAMP. There is often an initial lag between passing the payments from the bankruptcy trustee to the servicer; homeowners should not be penalized for a delay over

⁷⁵ HUD Mortgage Letter 2008-32, October 17, 2008.

which they have no control and which is occasioned solely by their exercise of their right to file bankruptcy.

Second, the modification documents should explicitly prohibit servicers from requiring homeowners to reaffirm mortgage debts. Although the guidance and supplemental directive appear to allow homeowners not to reaffirm in bankruptcy, the form modification agreement requires reaffirmation by its terms in paragraph 4E. The modification agreement should be amended to restate explicitly that the borrower does not waive any claims by entering into the modification and that no reaffirmation of the debt is required. Because reaffirmations of home mortgages have the potential to deny homeowners a fresh start, many bankruptcy judges refuse to approve them. Congress recognized this concern with an amendment to the Bankruptcy Code in 2005 that permits mortgages to be serviced in the normal course after bankruptcy even if the mortgage has not been reaffirmed. These purported reaffirmation agreements made outside the mandatory notice and review procedures of section 523(c) and (d) of the Bankruptcy Code have no effect, are not enforceable, and the government should not be involved in encouraging the practice.

Mortgages should remain assumable as between spouses, children, and other persons with a homestead interest in the property.

Federal law, the Garn-St Germain Depository Act of 1982, specifically forbids acceleration when the property is transferred from one spouse to another and permits a spouse or child to assume the mortgage obligations.⁷⁶ Such transfers are most likely to occur upon death or divorce. They may also occur in the context of domestic violence. Freddie Mac has long allowed mortgage assumptions by relatives as one method of working out delinquent mortgages.

Following these policies, the HAMP program should allow mortgages for certain homeowners to be assumable. Homeowners who have recently suffered the death of a loved one should not find themselves immediately faced with foreclosure or suddenly elevated mortgage payments.

Fair lending principles must be ensured throughout the HAMP process.

Incentive payments for pre-default homeowners are aimed at the necessary policy of ensuring that homeowners already facing hardship obtain sustainable loans, yet the additional funds for such reviews may implicate fair lending issues. The home price decline protection program may result in payments focused more on non-minority areas and should be reviewed for fair lending concerns. Servicer incentive payments based on reductions in the dollar amount of a payment also may raise fair lending considerations. Moreover, hardship affidavits and paperwork must be made available in appropriate languages to ensure wide access to the program. Data on loan modifications and applications are essential to ensuring equitable access to the program; these data must all be available as of fall 2009. Any further delay will limit transparency and delay accountability.

HAMP application procedures should better recognize and lessen the impact of exigent circumstances.

Aspects of the loan modification procedures, or gaps in current guidance, create hurdles for certain homeowners. For example, victims of domestic violence are unlikely to be able to obtain and should not be required to obtain their abuser's signature on loan modification documents. While predatory lending and predatory servicing can create default and an imminent risk of default, as recognized by the HAMP plan, the hardship affidavit does not contain an explicit reference to either category. Thus, at present, a loan modification would be available only to a homeowner who realizes that the fraud and predatory behavior that resulted in unreasonable levels of debt are legitimate grounds for seeking a modification and who is able to articulate and defend that categorization to a line-level employee of the servicer who may be relying in a formulaic way on the categories contained in the hardship affidavit or may be outright hostile to claims of predatory behavior.

The trial modification program should be further formalized and clarified, such that homeowners receive assurances of the terms of the permanent modification and homeowners are not put into default on their loans if they are current at the onset of the trial modification.

The trial modification program currently complicates matters for participating homeowners by increasing costs and failing to maximize the chances for long-term

⁷⁶ 12 U.S.C. § 1701j-3(d)(6) (2008) (transfer from borrower to spouse or children); 12 U.S.C. § 1701j-3(d)(7) (2008) (transfer to spouse pursuant to divorce decree or legal separation agreement).

success. Moreover, by binding homeowners but not servicers, it may further discourage some homeowners from participating.

Payments received during the trial modification period should be applied to principal and interest, not held in suspense until the end of the trial period. Trial modification payments should be applied as if the modification, and any capitalization, occurred at the outset of the trial period, with payments allocated accordingly between principal and interest. The policy of capitalizing arrears at the end of the modification period, including any difference between scheduled and modified payments, penalizes homeowners (including those not in default at the time of the trial modification) by raising the cost of the modification and increasing the chances that some homeowners will not pass the NPV test. The use of suspense accounts and capitalizing arrears after the trial period render meaningless the term “modification” in “trial modification.”

In addition, homeowners who are not delinquent at the start of the trial period and who are making payments as agreed under the trial plan currently are reported to credit bureaus as making payments under a payment plan; this may register as a black mark against their credit. Homeowners should not face decreased credit scores simply because they are seeking to attain a responsible debt load. For homeowners in bankruptcy, the new rules defining when trial payments are “current” fail to take into account the delay in initial disbursement that may occur when payments are made through the chapter 13 trustee.

Finally, homeowners need some assurance at the time of the trial modification that, if their income is as represented upon approval of the trial modification, the servicer will provide a final modification on substantially similar terms. Homeowners are bound by the trial modification; it is not clear that servicers are.

The borrower is required to sign the trial modification documents, but the servicer is not. This one-sided contract discourages some homeowners and advocates. Homeowners may decide that the costs of a trial modification—the capitalized interest, the sunk payments, the potential adverse credit reporting—are not worth the uncertain benefit of a permanent modification. Some servicers compound this problem by telling homeowners seeking modifications that they are under no obligation to offer a permanent modification. Indeed, the trial modification agreement itself, in paragraph 2F, appears to allow servicers to choose not to complete a permanent modification. According to paragraph 2F, homeowners are not entitled to a permanent modification if the servicer fails to provide the borrower with “a fully executed copy of this Plan and the Modification Agreement.” Should a servicer fail to provide the borrower with a fully executed copy, the borrower is left without a permanent modification and without any recourse, while the servicer may then retain the payments made and proceed to a foreclosure. Faced with this uneven exchange, many homeowners will rationally refuse to complete a trial modification, even if they would qualify for and benefit from a permanent modification.

The final modification agreement should make clear that the homeowners do not waive any rights nor are required to reaffirm the debt in order to enter into the modification.

Although the HAMP guidelines prohibit waiver of claims and defenses,⁷⁷ the language in paragraph 4E of the modification agreement, “[t]hat the Loan Documents are composed of duly valid, binding agreements, enforceable in accordance with their terms and are hereby reaffirmed,” could be construed as a waiver of some claims, particularly claims involving fraud in the origination or execution of the documents. In addition to the problems posed by reaffirmation of the debt in bankruptcy, reaffirmation of the debt and loan documents outside of bankruptcy could be construed as a waiver of defenses to the debt. Servicers, as discussed above and demonstrated by the attachments, are seeking even stronger waivers of legal rights; the form documents should give such unauthorized behavior no shelter. The modification agreement should clearly state that the borrower does not waive any claims and defenses by entering into the agreement and that the borrower is not required to reaffirm the debt.

The second lien program should be further developed to promote coordination with first lien modifications; servicers should be required to participate in both programs.

Servicers continue to express ignorance of the second lien program and widely refuse to modify second liens. For example, Bank of America told a Pennsylvania borrower that a home equity line of credit could not be modified because it was “written” as a second lien, even though it was the primary, and only, lien against

⁷⁷Supplemental Directive, 09–01, at 2, available at hmpadmin.com.

the property. Servicers will often service both the first and second liens. Frequently, servicers themselves hold the second lien. Yet often servicers refuse to address the second lien, despite the incentives in HAMP to do so. Servicers who hold second liens may prefer to gamble on a market recovery rather than accept the incentive payments under HAMP and recognize their losses now. Many servicers will choose not to participate in the second lien program absent a Federal mandate.

The second lien program should work in concert with the primary lien modification program to the greatest extent possible. Only such coordination will result in maximizing the potential of the program to save homes and communities.

4. Data collection and reporting should support the best HAMP outcomes possible.

The maximum amount of data should be made available to the public, including data on a loan-by-loan basis. The data should be made available in user-friendly formats that are easy to obtain and that allow for additional and varied processing and analysis. The data should be made available on a basis as close to real time as possible. Data collected by the government and disclosed to the public, including HAMP monitoring data and other data, should enable the government and the public to compare the performance of HAMP against specific benchmarks. The data should enable the government and the public to assess the extent to which HAMP is serving equitably those most heavily targeted for high risk loans (especially African-American, Latino and older borrowers).

V. Benchmarks for Performance, Mandatory Loan Modification Offers, and Other Servicing Reforms Should Be Required If the Program Does Not Produce Sufficient Results in Short Order.

Creating affordable and sustainable loan modifications for distressed homeowners is labor intensive. It is no surprise, then, that servicers continue to push homeowners away from HAMP loan modifications or delay the process substantially.

Initial data collection will make a more exact review of the HAMP program possible within the next few months. Freddie Mac already is engaged in substantial oversight. Our work nationwide on behalf of homeowners facing foreclosure and unaffordable loans tells us that many qualified homeowners are being unnecessarily turned away from HAMP, those receiving loan modifications often obtain terms quite different from HAMP, and even the HAMP-compliant modifications are limited in what they can do for homeowners with high loan principals.

We anticipate that the data will reflect the experience of hundreds of homeowners and their advocates, showing that the program is too narrow and too hard to implement. When the data substantiates our necessarily impressionistic description of the failures of HAMP, Congress should enact legislation to mandate loan modifications where they are more profitable to investors than foreclosure. Loss mitigation, in general, should be preferred over foreclosure. Additionally, Congress should revisit the question of bankruptcy relief. First-lien home loans are the only loans that a bankruptcy judge cannot modify.⁷⁸ The failure to allow bankruptcy judges to align the value of the debt with the value of the collateral contributes to our ongoing foreclosure crisis.

Basic problems in the structure of the servicing industry need to be addressed in order for the homeowner-servicer relationship to be functional. From the homeowner's perspective, one of the biggest obstacles to loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions. Federal law should require that mortgage servicers provide homeowners with contact information for a real person with the information and authority to answer questions and fully resolve issues related to loss mitigation activities for the loan. While the Real Estate Settlement Procedures Act currently requires servicers to respond to homeowners' request for information and disputes within 60 days, in practice many such inquires go unanswered. Despite this failure to respond, servicers are still permitted to proceed to collection activities, including foreclosure. Essential changes to this law governing servicers should ensure that homeowners facing foreclosure would no longer be at the mercy of their servicer. There should be transparency in the servicing process by allowing the homeowner to obtain key information about the loan and its servicing history. Servicers should be prohibited from initiating or continuing a foreclosure proceeding during the period in which an outstanding request for information or a dispute is pending.

⁷⁸Second liens can be modified if they are, as many are in the current market, completely unsecured because the amount of the first lien equals or exceeds the market value of the property.

Further reform of the tax code to simplify the exclusion of discharge of indebtedness income would also be of assistance to many homeowners, particularly homeowners with significant refinancing debt whose servicers are persuaded to do sustainable principal reductions.⁷⁹

VI. Conclusion

Thank you for the opportunity to testify before the Committee today. The foreclosure crisis is continuing to swell. We are drowning in the detritus of the lending boom of the last decade. The need to act is great. The HAMP program must be strengthened. Homeowners who qualify must have the right to be offered a sustainable loan modification prior to foreclosure. Passage of legislation to allow for loan modifications in bankruptcy, to reform the servicing industry, and to address the tax consequences of loan modifications also would aid in protecting homeowners from indifferent and predatory servicing practices and reducing the foreclosure surge. Together, these measures would save many homes and stabilize the market. We look forward to working with you to address the economic challenges that face our Nation today.

