IS TREASURY USING BAILOUT FUNDS TO INCREASE FORECLOSURE PREVENTION, AS CONGRESS INTENDED?

HEARING

BEFORE THE

SUBCOMMITTEE ON DOMESTIC POLICY

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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IS TREASURY USING BAILOUT FUNDS TO INCREASE FORECLOSURE PREVENTION, AS CONGRESS INTENDED?

FRIDAY, NOVEMBER 14, 2008

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC POLICY,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2154, Rayburn House Office Building, Hon. Dennis J. Kucinich (chairman of the subcommittee) presiding.

Present: Representatives Kucinich, Cummings, Issa, and Bilbray.

Staff present: Jaron R. Bourke, staff director; Charles Honig and Noura Erakat, counsels; Jean Gosa, clerk; Charisma Williams, staff assistant; Leneal Scott, information systems manager; Charles Phillips, minority senior counsel; Jason Scism, minority counsel; Molly Boyl, minority professional staff member; and Larry Brady and John Cuaderes, minority senior investigators and policy advisors.

Mr. KUCINICH. The subcommittee will come to order.

The Subcommittee on Domestic Policy of the Committee on Oversight and Government Reform is now in order. Today's hearing will examine the foreclosure crisis and its solutions.

Without objection, the Chair and the ranking minority member will have 5 minutes to make opening statements, followed by opening statements not to exceed 3 minutes by any other Member who seeks recognition. Without objection, Members and witnesses may have 5 legislative days to submit a written statement or extraneous materials for the record.

The title of this hearing is "Is Treasury Using Bailout Funds to Increase Foreclosure Prevention, as Congress Intended?" Two days ago, Secretary Paulson gave his answer: "No."

Secretary Paulson's policy reversal breaks with congressional intent, contradicts public assurances previously made by Treasury, and leaves the Federal Government without an adequate mechanism to stem a tide of home foreclosures. Congress' intent in enacting the Emergency Economic Stabilization Act of 2008, the statute that created the Troubled Asset Relief Program, was in part to buy troubled mortgage assets and implement a plan to minimize risk for foreclosures.

Only 3 weeks ago, Mr. Kashkari testified before the Senate that he was preparing to purchase troubled mortgage assets. Two weeks ago, Mr. Kashkari's top staff, including an individual with the position entitled "Interim Chief for Home Preservation" and another in charge of whole mortgage loan acquisition, spoke with my staff about the Troubled Asset Relief Program's plans to purchase troubled mortgage assets. Last week the Treasury filed an interim tranche report required by the Emergency Economic Stabilization Act stating that Treasury's policy teams were still committed to preserving homeownership.

Rather than prevent foreclosures by acquiring troubled mortgage assets as the Emergency Economic Stabilization Act authorized, Secretary Paulson announced on Wednesday that the Troubled Asset Relief Program would not buy mortgage assets. Instead, Treasury would exclusively continue along the path of providing preferred equity injections to handpicked companies. Thus, the only significant use by Treasury of the funds Congress authorized to address the mortgage crisis underlying the financial crisis includes, among other things, propping up a Beverly Hills banker; subsidizing the evisceration of National City Bank and the laying off of thousands of Clevelanders who worked there; and indirectly funding the payment of bonuses, compensation, and dividends by financial firms that could not have afforded to make them without the TARP capital infusion. I think it is fairly obvious that Congress would have never passed the Emergency Economic Stabilization Act had it known how Treasury would marshal the resources it was given.

There is a consensus among the business community, academics and policymakers that the financial crisis will not be resolved until the mortgage crisis is resolved. There is a further consensus from experts, some of whom you will hear from today, that resolution of the mortgage crisis demands stronger action by the Federal Government than private industry so far has been willing to undertake.

The Emergency Economic Stabilization Act enables Treasury to purchase and thereby control the mortgage servicing of potentially millions of mortgages that will soon go into default. That control, if exercised, would make a qualitative difference in the kind of loan modifications that would be performed because the Federal Government would not and should not have followed the same restricted loan modification policies so far pursued by private investors.

To accomplish the social policy of protecting neighborhoods and preserving the financial system as a whole, once TARP owned whole mortgage loans, acquired from the bank portfolios and securitized mortgage pools, TARP could direct mortgage servicers to make loan modifications in the principal balance of troubled mortgages. We are going to hear today from industry and academic experts alike about how critical this step is to fix our current mortgage crisis.

While there is some disagreement among experts whether Treasury currently possesses sufficient authority to purchase mortgages and effect loan modifications over the full range of mortgage and mortgage-related assets, and there remains an issue whether Treasury should pursue a mortgage guarantee program to replace or complement an asset-purchase and modification program, these technical questions, while important, should not obscure a fundamental fact: Treasury was uniquely empowered by Congress and positioned to embark on a range of foreclosure-prevention efforts that could not be undertaken by the private sector. Treasury had the money, and the technical challenges had solutions.

Rather than undertake this difficult but crucial work, the Treasury Department has abdicated its responsibility to stem the tide of mortgage foreclosures. They have passed the responsibility back to the private sector and additional inadequate government efforts. While there are many hard-working and well-intentioned people in the industry striving to do loan modifications, the hard truth is they are not keeping up with the number of borrowers needing modifications to prevent foreclosures and default.

As a predictable result, foreclosures have continued to mount, and millions more are forecast. Furthermore, experience is showing that there is a significant problem of redefault where borrowers who are among the lucky few to receive a loan modification at all are not receiving loan modifications that cure the dual problems of affordability and negative equity. Foreclosure is delayed, but not prevented. Treasury's action to abandon acquiring troubled mortgage assets unfortunately, maybe tragically, leaves the problem of negative equity unresolved.