⁷⁹See generally 2008 Nat'l. Taxpayer Advocate Ann. Rep. at vi—vii (summarizing recommendations regarding changes to the treatment and reporting of cancellation of debt income in the mortgage context).

Attachment A—Ocwen Loan Modification Agreement



Ocwen Loan Servicing, LLC
P.O. Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

June 1, 2009

Loan Number: [REDACTED]
Property Address: [REDACTED]

PROPOSED MODIFICATION AGREEMENT

Dear Borrower(s):

Enclosed please find a proposed modification agreement (the "Agreement") on your loan referenced above for your review and consideration.

In order to accept this modification on your loan, you must complete ALL of the following steps on or before June 12, 2009, ("Due Date"):

1. SIGN the bottom of the Agreement on the line(s) for the Borrower(s);
2. FAX the fully executed Agreement to: Attention: Home Retention Department
(407) 737-5693
3. PAY the full down payment in the amount of: \$1,281.00
[See Payment Instructions Attached]
4. NEW MONTHLY PAYMENT: \$737.82 (which may or may not include escrow)
starting on July 1, 2009.
5. SEND proof of insurance coverage* Attention: Escrow Department
(Send proof of insurance ONLY to Escrow Fax: 1-888-882-1816
Dept. DO NOT include the Agreement.) E-mail: dateinsuranceinfo@ocwen.com

* Proof of insurance and the Agreement must be sent separately to the correct departments using the fax numbers provided above. Failure to send proof of insurance coverage before the Due Date will constitute acceptance of a force placed policy and agreement to pay the costs of such force placed policy, so long as all other items are complete.

Time is of the essence on this offer. If ALL of the items above are not completed by the Due Date, the Agreement shall have no force or effect and any down payment received will be returned to you. Please be advised that Ocwen Loan Servicing, LLC will not delay, postpone or otherwise stop any collection efforts until ALL of the steps above have been completed.

If you have any questions or require additional information, please contact the Home Retention Department directly at (877) 596-8580.

Sincerely,

Ocwen Loan Servicing, LLC

6348635

This communication is from a debt collector attempting to collect a debt; any information obtained will be used for that purpose. However, if the debt is in active bankruptcy or has been discharged through bankruptcy, this communication is not intended as and does not constitute an attempt to collect a debt.



Ocwen Loan Servicing, LLC
P.O. Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

PAYMENT REMITTANCE INFORMATION

PLEASE DON'T FORGET TO:

1. Make checks payable to Ocwen Loan Servicing, LLC.
2. Always include your loan number with your payment.
3. The down payment must be in the form of certified funds.

OVERNIGHT DELIVERY

(Money Order & Certified Checks Only)

OCWEN LOAN SERVICING, LLC
ATTN: CASHIERING DEPARTMENT
12650 INGENUITY DRIVE
ORLANDO, FL 32826

MONEY GRAM

RECEIVER CODE: 3237
PAYABLE TO: OCWEN LOAN SERVICING, LLC
CITY: ORLANDO
STATE: FLORIDA
REFERENCE: [REDACTED]
AGENT LOCATER: (800) 926-9400

BANK WIRE

BANK: JPMorgan Chase Bank, NA
ABA: 021000021
ACCOUNT NAME: Ocwen Financial Corporation
ACCOUNT NUMBER: 00113339999
REFERENCE: Loan Number, Property Address,
and Borrower Name

Email: Transferfunds@ocwen.com with the details
of the wire.

BY WUOC

Code City: Ocwen
State: FL
Reference: Loan # [REDACTED]
Attn: Home Retention Department,
Home Retention Consultant

LOAN MODIFICATION AGREEMENT

Ocwen Loan Servicing, LLC ("Ocwen") is offering you this Loan Modification Agreement ("Agreement"), dated June 1, 2009, which modifies the terms of your home loan obligations as described in detail below:

- A. the Mortgage, Deed of Trust, or Security Deed (the "Mortgage"), dated and recorded in the public records of CLAY County, and
- B. the Note, of the same date and secured by the Mortgage, which covers the real and personal property described in the Mortgage and defined therein as the "Property", located at [REDACTED]

Pursuant to our mutual agreement to modify your Note and Mortgage and in consideration of the promises, conditions, and terms set forth below, the parties agree as follows:

1. You agree that the new principal balance due under your modified Note and the Mortgage will be \$125,056.60. Upon modification, your Note will become contractually current; however, fees and charges that were not included in this principal balance will be your responsibility.
2. You promise to make an initial down payment in the amount of \$1,281.00 on or before June 12, 2009, after which you will commence payments of principal and interest in the amount of \$555.87 beginning on July 1, 2009 and continuing on the same day of each succeeding month for a five (5) year period. At the end of this period, your payment is subject to change based on paragraph 4 below.
3. Any payments due for taxes and insurance will be your responsibility in addition to the payments of principal and interest required under the terms of this modification. If this loan is currently escrowed, Ocwen will continue to collect the escrow amounts with your monthly principal and interest payment.
4. Upon Modification, the annual rate of interest charged on the unpaid principal balance of your loan will be 4.42100%. This rate will remain in effect until the end of a five (5) year period beginning with your first payment after the down payment. At the end of this period, your interest rate will be calculated according to the terms of your original loan documentation.

6348635

This communication is from a debt collector attempting to collect a debt; any information obtained will be used for that purpose. However, if the debt is in active bankruptcy or has been discharged through bankruptcy, this communication is not intended as and does not constitute an attempt to collect a debt.



Ocwen Loan Servicing, LLC
P.O.Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

5. You promise to make payments of principal and interest on the same day of each succeeding month until May 1, 2036, at which time a final balloon payment in an amount equal to all remaining amounts under the Note and Modification will be due.
6. You will comply with all other covenants, agreements, and requirements of your Mortgage, including without limitation, the covenants and agreements to make all payments of taxes, insurance premiums, assessments, escrow items, impounds, and all other payments that you are obligated to make under the Mortgage, except as otherwise provided herein.
7. If you sell your property, refinance, or otherwise payoff your loan during the 12 months following the date of Modification, the Modification will be voidable at the sole option of Ocwen and all amounts owed under the obligations existing prior to the Modification will be due and owing.
8. You understand and agree that:
 - (a) All the rights and remedies, stipulations, and conditions contained in your Mortgage relating to default in the making of payments under the Mortgage will also apply to default in the making of the modified payments hereunder.
 - (b) All covenants, agreements, stipulations, and conditions in your Note and Mortgage will remain in full force and effect, except as herein modified, and none of the your obligations or liabilities under your Note and Mortgage will be diminished or released by any provisions hereof, nor will this Agreement in any way impair, diminish, or affect any of Ocwen's rights under or remedies on your Note and Mortgage, whether such rights or remedies arise there under or by operation of law. Also, all rights of recourse to which Ocwen is presently entitled against any property or any other persons in any way obligated for, or liable on, your Note and Mortgage are expressly reserved by Ocwen.
 - (c) Any expenses incurred in connection with the servicing of your loan, but not yet charged to your account as of the date of this Agreement, may be charged to your account after the date of this Agreement.
 - (d) You have no right of set-off or counterclaim, or any defense to the obligations of your Note or Mortgage.
 - (e) Nothing in this Agreement will be understood or construed to be a satisfaction or release in whole or in part of your Note and Mortgage.
 - (f) You agree to make and execute such other documents or papers as may be necessary or required to effectuate the terms and conditions of this Agreement which, if approved and accepted by Ocwen, will bind and inure to your heirs, executors, administrators, and assigns.
 - (g) You understand that this agreement is legally binding and that it affects your rights. You confirm that you have had the opportunity to obtain, independent legal counsel concerning this Agreement and are signing this Agreement voluntarily and with full understanding of its contents and meaning.
 - (h) Corrections and Omissions. You agree to execute such other and further documents as may be reasonably necessary to consummate the transactions contemplated herein or to perfect the liens and security interests intended to secure the payment of the loan evidenced by the Note.
9. BY EXECUTING THIS MODIFICATION, YOU FOREVER IRREVOCABLY WAIVE AND RELINQUISH ANY CLAIMS, ACTIONS OR CAUSES OF ACTION, STATUTE OF LIMITATIONS OR OTHER DEFENSES, COUNTERCLAIMS OR SETOFFS OF ANY KIND WHICH EXIST AS OF THE DATE OF THIS MODIFICATION, WHETHER KNOWN OR UNKNOWN, WHICH YOU MAY NOW OR HEREAFTER ASSERT IN CONNECTION WITH THE MAKING, CLOSING, ADMINISTRATION, COLLECTION OR THE ENFORCEMENT BY OCWEN OF THE LOAN DOCUMENTS, THIS MODIFICATION OR ANY OTHER RELATED AGREEMENTS.
10. BY EXECUTING THIS MODIFICATION, YOU IRREVOCABLY WAIVE ALL RIGHTS TO A TRIAL BY JURY IN ANY ACTION, PROCEEDING OR COUNTERCLAIM ARISING OUT OF OR RELATING TO THIS MODIFICATION AND ANY RELATED AGREEMENTS OR DOCUMENTS OR TRANSACTIONS CONTEMPLATED IN THIS MODIFICATION.

0349635

This communication is from a debt collector attempting to collect a debt; any information obtained will be used for that purpose. However, if the debt is in active bankruptcy or has been discharged through bankruptcy, this communication is not intended as and does not constitute an attempt to collect a debt.



Ocwen Loan Servicing, LLC
P.O. Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

Ocwen Loan Servicing, LLC

Borrower: [REDACTED]

By: _____

6348635

This communication is from a debt collector attempting to collect a debt; any information obtained will be used for that purpose. However, if the debt is in active bankruptcy or has been discharged through bankruptcy, this communication is not intended as and does not constitute an attempt to collect a debt.



Ocwen Loan Servicing, LLC
P.O. Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

PAYMENT REMITTANCE INFORMATION

PLEASE DON'T FORGET TO:

1. Make checks payable to Ocwen Loan Servicing, LLC.
2. Always include your loan number with your payment.
3. The down payment must be in the form of certified funds.

OVERNIGHT DELIVERY

(Money Order & Certified Checks Only)

OCWEN LOAN SERVICING, LLC
ATTN: CASHIERING DEPARTMENT
12650 INGENUITY DRIVE
ORLANDO, FL 32826

MONEY GRAM

RECEIVER CODE: 3237
PAYABLE TO: OCWEN LOAN SERVICING, LLC
CITY: ORLANDO
STATE: FLORIDA
REFERENCE: [REDACTED]
AGENT LOCATER: (800) 926-9400

BY WUOC

Code City: Ocwen
State: FL
Reference: Loan [REDACTED]
Attn: Home Retention Department,
Home Retention Consultant

BANK WIRE

BANK: JPMorgan Chase Bank, NA
ABA: 021000021
ACCOUNT NAME: Ocwen Financial Corporation
ACCOUNT NUMBER: 00113339999
REFERENCE: Loan Number, Property Address,
and Borrower Name
Email: Transferfunds@ocwen.com with the details
of the wire.

LOAN MODIFICATION AGREEMENT

Ocwen Loan Servicing, LLC ("Ocwen") is offering you this Loan Modification Agreement ("Agreement"), dated June 3, 2009, which modifies the terms of your home loan obligations as described in detail below:

- A. the Mortgage, Deed of Trust, or Security Deed (the "Mortgage"), dated and recorded in the public records of CLAY County, and
- B. the Note, of the same date and secured by the Mortgage, which covers the real and personal property described in the Mortgage and defined therein as the "Property", located at [REDACTED]

Pursuant to our mutual agreement to modify your Note and Mortgage and in consideration of the promises, conditions, and terms set forth below, the parties agree as follows:

1. You agree that the new principal balance due under your modified Note and the Mortgage will be \$31,082.01. Upon modification, your Note will become contractually current; however, fees and charges that were not included in this principal balance will be your responsibility.
2. You promise to make an initial down payment in the amount of \$287.00 on or before June 12, 2009, after which you will commence payments of principal and interest in the amount of \$94.12 beginning on July 1, 2009 and continuing on the same day of each succeeding month for a five (5) year period. At the end of this period, your payment is subject to change based on paragraph 4 below.
3. Any payments due for taxes and insurance will be your responsibility in addition to the payments of principal and interest required under the terms of this modification. If this loan is currently escrowed, Ocwen will continue to collect the escrow amounts with your monthly principal and interest payment.
4. Upon Modification, the annual rate of interest charged on the unpaid principal balance of your loan will be 2.00000%. This rate will remain in effect until the end of a five (5) year period beginning with your first payment after the down payment. At the end of this period, your interest rate will be calculated according to the terms of your original loan documentation.

6348643

This communication is from a debt collector attempting to collect a debt; any information obtained will be used for that purpose. However, if the debt is in active bankruptcy or has been discharged through bankruptcy, this communication is not intended as and does not constitute an attempt to collect a debt.



Ocwen Loan Servicing, LLC
P.O. Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

5. You promise to make payments of principal and interest on the same day of each succeeding month until May 1, 2021, at which time a final balloon payment in an amount equal to all remaining amounts under the Note and Modification will be due.
6. You will comply with all other covenants, agreements, and requirements of your Mortgage, including without limitation, the covenants and agreements to make all payments of taxes, insurance premiums, assessments, escrow items, impounds, and all other payments that you are obligated to make under the Mortgage, except as otherwise provided herein.
7. If you sell your property, refinance, or otherwise payoff your loan during the 12 months following the date of Modification, the Modification will be voidable at the sole option of Ocwen and all amounts owed under the obligations existing prior to the Modification will be due and owing.
8. You understand and agree that:
 - (a) All the rights and remedies, stipulations, and conditions contained in your Mortgage relating to default in the making of payments under the Mortgage will also apply to default in the making of the modified payments hereunder.
 - (b) All covenants, agreements, stipulations, and conditions in your Note and Mortgage will remain in full force and effect, except as herein modified, and none of the your obligations or liabilities under your Note and Mortgage will be diminished or released by any provisions hereof, nor will this Agreement in any way impair, diminish, or affect any of Ocwen's rights under or remedies on your Note and Mortgage, whether such rights or remedies arise there under or by operation of law. Also, all rights of recourse to which Ocwen is presently entitled against any property or any other persons in any way obligated for, or liable on, your Note and Mortgage are expressly reserved by Ocwen.
 - (c) Any expenses incurred in connection with the servicing of your loan, but not yet charged to your account as of the date of this Agreement, may be charged to your account after the date of this Agreement.
 - (d) You have no right of set-off or counterclaim, or any defense to the obligations of your Note or Mortgage.
 - (e) Nothing in this Agreement will be understood or construed to be a satisfaction or release in whole or in part of your Note and Mortgage.
 - (f) You agree to make and execute such other documents or papers as may be necessary or required to effectuate the terms and conditions of this Agreement which, if approved and accepted by Ocwen, will bind and inure to your heirs, executors, administrators, and assigns.
 - (g) You understand that this agreement is legally binding and that it affects your rights. You confirm that you have had the opportunity to obtain, independent legal counsel concerning this Agreement and are signing this Agreement voluntarily and with full understanding of its contents and meaning.
 - (h) Corrections and Omissions. You agree to execute such other and further documents as may be reasonably necessary to consummate the transactions contemplated herein or to perfect the liens and security interests intended to secure the payment of the loan evidenced by the Note.
9. BY EXECUTING THIS MODIFICATION, YOU FOREVER IRREVOCABLY WAIVE AND RELINQUISH ANY CLAIMS, ACTIONS OR CAUSES OF ACTION, STATUTE OF LIMITATIONS OR OTHER DEFENSES, COUNTERCLAIMS OR SETOFFS OF ANY KIND WHICH EXIST AS OF THE DATE OF THIS MODIFICATION, WHETHER KNOWN OR UNKNOWN, WHICH YOU MAY NOW OR HEREAFTER ASSERT IN CONNECTION WITH THE MAKING, CLOSING, ADMINISTRATION, COLLECTION OR THE ENFORCEMENT BY OCWEN OF THE LOAN DOCUMENTS, THIS MODIFICATION OR ANY OTHER RELATED AGREEMENTS.
10. BY EXECUTING THIS MODIFICATION, YOU IRREVOCABLY WAIVE ALL RIGHTS TO A TRIAL BY JURY IN ANY ACTION, PROCEEDING OR COUNTERCLAIM ARISING OUT OF OR RELATING TO THIS MODIFICATION AND ANY RELATED AGREEMENTS OR DOCUMENTS OR TRANSACTIONS CONTEMPLATED IN THIS MODIFICATION.

6348643

This communication is from a debt collector attempting to collect a debt; any information obtained will be used for that purpose. However, if the debt is in active bankruptcy or has been discharged through bankruptcy, this communication is not intended as and does not constitute an attempt to collect a debt.



Ocwen Loan Servicing, LLC
P.O.Box 785052
Orlando, Florida 32878

WWW.OCWEN.COM

Ocwen Loan Servicing, LLC

Borrower: [REDACTED]

By: _____

6348643

This communication is from a debt collector attempting to collect a debt; any information obtained will be used for that purpose. However, if the debt is in active bankruptcy or has been discharged through bankruptcy, this communication is not intended as and does not constitute an attempt to collect a debt.


Attachment B—Aurora Loan Services Letter and Workout Agreement

RECEIVED FAX May 23 2009 10:24 AM FAX Station 00441 AND COMAIL PA

FROM : PROJEKT GROUP

FAX NO. : 561-272-6295

May, 23 2009 10:24PM P2

 **Aurora - Loan Services**

LIMIT 0038261699

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

May 20, 2009

12C

3640038261699534LM22405-20-09

[REDACTED]

RE: Loan No. [REDACTED]
Property Address: [REDACTED]

Dear Customer(s):

Enclosed please find two copies of a Special Forbearance Agreement which has been prepared on your behalf. Please sign, date and return one copy to Aurora Loan Services and retain the second copy for your records.

You have been conditionally approved for this Special Forbearance Agreement as a result of the information that you provided to Aurora Loan Services. Your approval for the Special Forbearance Agreement is conditional upon Aurora Loan Services verifying the information that you provided.

Please execute the attached Special Forbearance Agreement and return it along with (1) the information requested in the enclosed package; (2) the completed financial statement; and (3) your initial payment in the amount of \$870.41. This payment as well as the requested information must be received in our office on or before 06/01/2009.

To expedite processing of your Special Forbearance Agreement, please fax the signed Agreement to Aurora Loan Services at 866-517-7975, and remit the initial payment via Western Union Quick Collect. When sending funds via Western Union, please use the Code City: BLUFF, NE and always include your Aurora Loan Services loan number for prompt posting to your account. Any funds received after 5:00 p.m. ET will be posted the next business day.

Certified Funds should be made payable to Aurora Loan Services. Please include your Aurora Loan Services loan number on the certified funds and mail the funds separately to our Payment Processing Center at:

<u>Overnight Delivery Services</u>	or	<u>U.S. Postal Delivery Services</u>
Aurora Loan Services		Aurora Loan Services
Attn: Cashiering Dept.		Attn: Cashiering Dept.
10350 Park Meadows Drive		P.O. Box 5180
Littleton, CO 80124		Denver, CO 80217-5180

IMPORTANT INFORMATION ON PAGE 2




Received Fax: May 23 2009 8:11PM Fax Station: 001481 AND CC: ANI PA

FROM : PROJEKT GROUP

FAK NO. : 561-272-6295

May. 23 2009 10:25PM P3

 **Aurora • Loan Services**

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0509 • FAX: 303-728-7648

Loan No. [REDACTED]

Page 2 of 2

Please mail all correspondence, requested information and the executed agreement to our Servicing Center at:

<u>Overnight Delivery Services</u>	or	<u>U.S. Postal Delivery Services</u>
Aurora Loan Services		Aurora Loan Services
Attn: Home Retention		Attn: Home Retention
2617 College Park		P.O. Box 1706
Scottsbluff, NE 69361		Scottsbluff, NE 69363-1706

Notwithstanding anything to the contrary contained in the Special Forbearance Agreement, the parties hereto acknowledge the effect of a discharge in bankruptcy that may have been granted to the Borrower(s) prior to the execution hereof and that the Lender may not pursue the Borrower(s) for personal liability. However, the parties acknowledge that the Lender retains certain rights, including but not limited to the right to foreclose its lien under appropriate circumstances. The parties agree that the consideration for this Agreement is Aurora Loan Services' forbearance from presently exercising its rights and pursuing its remedies under the Security Instrument as a result of the Borrower's default of its obligations there under. Nothing herein shall be construed to be an attempt to collect against the Borrower(s) personally or an attempt to revive personal liability.

Signing the attached documents in no way affects or eliminates any rights you have been given in this letter or any correspondence attached hereto.

If you have any questions, please contact one of our Home Retention Counselors at the address above or by calling 800-550-0509.

Sincerely,

Home Retention Group
Aurora Loan Services

Enclosure

Aurora Loan Services is a debt collector. Aurora Loan Services is attempting to collect a debt and any information obtained will be used for that purpose. However, if you are in bankruptcy or received a bankruptcy discharge of this debt, this communication is not an attempt to collect the debt against you personally, but is notice of a possible enforcement of the lien against the collateral property.



AURORA LOAN SERVICES LLC

FROM :PROJEKT GROUP FAX NO. :561-272-6295 May. 23 2009 10:25PM P4

Aurora • Loan Services

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69361-1706
PHONE: 600-550-0508 • FAX: 303-728-7648

WORKOUT AGREEMENT

BY AND BETWEEN AURORA LOAN SERVICES

AND

Property Address: [REDACTED] Loan No. [REDACTED]

This Workout Agreement is made May 20, 2009, by and between AURORA LOAN SERVICES ("Lender") located at 2617 College Park, Scottsbluff, NE 69361, and [REDACTED] (individually and collectively, "Customer").

WHEREAS, Lender is the servicing agent and/or the owner and holder of a certain Note dated 06-14-06, executed and delivered by Customer, in the original principal amount of \$ 256,000 (the "Note"). The Note is secured by a mortgage, deed of trust or comparable security instrument dated 06-14-06, (the "Security Instrument"), on the property located at the address specified above (the "Property"). The Note and Security Instrument are collectively referred to as the "Loan Documents".

WHEREAS, Customer is in default under the Loan Documents, has failed to make payment of monthly installments of principal, interest, and escrow, if any, and has incurred additional expenses authorized under the Loan Documents, resulting in a total arrearage now due of \$ 30,515.07, as more particularly set forth below:

Unpaid monthly payment(s) of PITI* from 07-01-08 through and including 05-20-09	\$ 25,906.65
Accrued Late Charges	689.92
NSF Charges	.00
Legal Fees	1,808.00
Corporate Advances**	2,110.50
Other Fees***	.00
Minus Credit (suspense balance/partial payment)	.00
Total Amount Due (the "Arrearage")	\$ 30,515.07

* "PITI" means the monthly payment of principal, interest, and escrows, required, for taxes and insurance premium installments.

** "Corporate Advances" include, but are not limited to, property inspection fees, property preservation fees, legal fees, foreclosure fees and costs, appraisal fees, BPO (i.e. broker price opinion) fees, title report fees, recording fees, and subordination fees.


*** "Other Fees" include, but are not limited to, short payment advances and Speed ACH fees.



FROM : PROJEKT GROUP

FAX NO. : 561-272-6295

May. 23 2009 10:26PM P5


Aurora - Loan Services

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
 PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. [REDACTED]

Page 2 of 5

WHEREAS, as a result of Customer's default, Lender (i) has the right to accelerate, and to require Customer to make immediate payment in full, all of the sums owed under the Note and secured by the Security Instrument, (ii) has so accelerated and declared due in full all such sums, and (iii) may have already commenced foreclosure proceedings to sell the Property.

WHEREAS, as of the date of execution of the Agreement, Lender commenced Foreclosure proceedings to sell the property on 10/29/08 by legal filing in the county and state where the Property is located. A Foreclosure sale has not yet been scheduled.

WHEREAS, customer has requested Lender's forbearance in exercising its rights and remedies under the default provisions of the Loan Documents and with regard to any foreclosure action that may now be pending.

WHEREAS, Customer has requested and Lender has agreed to allow Customer to repay the Arrearage pursuant to a loan work-out arrangement on the terms set forth herein.

NOW, THEREFORE, in consideration of the promises and mutual covenants herein contained, the parties hereto agree as follows:

1. Term. This Agreement shall expire on the "Expiration Date," as defined in Attachment A.

2. Lenders Forbearance. Lender shall forbear from exercising any or all of its rights and remedies now existing or arising during the term of this Agreement under the Loan Documents, provided there is no "Default", as such term is defined in paragraph 5.

3. Customer's Admissions. Customer admits that the Arrearage is correct and is currently owing under the Loan Documents, and represents, agrees and acknowledges that there are no defenses, offsets, or counterclaims of any nature whatsoever to any of the Loan Documents or any of the debt evidenced or secured thereby.

Customer admits and agrees that any and all postponements of a foreclosure sale, made during the term of this Agreement or in anticipation of this Agreement, are done by mutual consent of the Customer and Lender and that, to the extent allowed by applicable law, any such foreclosure sale may be postponed from time to time until the loan evidenced by the Note is fully reinstated or the foreclosure sale is consummated. Lender shall be under no obligation to dismiss a pending foreclosure proceeding until such time as all terms and conditions of this Agreement and Attachment A have been fully performed.


4. Terms of Workout. See Attachment A, which is made a part hereof.



FROM : PROJEKT GROUP

FAX NO. : 561-272-6295

May, 23 2009 10:26PM P6


Aurora • Loan Services

 2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69383-1706
 PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. [REDACTED]

Page 3 of 5

5. **Default.** If Customer fails to make any of the payments specified in Attachment A on the due dates and in the amount stated, or otherwise fails to comply with any of the terms and conditions herein or therein (any such even hereby defined as a "Default"), Lender, at its sole option, may terminate this Agreement without further notice to Customer. In such case, all amounts that are then owing under the Note, the Security Instrument, and this Agreement shall become immediately due and payable, and Lender shall be permitted to exercise any and all rights and remedies provided for in the Loan Documents, including, but not limited to, immediate commencement of a foreclosure action or resumption of a pending foreclosure action without further notice to Customer.

6. **No Waiver.** Nothing contained herein shall constitute a waiver of any of all of the Lender's rights or remedies, including the right to commence or resume foreclosure proceedings. Failure by Lender to exercise any right or remedy under this Agreement or as otherwise provided by applicable law shall not be deemed to be a waiver thereof.

7. **Status of Default and Foreclosure.** Customer acknowledges that if the Lender previously notified the Customer that the account was in default, that the Note and Security Instrument are accelerated and the debt evidenced by the Note is due in full, the account remains in default, such Loan Documents remain accelerated, and such debt due in full, although Customer may be entitled by law to cure such default by bringing the loan evidenced by Note current rather than paying it in full. Lender's acceptance of any payments from Customer which, individually, are less than the total amount due to cure the default described herein shall in no way prevent Lender from continuing with collection action, or require Lender to re-notify Customer of such default, re-accelerate the loan, re-issue any notice, or resume any process prior to Lender proceeding with collection action if Customer defaults. Customer agrees that a foreclosure action if commenced by the Lender against Customer will not be withdrawn unless Lender determines to do so by applicable law. In the event Customer Defaults, the foreclosure will commence, or resume from the point at which it was placed on hold, without further notice.

8. **Limited Modification.** Except as otherwise provided in this Agreement, the Note and Security Instrument, and any amendments thereto, are ratified and confirmed and shall remain in full force and effect.


1 A typical example of this would be if Lender decides to accept a partial or untimely payment from Customer instead of returning such payment or terminating this Agreement as provided herein, Lender shall not be precluded from rejecting a subsequent partial or untimely payment, terminating this Agreement, or taking any other action permitted by applicable law.



FROM : PROJEKT GROUP

FAX NO. : 561-272-6295

May. 23 2009 10:27PM P7


Aurora • Loan Services

 7617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
 PHONE: 800-630-0308 • FAX: 303-728-7648

Loan No. [REDACTED]

Page 4 of 5

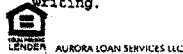
9. Application of Payments. The payments received by Lender from Customer pursuant to this Agreement shall be applied, at Lender's sole option, first to the earliest monthly payment under the Note that is due. Any amounts received by Lender that are less than the full payment under then due and owing under this Agreement shall be, at Lender's sole option, (1) returned to Customer, or (2) held by Lender in partial or suspense payment balance until sufficient sum is received by Lender to apply a full payment. If this Agreement is canceled and/or terminated for any reason, any remaining funds in this partial or suspense payment balance shall be credited towards Customer's remaining obligation balance in connection with the loan and shall not be refunded.

10. Methods of Making Payments. All payments made to Lender under this Agreement shall (i) contain the Lender's loan number shown above, (ii) unless otherwise agreed to by the Lender, be payable in certified funds by means of cashier's check, Western Union (code city: Bluff, NE) money order, or certified check, and (iii) be sent to AURORA LOAN SERVICES as specified in Attachment A. Any payment made other than strictly pursuant to the requirements of this paragraph 10 and Attachment A shall not be considered to have been received by Lender, although Lender may, in its sole discretion, decide to accept any non-conforming payment.

11. Credit Reporting. The payment status of Customer's loan in existence immediately prior to execution of this Agreement will be reported monthly to all credit reporting agencies for the duration of this Agreement and thereafter. Accordingly, Lender will report the loan subject to this Agreement as delinquent if the loan is not paid current under the Loan Documents, even if Customer makes timely payments to Lender under this Agreement. However, Lender may disclose that Customer is in a repayment or work-out plan. This Agreement does not constitute an agreement by Lender to waive any reporting of the delinquency status of loan payments.

12. Property Taxes, Insurance, and Other Amounts. If Customer's loan is not escrowed for taxes and insurance premium payments, it is Customer's responsibility to pay all property taxes, premiums for insurance, and all other amounts Customer agreed to pay as required under the terms of the Loan Documents. Customer's failure to pay property taxes, amounts owed on any senior lien security instrument, other amounts that may attain priority over the Security Instrument, or insurance premiums, in each case before their due date, shall constitute a Default hereunder.

13. The Entire Agreement. This Agreement sets forth all of the promises, covenants, agreements, conditions and understandings between the parties hereto with respect to the subject matter hereof. This Agreement supersedes all prior understandings, inducements or conditions, express or implied, oral or written, with respect thereto except as contained or referred to herein. This Agreement may not be amended, waived, discharged or terminated orally but only by an instrument in writing.




Received by: [redacted] May 23 2009 8:11 AM Fax Station: COLAN AND COLAN PA

FROM :PROJEKT GROUP

FAX NO. :561-272-6295

May. 23 2009 18:28PM PB

 Aurora • Loan Services

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. [redacted]

Page 5 of 5

14. Time is of the Essence. The Customer agrees and understands that TIME IS OF THE ESSENCE as to all of the Customer's obligations under this Agreement. The grace period for monthly payments under the Loan Documents will not apply to payment under this Agreement. Therefore, the Lender must receive the payments under this Agreement on or before the Due Dates specified in Attachment A.

15. Assignment by Customer Prohibited. This Agreement shall be non-transferable by Customer. However, if the legal or beneficial interest or the servicing of this loan is transferred by Lender, this Agreement inures to the benefit of any subsequent servicer or beneficial interest holder of the Note.

16. Severability. To the extent that any word, phrase, clause, or sentence of this Agreement shall be found to be illegal or unenforceable for any reason, such word, phrase, clause, or sentence shall be modified or deleted in such a manner so as to make the Agreement, as modified, legal and enforceable under applicable law, and the balance of the Agreement or parts thereof shall not be affected thereby, the balance being construed as severable and independent; provided that no such severability shall be effective if it materially changes the economic benefit of this Agreement to either party.

17. Execution in Counterparts. This Agreement may be executed and delivered in two or more counterparts, each of which, when so executed and delivered, shall be an original, but such counterparts shall together constitute but one and the same instrument and Agreement. Facsimile signatures shall be deemed as valid as originals.

18. Customer Contact. If Customer has any questions regarding this matter, Customer should contact one of Lender's Loan Counselors at the address above or by calling 800-550-0509.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed as of the date signed.

Dated: _____
[redacted] Borrower

Dated: _____
[redacted] Borrower

Aurora Loan Services

Dated: _____


Aurora Loan Services is a debt collector. Aurora is attempting to collect a debt and any information obtained will be used for that purpose. However, if you are in bankruptcy or received a bankruptcy discharge of this debt, this communication is not an attempt to collect the debt against you personally, but is notice of a possible enforcement of the lien against the collateral property.



FROM: PROJEKT GROUP

FRX NO. 1561-272-6295

May. 23 2009 10:28PM P9


Aurora Loan Services

 2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
 PHONE: 800-550-0908 • FAX: 303-728-7668

ATTACHMENT A-STIPULATED PAYMENTS

a.1 For purposes of repayment of the Arrearage, Customer shall pay \$870.41, on or before 06/01/2009. Thereafter, Customer shall pay three (3) stipulated monthly payments each in the amount of \$870.41 (each, a "Plan payment"). On or before 06/01/2009 (the "Agreement Return Date"), Customer shall execute and return the Agreement, including this Attachment A, in accordance with the following instructions:

<u>If by overnight mail service to</u>	<u>or if by US Postal Services to</u>
Aurora Loan Services	Aurora Loan Services
Attention: Home Retention	Attention: Home Retention
2617 College Park	P.O. Box 1706
Scottsbluff, NE 69361	Scottsbluff, NE 69363-1706

The Agreement will be of no force and effect unless Lender receives the executed Agreement, including Attachment A, as well as the first Plan payment by the Agreement Return Date. Customer shall remit to Lender the first Plan payment, in the amount specified above, made payable to Aurora Loan Services in certified funds by means of cashier's check, money order, Western Union (code city: Bluff, NE), or certified check. All Plan payments, including the first Plan payment, shall contain the Lender's loan number shown in the Agreement and, unless otherwise agreed to by the Lender, shall be payable in certified funds as described above and to be sent to Lender's Payment Processing Center in accordance with the following instructions:

<u>If by overnight mail service to</u>	<u>or if by US Postal Services to</u>
Aurora Loan Services	Aurora Loan Services
Attention: Cashiering Department	Attention: Cashiering Department
10350 Park Meadows Drive	P.O. Box 5180
Littleton, CO 80124	Denver, CO 80217-5180

a.2 Plan payments are to be paid on or before the 1st day of every month (each, a "Due Date"). Lender must receive each Plan payment by the Due Date of each month. The Agreement shall expire on the Due Date of the last Plan payment contemplated by section a.1 above (the "Expiration Date"). At the time Customer makes the third (3rd) Plan payment under this Agreement, it shall be the Customer's responsibility to provide Aurora with accurate and complete financial information in support of the Customer's request for a loan modification or other workout option. Customer must also provide Lender with a completed Borrower's Financial Statement and proof of income (copies of Customer's two (2) most recent pay stubs) to enable Lender to properly evaluate Customer's current financial situation and the Customer's request for a loan modification or other loan workout option. Tender of the last Plan payment shall not be deemed acceptance by Aurora of a workout plan or loan modification.




RECEIVED BY: [REDACTED] MAY 23 2009 10:29 FAX: 303-728-7648 FROM: PROJEKT GROUP

FROM : PROJEKT GROUP

FAX NO. : 561-272-6295

May. 23 2009 10:29PM P10

 Aurora - Loan Services

2617 COLLEGE PARK • P.O. BOX 1706 • SCOTTSBLUFF, NE 69363-1706
PHONE: 800-550-0508 • FAX: 303-728-7648

Loan No. [REDACTED]

- b. The aggregate Plan payment will be insufficient to pay the Arrearage. At the Expiration Date, a portion of the Arrearage will still be outstanding. Because payment of the Plan payments will not cure the Arrearage, Customer's account will remain delinquent. Upon the Expiration Date, Customer must cure the Arrearage through a full reinstatement, payment in full, loan modification agreement or other loan workout option that Lender may offer (individually and collectively, a "Cure Method.") Customer's failure to enter into a Cure Method will result in the loan being disqualified from any future Lender Home Retention Group program with respect to the loan evidenced by the Note, and regular collection activity will continue, including, but not limited to, commencement or resumption of the foreclosure process, as specified in paragraphs 5 and 7 of the Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Attachment A to be duly executed as of the date signed below.

Dated: _____
[REDACTED] Borrower

Dated: _____
[REDACTED] Borrower

Aurora Loan Services

Dated: _____ By: _____

Title: _____



Attachment C—Chase Waiver of HAMP Rights

JPMorgan Chase Bank, National Association,
successor interest to Washington Mutual Bank ("Lender")
 has offered to try to qualify you for a modification (an "MHA Modification") under the Making Home Affordable
 Plan announced by the Obama Administration on March 4, 2009. You have declined to be considered for an MHA
 Modification, opting instead to go forward with the modification offer made by Lender to you prior to the
 March 4, 2009 announcement (the "Prior Modification").

Had you qualified for an MHA Modification, you may have been entitled to the following:

- A reduction in monthly payment to no more than 31% of documented and verified gross monthly income (DTI).
- A modification sequence requiring the Lender to first reduce the interest rate (subject to a rate floor of 2%), then if necessary extend the term or amortization of the loan up to a maximum of 40 years, and then if necessary forbearing principal to get to the 31% DTI.
- Up to \$1,000 of principal reduction payments on your mortgage each year for up to five years for making your payments on time each year.

By signing below, you acknowledge that (i) you have been advised of and understand the above features of an MHA Modification, (ii) you understand and agree that Lender is not obligated to match such features in the Prior Modification, (iii) you have voluntarily declined consideration for an MHA Modification, and (iv) you have agreed to hold Lender, its successors and assigns, harmless as a result of your decision to decline consideration for an MHA Modification and enter into the Prior Modification.

_____	_____
Borrower Name	Date
_____	_____
Borrower Name	Date
_____	_____
Borrower Name	Date
_____	_____
Borrower Name	Date
_____	_____
Borrower Name	Date
_____	_____
Borrower Name	Date

Attachment D—WaMu HAMP Trial Plan Agreement provision requiring waiver of loan modification upon subsequent bankruptcy filing.

Page 1
Loan # 

Washington Mutual
7255 Bynemeadows Way
Jacksonville, FL 32256

TRIAL PLAN AGREEMENT

- * Your loan is now due for the months of 06/09 to 06/09.
- * You must send \$0.00 to reduce your total delinquency.
- * We must receive the initial payment of \$922.37 along with your signed Trial Plan Agreement ("Agreement") by 07/01/09. After that, the payment schedule outlined below must be followed. If you do not make your payments on time, or if any of your payments are returned for non-sufficient funds, this Agreement will be in breach and collection and/or foreclosure activity will resume.

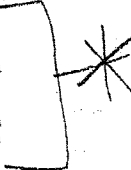
Your payments must be received in our office on or before the following dates:

\$922.37	08/01/09
\$922.37	09/01/09

Payments are subject to change due to escrow analysis and or interest rate changes, if applicable. If you are notified of a payment adjustment, please contact our office immediately so we can adjust the terms of your Agreement accordingly. If all payments are made as scheduled, we will reevaluate your application for assistance and determine if we are able to offer you a permanent workout solution to bring your loan current.

All of the original terms of your loan remain in full force and effect, unless specifically mentioned within this Agreement. If any part of this Agreement is breached, Washington Mutual has the option to terminate the Agreement and begin or resume foreclosure proceedings pursuant to your loan documents and applicable law.

You acknowledge that in the event you file a petition in bankruptcy, Washington Mutual may elect to take any and all actions necessary, including, but not limited to voiding this Agreement, filing a Motion for relief from the automatic stay or a Motion to dismiss or any permitted state law remedies, which in Washington Mutual's judgment are reasonably necessary to secure or protect our security, the value of the security and/or to enforce our rights under the original terms of your loan.



I/We agree to the above Agreement and will make payments as outlined above. I/We understand that foreclosure action can be taken if the terms of this Agreement are not met.

Date
LA-IM036-004-B9E.5797.071006

Attachment E—Comment of Professor Alan M. White

Comment on Adelino, Girardi and Willen
Alan M. White, Valparaiso University School of Law

In their recent paper, Adelino, Girardi and Willen argue that mortgage servicers have acted reasonably in not modifying significant numbers of defaulted mortgages, but instead in going ahead with foreclosures. They report on some empirical findings from their data, and then also posit a purely theoretical model which might, they argue, justify servicer inaction.

The empirical data demonstrate that servicers were not significantly more likely to modify mortgages held in portfolio than mortgages held in securitized pools. While this finding tends to rule out some possible explanations for inadequate levels of modifications, it does not in itself demonstrate that servicers pursued the optimal modification and foreclosure strategies.

The theoretical portion of the paper points out the significance of two factors that servicers must consider in deciding whether to modify mortgages. First, if many defaulted mortgage borrowers are able to bring their loans current or pay them in full (cure the default) then offering those borrowers a modification that reduces the value of the loan to investors results in losses. Second, modifications that are not successful, because the homeowner eventually defaults in making modified payments, can increase losses.

While the theoretical point is correct, current, actual experienced cure and redefault rates do not justify servicers' failure to modify mortgages. For example, if a servicer assumes that 30% of the loans being considered for modification will cure, and that 40% of the loans modified will redefault, and if we also assume that loss severities on foreclosure sales are greater than 60%, as they are today, then modification produces a net benefit for investors so long as the modified loan's present value is at least 80% of the unmodified loan value. Few, if any modifications currently being made reduce the present value of the mortgage payments by 20%. Much more typical are temporary interest rate reductions, combined with capitalization of past-due interest, that result in very modest reductions in the present value of future cash flows.

Moreover, a 30% cure rate in today's environment is highly unrealistic. While the paper's authors cite the cure rate experienced for all loans 60 days delinquent or more, most servicers are unlikely to consider all 60-day past due loans as modification candidates. Servicers will also select out homeowners who can realistically refinance, which is the most common form of cure, and steer them towards that alternative. Thus, the self-cure probability for mortgages considered for possible modification is likely to be much lower than 30%.

Similarly, a 40% redefault rate has been the result, in part, of poor modification strategies. Most servicers have been increasing mortgage debt, and often increasing monthly payments, when modifying loans. Even modifications that reduced monthly payments in 2008 did not reduce them significantly, averaging about \$100 in payment reduction, or less than 10%. The OCC/OTS mortgage metrics report for the first quarter of 2009 demonstrates convincingly that modifications with significant payment reductions have much lower redefault rates. A modification program that includes both principal and monthly payment reductions should experience redefault rates in the 20% to 30% range.

The third important factor to consider is loss severities. Modifications are much less attractive to servicers who can recover 60% of the loan balance in a foreclosure than when they can only recover 35%. Loss severities actually experienced in 2009 by mortgage servicers have been rising steadily, and exceeded 65% in June 2009, i.e. servicers recovered less than 35% of the total debt in foreclosure sales.

Using real-world rates for loss severities, self-cure and redefault, and a well-designed modification program, mortgage servicers would clearly increase investor returns by modifying every mortgage where a homeowner has sufficient income to make a stream of payments worth at least 75% to 80% of the debt.

It is also the case that many homeowners are unable to afford their contractual payments, not because the payments have escalated, but because the loans were unaffordable at initiation, and/or because the homeowners have suffered a loss in income. Nevertheless, many homeowners may be able to make monthly payments sufficient to provide investors with 80% or more of the loan value, and servicers should be evaluating every loan with that possibility in mind. There is, unfortunately, no publicly available data on the current incomes of mortgage borrowers in default, so the ultimate question, i.e. how many foreclosures can be prevented, cannot realistically be answered. But it would be just as simplistic to say that all foreclosures are unavoidable as it is to say that all are preventable.

A final point bears mention. The only question considered by the Adelino paper is whether mortgage modifications result in a better return to the investors holding the mortgages. Foreclosures cause losses that are external to the mortgage contract, including to the values of neighboring properties (some of which are collateral for other lenders' mortgages) and to communities and local governments. Those losses can also be mitigated with a well-designed and fully implemented modification and debt reduction program. The Home Affordable program already provides some compensation to investors to encourage the reduction of these externalities, and further forms of compensation in conjunction with voluntary or mandatory mortgage modifications would be worth considering.

**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM HERBERT M. ALLISON, JR.**

Q.1. One issue that was brought to my attention recently concerned servicer advances, that is, scheduled principal and interest payments and other costs that servicers must advance to the trust when the borrower fails to make a monthly payment. As you may know, these servicer advances play a critical role in any successful mortgage modifications.

Independent servicers use outside financing to provide these advances, traditionally at low costs due to the minimal credit risk involved. However, given the current liquidity shortages in the market, financing such advances has become prohibitively expensive. And while the Term Asset Loan Facility (TALF) includes servicer advances as eligible collateral under the program, servicers tell me that the TALF is hamstrung by stringent rating requirement, particularly incompatible to HAMP modification process. Indeed, HAMP's prolonged modification timeline creates inherent risk for the creditors, lowering the credit rating on the assets backed by servicer advances accordingly.

Has this issue been brought to the Treasury's attention?

A.1. Yes, Treasury is aware of the issue. Servicer advances play an important role in the residential mortgage backed securities market as well as in the HAMP program. This was a consideration when the Federal Reserve elected to make servicer advances TALF eligible. Subsequently, based on the state of the residential market, rating agencies have required a greater level of subordination by the servicer advance firms in order to obtain an AAA-rating and make them TALF eligible. Treasury recognizes higher levels of subordination can result in a higher cost of funds for some servicers, but Treasury does not have any influence on the rating agency opinions and decisions.

Q.2. How serious do you think this issue is?

A.2. Although the issue may be of concern for an affected firm, it is not clear that the issue is widespread. Treasury has received reports that a servicer has already obtained the required AAA-rating and issued TALF-eligible securities.

Q.3. What plans do you have to address it?

A.3. Treasury has examined the issue, but at this time Treasury believes the TALF program is providing a viable financing solution to independent servicers and therefore, does not believe the program requires significant modifications.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR JOHNSON
FROM HERBERT M. ALLISON, JR.**

Q.1. Are a proportionate number of rural homeowners facing foreclosure as in urban or suburban areas?

A.1. The proportion of homeowners facing foreclosure is higher in urban and suburban areas than in rural areas. Particularly hard hit are newer subdivisions on the outer edges of metropolitan areas. Many of the homes in these areas were purchased in the last three or 4 years prior to the housing crisis, and therefore their

owners suffered greater home price declines. Proportionately, these suburban homeowners also took out a higher number of subprime mortgages. Another difficult segment has been urban areas where homes values are slightly below the state average while the income level of the residents is significantly below the state average. Regarding rural housing, conclusive research on rural mortgage lending is hampered by the limitations on Home Mortgage Disclosure Act data and the difficulty of getting comprehensive local data of all varieties in smaller communities. Still, we are well aware that rural areas have not been immune from foreclosures. For definitive figures on foreclosure data for rural, urban, and suburban homeowners, we suggest that you please refer to the Department of Housing and Urban Development (HUD).

Q.2. Are they seeking refinancing and modifications at the same rate?

A.2. We do not have reliable data on the rate that rural homeowners are seeking refinancings and modifications relative to urban and suburban homeowners.

Q.3. During the hearing, both of you talked about your outreach programs to help with modifications. What specific outreach is being done to prevent home foreclosures and educate homeowners about the programs that are available through Hope for Homeowners (H4H) and Making Home Affordable in rural areas?

A.3. Reaching delinquent borrowers to encourage their participation in the Making Home Affordable program is a key responsibility of participating servicers, who are expected to have written procedures for outreach attempts until constructive borrower contact is established. These requirements are the same, regardless of the location of the borrowers. Often, repeated attempts using alternative contact methods are required to reach borrowers. At a minimum the written contact procedures should include:

- a. Evaluation of Delinquent Borrowers—Within 30 days of execution of a Servicer Participation Agreement and monthly thereafter, identify all borrowers in the servicing portfolio that meet the basic HAMP eligibility criteria (owner occupant, loan originated before January 1, 2009, loan amount within GSE loan limits, borrower is at least 60 days delinquent) and send solicitation letters similar in format to those posted at *www.hmpadmin.com*.
- b. Written Contact Attempts—Send a minimum of three letters in varying formats such as email, courier services, and hand delivery.
- c. Telephone Contact Attempts—Initiate no less than four telephone contact attempts per borrower.

In addition, the Making Home Affordable website and the HOPE Hotline (1-888-995-HOPE), the two main points of entry for inquiring about the MHA program, are available to everyone regardless of their location.

The Hope for Homeowners program is administered by the Department of Housing and Urban Development, which would be in a better position to address specific outreach related to that program.

Q.4. Are you seeing any other foreclosure trends in rural areas that are worth noting before this Committee?

A.4. Smaller, community-based financial institutions such as those that are more prevalent in rural areas appear to be less likely to foreclose on their borrowers than the large money-center institutions that predominate in urban and suburban areas. This may be because of the more personal nature of banking in smaller institutions.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER
FROM HERBERT M. ALLISON, JR.**

Q.1. The Obama administration is now considering a proposal that would allow people to rent back a property when they have defaulted. The question is, won't this cause more damage to the secondary market for mortgages? Investors buy MBS for a stream of payments securitized by real property. They do not buy them to become landlords. Negating the trust agreement by forcing investors to rent rather than be made whole on their investment will only further damage the value of MBS in the United States and harm future home buyers.

A.1. While the Obama administration is considering a number of options to address the growing number of foreclosures, the Treasury Department is very cognizant of the need to respect contractual rights of investors. This is evident in how Treasury designed and operates the Making Home Affordable loan modification program, which has been guided in its underlying principles by the contractual relationships between servicers and investors.

Q.2. I have heard reports that the GSEs have tightened underwriting criteria for condominiums and townhome communities. I know in certain areas there were significant losses on loans where these projects were overbuilt, especially in Florida; clearly adjustments were necessary. But I'm hearing the guidelines are going beyond this and are making it hard for creditworthy borrowers living in established, healthy developments to get mortgages. What's the right balance on this? Given the need for prudential management at these institutions, what is this Administration's plan to make sure we don't go so far as to actually hurt healthy homeowners while we're trying to help them? Is there a review process that looks at what all the regulators, the GSEs and FHA are doing to make sure we are getting at this problem in a coordinated fashion? We shouldn't operate at cross purposes with some trying to be prudently flexible and others using the wrong tools.

A.2. The Treasury Department defers to the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the Federal Housing Administration on this question.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR JOHNSON
FROM WILLIAM APGAR**

Q.1. Are a proportionate number of rural homeowners facing foreclosures as in urban and suburban areas?

A.1. Although conclusive research on rural mortgage lending is hampered by the limitations on Home Mortgage Disclosure Act data and the difficulty of getting comprehensive local data of all varieties in smaller communities, based on the available data it appears that the proportion of homeowners facing foreclosure is higher in urban and suburban areas than in rural areas. Particularly hard hit are newer subdivisions on the outer edges of metropolitan areas. Many of the homes in these areas were purchased in the last three or 4 years prior to the housing crisis, and therefore their owners suffered proportionately higher home price declines. Proportionately, these suburban homeowners took out a higher number of subprime mortgages. Another particularly hard hit area has been in urban areas where homes values are slightly below the state averages in terms of value while the income level of the residents are significantly below the state average income levels.

We understand from our HUD field office in South Dakota that the mortgage default rate in South Dakota is very low. According to data published by the Mortgage Bankers Association, South Dakota had the second lowest rate of foreclosure filings and the fourth lowest percentage of home loans in foreclosure in second quarter 2009. As noted above, the number of foreclosures and sub-prime mortgages in South Dakota are substantially less than other areas around the country. However, according to data located on HUD's NSP website, there are a number of foreclosures and sub-prime mortgages that do exist with the highest concentration in the Sioux Falls Metropolitan Statistical Area (MSA) and Rapid City HUD Metro FMR Area (HMFA). Minnehaha, Pennington, and Meade counties have the highest estimated number of foreclosures.

However, like other communities around the Nation, rural areas in South Dakota have not been immune from foreclosures. In fact, some rural counties in South Dakota are experiencing high percentages of foreclosure. According to HUD data, the counties of Shannon, Buffalo, Dewey, and Ziebach have the highest percentage rate of foreclosures in the state with rates of 10 percent or greater at the end of 2008.

Q.2. Are they seeking refinancing and modifications at the same rate?

A.2. We do not have reliable data on the rate that rural homeowners are seeking refinancings and modifications relative to urban and suburban homeowners.

Q.3. During the hearing both of you talked about your outreach programs to help with modifications. What specific outreach is being done to prevent home foreclosures and educate homeowners about the programs that are currently available through Hope for Homeowners (H4H) and Making Home Affordable in rural areas?

A.3. Although the Making Home Affordable program and Hope for Homeowners Programs have not specifically targeted rural areas for outreach efforts, the steps that servicers are expected to take to reach at-risk borrowers is the same regardless of the location of the borrower. Reaching delinquent borrowers to encourage their participation in the MHA program is a key responsibility of participating servicers. Often, repeated attempts using alternative contact methods are required to reach borrowers. Servicers that participate

in the program are expected to have written procedures for outreach attempts until constructive borrower contact is established. In addition, the Making Home Affordable website and the HOPE Hotline (1-888-995-HOPE), the two main points of entry for inquiring about the MHA program, are available to everyone regardless of their location.

Earlier this summer in Miami, the Administration launched a nationwide campaign to promote the Making Home Affordable Program (and HOPE for Homeowners which has been incorporated into the overall MHA program) in communities most in need. The campaign involves a series of outreach events to engage local housing counseling agencies, community organizations, elected officials and other trusted advisors in the target markets to build public awareness of Making Home Affordable, educate at-risk borrowers about available options, prepare borrowers to work more efficiently with their servicers and drive them to take action. HUD leverages local housing partners who are on the ground and on the front lines with at-risk borrowers to help broaden our outreach efforts and keep more people in their homes.

In addition, HUD, in partnership with many nonprofit counseling agencies, provides housing counseling assistance to the record number of homeowners at risk of foreclosure, particularly those preparing to take advantage of the foreclosure prevent programs made available under this Administration. HUD-approved counseling agencies are located across the Nation (in rural and urban communities) and provide distressed homeowners with a wealth of information and assistance for avoiding foreclosures. The counselors provide assistance over the phone and in person to individuals seeking help with understanding the Making Home Affordable program and often work with borrowers eligible for the Administration's refinance or modification program to compile an intake package for servicers. These services are provided free of charge by nonprofit housing counseling agencies working in partnership with the Federal Government and funded in part by HUD and NeighborWorks® America. The list of approved HUD counselors can be found at: <http://www.hud.gov/offices/hsg/sfh/hcc/fc/>.

In South Dakota, HUD field staff participate in various events, sponsored by realtors, mortgage bankers and consumer organizations, to provide information on FHA program, including benefits of refinancing into FHA products.

Q.4. Are you seeing any other foreclosure trends in rural areas that are worth noting before this Committee?

A.4. Smaller, community-based financial institutions such as those that are more prevalent in rural areas appear to be less likely to foreclose on their borrowers than the large money-center institutions that predominate in urban and suburban areas. This may be because of the more personal nature of banking in smaller institutions.

**RESPONSE TO WRITTEN QUESTION OF SENATOR SHELBY
FROM JOAN CARTY**

Q.1. In your testimony you mention many common themes as to why families are in distress as you discuss the need for quicker action. In addition to mortgage terms, you mention many life events. This seems to at least partially support Dr. Willen's studies that have shown life events to be one of the primary causes of the financial difficulties that have lead to foreclosure.

As you counsel these families, what steps do you encourage them to take that will allow them to remain current on their mortgages following a loan modification?

A.1. Thank you for your interest in our work. As we counsel families following a loan modification, we encourage them to take the following steps:

1. Always pay family necessities (food and current medical bills expenses), then housing related bills, including real estate taxes and insurance if they are not included in your mortgage bill.
2. Also pay child support and income tax debt. Not addressing these debts can result in very serious and expensive problems.
3. Concentrate on paying secured debt until their finances allow them to start paying unsecured debt.
4. Develop an action plan where the goal will be to save at least 8 months of living expenses in case of emergencies. Client could save money by budgeting. A counselor could help the client identify areas where client can save money.
5. If client has high credit card debt, client can work to get all debt consolidated at a lower interest rate and lower payments.
6. Work to rebuild a good credit history: It's important that a client rebuilds his/her credit history because the credit score will determine the future interest rate that client will be charged on both secured and revolving credit. Also, most insurance companies charge a higher premium to people who have poor credit scores.
7. After saving for at least 8 months of living expenses, client could do the same to save for a car, repairs on the house, and for any long term and short term expenses.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM PAUL S. WILLEN**

Q.1. In previous hearings, we heard many times that large percentages of sub-prime borrowers would have actually qualified for traditional mortgages. In your testimony you said, "most borrowers who got subprime mortgages would not have qualified for a prime mortgage for that transaction."

As you noted the assumption that people were steered toward subprime mortgages has been at the center of a lot of policy debates in this area. Could you expand a bit on why your research finds this assumption to be inaccurate?

A.1. In our research, we showed that prime lenders would not have underwritten the vast majority of subprime loans¹—in other words, that subprime borrowers weren't steered to subprime loans but rather would have been rejected by prime lenders. Our analysis used the following criteria for qualifying for a prime loan—that the borrower have a FICO score above 620 **and** a debt-to-income ratio less than 40 percent **and** that the combined loan-to-value ratio fell below 90 percent **and** that the borrower fully documented income. By our count, less than 10 percent of the subprime loans made in 2005 and 2006 passed all these tests. Furthermore, we found that fraction had actually declined over time.

Previous claims by some that the data showed steering into subprime loans were based on a misunderstanding of what constitutes a subprime loan. A much-cited *Wall Street Journal* article from December of 2007 purported to show that a large and increasing number of subprime borrowers would, in fact, have qualified for prime loans. However, the analysis focused exclusively on FICO scores, and was based on the erroneous assumption that anyone with a FICO score above 620 automatically qualified for a prime loan. It is true that a FICO below 620 generally renders a borrower ineligible from a prime loan, but the converse is not true: to get a prime loan one needs a high FICO score and to pass the other tests noted above. The *Wall Street Journal* article was correct in its claim that the number of borrowers with FICO above 620 in subprime pools had grown over time—in our data it grew from less than 40 percent in 2000 to more than 70 percent in 2006. What the article failed to mention was that the fraction with, for example, very high LTV score had increased dramatically over the same period.

The steering claim is at least partly based on a misunderstanding of what a subprime loan is. Most of what makes subprime loans different from prime loans involves the characteristics of the transaction and the borrower. There are three ways to see this. The first involves the fact that the small subset of subprime borrowers who would have qualified for prime treatment got loans that were virtually indistinguishable from the equivalent prime borrowers: two-thirds had fixed rate mortgages with an average interest rate of 6.6 percent. The second involves the fact that prime and subprime loans with similar characteristics perform similarly in the data. A 90 percent LTV subprime loan to a borrower with a 620 FICO score is not significantly more likely to default than an otherwise identical prime loan. Finally—and contrary to common assumption—our research shows that subprime loans were not any more likely to have “risky features” like interest-only or negative amortization payment options.

Q.2. In your testimony and your papers you discuss impact of a downturn in housing prices on the default rates. Specifically, while discussing the role of life-event on default rates, your testimony states “when home prices fall, some borrowers can no longer profitably sell, and then income-disrupting life-events really take a toll.” You further state that “foreclosures rarely occur when borrowers

¹*Just the Facts: An initial analysis of the subprime crisis*, With Chris Foote, Kris Gerardi and Lorenz Goette. 2008. *Journal of Housing Economics*, 17(4):291–305.

have positive equity.” I believe that this is an important point and one must be in the center of a discussion about what happened to cause the downturn in our housing market and subsequently in our economy.

Given the importance of equity in a home to prevent foreclosures, do you believe that relaxed down payment standards, which allowed people to purchase homes with little or no down payment, left homeowners more vulnerable to these life-events?

A.2. Yes I do. The reason that lenders view home mortgages as safe and the reason that borrowers pay low interest rates is that the loan is secured by the property, and thus the lender is not as exposed to the borrower’s ability or willingness to repay the loan. For the borrower, the whole logic of buying a home with a mortgage depends on the ability of the borrower to sell the property if his or her circumstances change. I think the willingness of lenders to make zero-down loans, and the willingness of borrowers to take them out, resulted from the belief that house prices would continue to rise and that the borrower would quickly build equity. Going forward, it will be important for both borrowers and lenders to take the possibility of substantial price declines into account, no matter how improbable such a decline may appear at the time.

Q.3. Other testimony submitted to the Committee seemed to indicate that the primary reasons the loan modifications have not been occurring at a faster pace are largely logistical reasons within the lenders. You seem to suggest that this is not the reason, but rather, contrary to popular belief, there simply economic factors that prevent the modifications from moving forward.

Please respond to this, as well as the criticism that your research was not relevant because it analyzed loan modification programs in existence prior to the efforts of the past year.

A.3. The claim that the problems are “logistical” does not make economic sense. For a profitable opportunity, firms can and will increase capacity. In the fall of 2008, there was a dramatic increase in refinancing activity, which initially caused problems because lenders were understaffed. Within weeks, lenders were able to overcome this and refinance record-breaking numbers of loans. If loan modification were highly profitable for lenders, they would hire lots of staff. The foreclosure crisis started in 2007, so the idea that lenders were still struggling to “staff up” in 2009 must be erroneous, in my opinion.

Our claim in the paper is that a logical explanation for the paucity of modifications is that they aren’t profitable for lenders. Whether loan modifications are socially useful is a completely separate question which we do not address in the paper. That said, we do argue essentially that making social policy based on the assumption that it is in the interests of lenders to modify loans—*i.e.*, that the interests of lenders and society are perfectly aligned—is mistaken.

Q.4. In their recently released white paper, the Administration suggests that certain type of products should be construed as “plain vanilla” and therefore safe for all consumers, while other loans should presumably carry a warning symbol, or perhaps be banned outright.

Based on your research and experience, are there times when a 30-year fixed mortgage could be more dangerous than an adjustable rate mortgage? As you stated in your testimony, doesn't the characteristics of the borrower drive the success or failure of the loan generally?

A.4. I personally would strongly disagree with the (original) suggestion. Fixed-rate mortgages have performed better than adjustable rate mortgages in the crisis, but that statement is entirely relative. According to the Mortgage Bankers Association, between the first quarter of 2007 and today, the fraction of subprime adjustable rate mortgages that were more than 90 days delinquent grew from 4 percent to 17 percent, which is, of course, dismal. Would the figures have been dramatically different if those borrowers got fixed-rate mortgages? The evidence does not suggest it would have. The percentage of *subprime fixed* rate loans that were more than 90 days delinquent rose from 3 percent to 13 percent.

Features like adjustable rates, interest only, negative amortization payment options, and low documentation are risk factors—but in my view they only account for a small percentage of the risk associated with a loan. Identifying a fixed rate mortgage as unquestionably “safe” would, I believe be a disservice to consumers. A borrower with problematic credit buying a house with little or no money down is a risky proposition regardless of what type of loan the borrower uses—and to identify such a mortgage as “inherently safe” simply because certain features like adjustable rates are absent would be thus irresponsible.

Q.5. Your testimony indicates that a plausible explanation for lenders reluctance to renegotiate loans is that it simply isn't profitable because of “re-default risk” and “self-cure risk.”

What do you believe is the best way forward with respect to the mortgage problems facing the country?

A.5. I think that there are two things we need to do. The first is to focus government efforts on helping unemployed borrowers. I have, along with several colleagues in the Federal Reserve System, circulated a proposal to provide loans or grants to unemployed homeowners.² As I argued in my testimony, most borrowers default because of the combination of negative equity *and* a life-event like job loss. But because unemployed borrowers, unlike speculators, may be quite committed to living in the home they own, lenders may view them as having high “self-cure risk” and thus be unwilling to help them by easing the terms of their debt. A government program to tide committed homeowners through troubled times would prevent foreclosures.

All that said, the number of preventable foreclosures is in my view far lower than many have assumed. Ultimately, and unfortunately, the best foreclosure prevention program imaginable will not prevent more than 20 percent of the foreclosures we can expect. Thus, I think the second key policy initiative should be to minimize the effects of foreclosures both on borrowers and communities. This means making sure that adequate rental housing is available for

²A *Proposal to Help Distressed Homeowners: A Government Payment-Sharing Plan* by Chris Foote (Boston Fed), Jeff Fuhrer (Boston Fed), Eileen Mauskopf (Board of Governors) and Paul Willen (Boston Fed).

displaced families, and that foreclosed properties transition to committed homeowners who are able to afford them as soon as is practicable.

Q.6. Your testimony casts serious doubts about the effectiveness of loan modification programs. If job-loss is driving foreclosures, it appears that government programs to pay servicers and borrowers to modify mortgages will not help many homeowners. It will, however, cost the taxpayers a lot.

Is the best way to prevent foreclosures to simply make sure we have solid economic growth and a vibrant job market?

A.6. Yes and no. There is no question that a vibrant job market would help mitigate the foreclosure problem. The 482,000 people filing new claims for unemployment insurance in the week ended January 15, 2009 are all candidates for foreclosure if they have negative equity in their homes. Reducing that number will reduce foreclosures. The problem is that even when times are good, the mix of jobs and firms changes continuously and so large numbers of people lose jobs. In the last forty years, in spite of several vigorous expansions and vibrant job markets we have rarely seen a week with fewer than 300,000 new claims for unemployment insurance, far fewer than today, to be sure, but still a significant number. As I said in my testimony, we expect foreclosures to remain elevated for a considerable period, regardless of what happens to the labor market. In Massachusetts in the 1990s, foreclosures persisted at high levels long after a vigorous economic recovery started.

Q.7. During previous hearing this Committee has heard testimony that had lenders given borrowers sustainable loans rather than sub-prime loans, we would not be now facing a foreclosure crisis.

- Do you agree with this conclusion?
- What types of borrowers typically received sub-prime loans?
- Could most sub-prime borrowers qualified for prime loans?

A.7. No, I do not agree with the conclusion. In a recent paper, two co-authors and I addressed exactly this question. The dramatic fall in house prices we observed over the last 3 years would have caused a crisis with or without subprime lending. We showed that falling house prices we observed for 2005 house buyers would have caused a dramatic increase in foreclosures even for the 2002 vintage of buyers, almost none of whom received subprime loans. By contrast, the subprime-heavy 2005 vintage would have faced almost no foreclosures if house prices appreciated as they did earlier in the decade.

The main risk factors in a loan are the credit score of the borrower and the amount of equity the borrower has in the house. Other things, like whether the loan is labeled subprime or whether the loan was interest-only do matter, but only marginally. In most cases, the only way a lender could have prevented a subprime foreclosure was by refusing to do business with the borrower. A 100 percent LTV loan to a borrower with 600 credit score will always be a risky proposition.

Some have attributed the run-up in house prices and the subsequent fall to subprime lending, but there is little evidence in the

data to support this claim. Robert Shiller dates the house price boom in the United States to 1998, whereas subprime did not start to grow rapidly until 2004.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM MARY COFFIN**

Q.1. Hope for Homeowners and the Making Homes Affordable Programs are both based on the idea that if we are able to modify a borrower's loan and thus decrease that person's monthly debt to income ratio, homeowners will be able to keep up with their payments. This will in turn reduce the number of foreclosures and stabilize our housing market. While you are probably not yet able to speak to statistics regarding these programs, however, historically, have you seen that reducing a borrower's monthly debt to income ratio alone has a high success rate in keeping that borrower current in his or her new loan?

A.1. Every borrower faces fairly unique circumstances and the economic environment continues to shift, so it is difficult to make broad statements of a general nature. It has been my experience that reducing the borrower's monthly expenses overall, whether those are related to debt or other living expenses, and the borrower staying within that new budget will increase that borrower's chances of staying current with his or her mortgage payments. As mortgage servicers, we only can impact the mortgage payment component of a customer's overall obligations, so when we do reduce that payment we are doing our part to help bring their expenses in line with their income.

We will even work to reduce the mortgage payment when we believe it will help the customer keep their home even if the mortgage debt is not the source of the financial difficulties. A meaningful portion of our borrowers come to us with housing payment-to-gross income ratios less than 31 percent before modification. We find the majority of these customers have problems with their overall debt and expense levels, and their mortgage delinquency is really a symptom of a larger financial problem. Such customers do not appear to need help with their first mortgage and they are not eligible for HAMP, but many will lose their home through foreclosure without a modification. As a result, first mortgage investors, such as Freddie Mac and Fannie Mae, have been approving retention modifications with characteristics similar to HAMP for customers who fail to qualify for HAMP; primarily those with pre-modification HDTI ratios below 31 percent and/or those who need to go below 31 percent HDTI to achieve overall affordability targets.

Q.2. We face a bit of a dilemma with how to inform the public about these programs. If we believe that loan modifications are truly the best way to stabilize our housing market, then we must make sure the public is aware of the programs. However, at the same time, we risk setting unrealistic expectations for the public as it relates to the sacrifices necessary for the program to be effective. What have been your experiences with customers seeking loan modifications before and after the government made them a priority? Are we in fact reaching more of the most vulnerable? Are the expectations of the public realistic?

A.2. One issue that servicers have faced is a gap between consumer expectations regarding the availability of Home Affordable Modification Program and our ability to actually implement the program. The original announcement about the program was made by the Administration on February 18, but program guidelines weren't available for 2 to 3 months after that and changes were being made to HAMP as late as July. In addition, there was no HAMP available for FHA borrowers until mid August and guidelines for the second lien HAMP have not been released as of the beginning of September. As a result, customers heard about the program and contacted their servicers about their potential to benefit from HAMP before—and sometimes months before—the program could be made available to them.

We believe the priority should be to assist those who have been hardest hit by the economic downturn and are not able to afford their monthly mortgage payments. Following the government's HAMP announcement, however, the ratio of current customers contacting us increased dramatically compared to those who were delinquent. While we agree that HAMP should be available to borrowers who haven't yet missed a payment but are at risk of imminent default, this could hamper, to some extent, our ability to reach and assist the already delinquent borrowers who are most at risk.

Public perception and individual expectations also vary widely, and there are borrowers out there who don't fully understand what HAMP is for and who should expect to benefit from the program. Some borrowers, for example, are fully able to afford their monthly mortgage payments, but expect that they should be eligible for a loan modification through HAMP simply because the current market value of their home has decreased. These borrowers' circumstances clearly aren't addressed by HAMP and weren't intended to be, yet this misperception of the program creates additional call volume for servicers and eventually results in frustration for the customer.

This misalignment of consumer expectations regarding HAMP and the realities of the program has created some confusion and frustration among borrowers. We continue to discuss with Treasury ways that we can avoid similar challenges as new elements of HAMP or other borrower assistance programs are rolled out in the future.

**RESPONSE TO WRITTEN QUESTION OF SENATORS CORKER
AND VITTER FROM MARY COFFIN**

Q.1. The SAFE Act was designed to require licensing of loan officers, not mortgage servicers or employees that perform modifications and loss mitigation. However, I understand that this Act is being interpreted to apply to servicers. HUD has indicated it wants to include employees that do modifications within the licensing and registration scheme. Is this interpretation—that loss mitigators are covered by SAFE—going to impede your ability to do modifications?

A.1. Requiring any employee performing loan workouts, loss mitigation or loan modifications to be registered under the SAFE Act would impose a significant burden on mortgage servicers and definitely would impede our efforts to provide relief to struggling bor-

rowers at a critical time and undermine the objectives of the Making Home Affordable initiatives. One of the most important issues is that it would severely restrict our ability to add employees to our home retention team or shift employees to home retention efforts as work demands vary. In response to significant increases in the volume of modifications we are considering, for example, Wells Fargo hired and trained 4,000 people in the first half of the year. It would have been impossible to register all or a significant number of those new staff in time to deal with the increase in activity that we have experienced.

SAFE was not constructed to cover servicers or servicing personnel, but to establish nationwide oversight of individual loan originators, lenders and mortgage brokers. SAFE's education and testing requirements, for example, are focused on origination issues and don't address servicing-related matters. Loan modifications present none of the risks or concerns that the SAFE Act was intended to address, namely: accountability and tracking of mortgage loan originators; enhanced consumer protections; reducing fraud in the mortgage loan origination process. In a modification scenario, the mortgage has already been originated and the borrower is already aware of and contractually bound by the terms of their mortgage. Modifications do not present sales opportunities to Agency-regulated institutions.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM CURTIS GLOVIER**

Q.1. In your testimony you focus on the need for additional principle reduction.

Have you analyzed how many homes would need principle reductions, and how much principle would need to be written off, to stabilize our housing market?

A.1. Based on an analysis of non-performing loans in the Loan Performance data base as of April 30, 2009, (covering the non-agency mortgage-backed securities market), we believe that approximately 1,622,000 homes would need principal reductions to prevent a foreclosure.

In the aggregate, this equates to a reduction in mortgage debt of approximately \$120.25 billion, which is approximately \$74,000 per homeowner. This amount represents 6.8 percent of the \$1.765 trillion non-agency residential mortgage market and would result in a principal reduction of approximately 30 percent per mortgage loan.

Q.2. What level of taxpayer money do you believe would be necessary for these reductions?

A.2. No taxpayer contribution is necessarily required to achieve this principle reduction. It is certainly conceivable that the principal reduction could be borne entirely by the investors in the residential mortgage-backed securities.

While some form of compensation for accepting a principal reduction of the first mortgage could serve as an incentive for facilitating more and quicker action, the Mortgage Investors Coalition supports policies that drive mortgage foreclosure avoidance policy toward

principal reduction and refinancings (like those originally intended by the Hope for Homeowners program). We believe it is a better policy for homeowners because it reestablishes homeowner equity.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM ALLEN JONES**

Q.1. Hope for Homeowners and the Making Home Affordable Programs are both based on the idea that if we are able to modify a borrowers loan and thus decrease that person's monthly debt to income ratio, homeowners will be able to keep up with their payments. This will in turn reduce the number of foreclosures and stabilize our housing market.

While you are probably not yet able to speak to statistics regarding these programs. However, historically have you seen that reducing a borrowers monthly debt to income ratio alone has a high success rate in keeping that borrower current in his or her new loan?

A.1. Bank of America applauds the Obama Administration's Homeowner Affordability and Stability Plan's focus on assisting financially distressed homeowners with their mortgage payments through their refinancing and loan modification program. We strongly support the Administration's focus on affordability in the loan modification and refinance processes in order to achieve long-term mortgage sustainability for homeowners. The Administration's focus on affordability and sustainability is consistent with the approach we have successfully developed with our customers. While there are many factors that influence whether a borrower will be able to perform on their loan, including the borrower's continued employment and whether the borrower has a desire to continue to remain in their home, we believe that reducing the borrower's monthly payment to a 31 percent debt to income ratio under these programs should help to reduce the number of foreclosures and help stabilize housing markets. Our research suggests that reducing the borrowers 1st lien monthly mortgage obligation provides incrementally more benefit than other modification factors. The degree of this reduction is what is important. Payment change alone is not the sole factor. Other factors such a mod type, borrower profile, equity, etc are determining factors in the probability of success.

Q.2. We face a bit of a dilemma with how to inform the public about these programs. If we believe that loan modifications are truly the best way to stabilize our housing market, then we must make sure the public is aware of the programs. However, at the same time, we risk setting unrealistic expectations for the public as it relates to the sacrifices necessary for the program to be effective.

What has been your experiences with customers seeking loan modifications before and after the government made them a priority? Are we in fact reach more of the most vulnerable? Are the expectations of the public realistic?

A.2. We have made important progress under our programs before HAMP, yet HAMP represents a watershed in loan modifications.

The program applies lessons we learned in early efforts across the industry, establishes uniform national standards and provides appropriate incentives to borrowers, servicers and investors. We are confident HAMP enables servicers to help more struggling homeowners and will play a key role in stabilizing the housing markets and promoting economic recovery.

However, the program was not designed to assist borrowers who have vacated their home or no longer occupy the home as their principal residence. Nor was the program structured to assist the unemployed or those who already have a relatively affordable housing payment of less than 31 percent of their income. Out of our HAMP eligible population, as recently defined by Treasury, of the customers we've talked with, a significant number are known to fall into one of these four categories. This demonstrates the depth of the Nation's recessionary impacts on homeowners, not the failure of the government program or the efforts of participating mortgage servicers.

Bank of America believes it is necessary to provide solutions to these customer segments that fall outside HAMP's target reach—and we are doing so. We have non-HAMP options we consider to avoid foreclosure including modification programs for non-owners and borrowers with a debt-to-income ratio below 31 percent, and importantly, forbearance programs for the unemployed.

We also are working with Treasury to expand HAMP to assist in meeting these same challenges—specifically including a program for the unemployed and allowance for a housing ratio less than 31 percent for low-to-moderate income borrowers.

The benefit of having Treasury take the lead to address these challenges is creating an industry standard that helps all customers and provides investor incentive to help more borrowers qualify. In any case, Bank of America will continue to provide solutions to these customers.

**RESPONSE TO WRITTEN QUESTION OF SENATORS CORKER
AND VITTER FROM ALLEN JONES**

Q.1. The SAFE Act was designed to require licensing of loan officers, not mortgage servicers or employees that perform modifications and loss mitigation. However, we understand that this Act is being interpreted to apply to servicers. Even HUD has indicated it wants to include employees that do modifications within the licensing and registration scheme. Is this interpretation—that loss mitigators are covered by SAFE—going to impede your ability to do modifications?

A.1. If this interpretation were to apply to our loss mitigation employees, then it would impose additional burdens that would impair our ability to do loan modifications on a timely basis.