I hope that today's hearing will permit us to have a thorough examination of the basis for the Treasury Department's decision to ignore the foreclosure prevention objective of the Troubled Asset Relief Program. As Congress may soon receive a request for a second installment of $350 billion toward the Troubled Asset Relief Program, and as we are on the eve of a new administration which will have the opportunity to reconsider Secretary Paulson's decision, it would be helpful to Members of Congress and to the next administration to understand the viewpoints and assess the judgment of the current Troubled Asset Relief Program leadership before deciding to entrust to them the remainder of the bailout funds and continue their policies.

[The prepared statement of Hon. Dennis J. Kucinich follows:]

Opening Statement
Of
Dennis J. Kucinich
Chairman
Domestic Policy Subcommittee
Oversight and Government Reform Committee
Friday, November 14, 2008
2154 Rayburn HOB
10:00 a.m.

"Is Treasury Using Bailout Funds to Increase Foreclosure Prevention, as Congress Intended?"

The title of this hearing is, "Is Treasury Using Bailout Funds to Increase Foreclosure Prevention, as Congress Intended?" Two days ago, Secretary Paulson gave us an answer: "No."

Secretary Paulson's policy reversal breaks with Congressional intent, contradicts public assurances previously made by Treasury, and leaves the federal government without an adequate mechanism to stem a tide of home foreclosures. Congress' intent in enacting the Emergency Economic Stabilization Act of 2008 (or EESA), the statute that created the Troubled Asset Relief Program (or TARP), was in part to buy troubled mortgage assets and implement a plan to minimize risk for foreclosures. Only three weeks ago, Mr. Kashkari testified before the Senate that he was preparing to purchase troubled mortgage assets. Two weeks ago, Mr.

Kashkari's top staff, including an individual with the position, "Interim Chief for Home Preservation" and another in charge of whole mortgage loan acquisition, spoke with my staff about TARP's plans to purchase troubled mortgage assets. Last week, the Treasury filed an interim tranche report required by EESA, stating that Treasury's policy teams were still committed to preserving home ownership.

Rather than prevent foreclosures by acquiring troubled mortgage assets as EESA authorized, Secretary Paulson announced on Wednesday that TARP would not buy mortgage assets. Instead, Treasury would exclusively continue along the path of providing preferred equity injections to hand-picked companies. Thus, the only significant use by Treasury of the funds Congress authorized to address the mortgage crisis underlying the financial crisis includes, among other things, propping up a Beverly Hills banker to the stars; subsidizing the evisceration of National City Bank and the laying-off of thousands of Clevelanders who worked there; and indirectly funding the payment of bonuses, compensation, and dividends by financial firms that could not have afforded to make them without the TARP capital infusion. I think it's fairly obvious that Congress would have never passed the EESA had it known how Treasury would marshal the resources it was given.

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I hope that today's hearing will permit us a thorough examination of the basis for Treasury's decision to ignore the foreclosure prevention objective of the Troubled Asset Relief Program. As Congress may soon receive a request for the second installment of $350 billion toward the TARP, and as we are on the eve of a new Administration which will have the opportunity to reconsider Secretary Paulson's decision, it would be helpful to Members of Congress and to the next Administration to understand the viewpoints and assess the judgment of the current TARP leadership, before deciding to entrust to them the remainder of the bailout funds and continue their policies.

Mr. KUCINICH. At this time I am pleased to recognize the distinguished Congressmember from the State of California, Mr. Darrell Issa, who has been not just a ranking member of this subcommittee, but a partner in expressing concern over so many of these issues that are reflected not only in this $700 billion bailout, but in Treasury's management of it.

Mr. Issa, I just want to thank you personally for the efforts that you have made. They have been outstanding. I am pleased to be with you today, having you join Mr. Cummings and I.

Thank you.

Mr. ISSA. Thank you, Mr. Chairman. In that this may be the last hearing that you and I do together in our present capacities, I want to thank you for 2 solid years of bipartisan, cooperative work, which from a field hearing standpoint began with going to Cleveland and looking at this problem approximately 18 months before the Treasury came and said they had a crisis that needed to immediately be handled.

Mr. Chairman, today I appreciate your holding this hearing, and I appreciate the joint effort that brought our witness to us today. The focus of today's hearing is stated to be to determine whether or not the administration is following the intent of Congress embodied in the $700 billion financial bailout package related to mortgage foreclosure prevention.

My interpretation of Mr. Kashkari's testimony and the remarks by Secretary Paulson on Wednesday demonstrate to me that the administration is ignoring congressional intent and reversing course of their original request. I don't know whether to call this fire-ready-aim, or something more pejorative.

I approach this issue with somewhat of an interesting perspective because I, like the chairman, voted against the bailout not once, but twice. Chairman Kucinich and I sometimes disagree on the proper role of the Federal Government. In fact, when it comes to some of the solutions that could be used under the TARP, we may, in fact, reach opposite conclusions. But I think we stand here today or sit here today united in two parts of the problem: One, it was disingenuous in the way that the administration came to us with a crisis which ultimately could not have been a crisis as described because the money has not in any way, shape or form been used as it was asked for; and, two, that, in fact, Treasury's request for authority appears to be a request for a blank check of $700 billion, rather than any definable use of the money other than vaguely saying the money would be used.

Today I find myself in an odd situation. I am asking whether I agree with the chairman or not as to exactly what we are supposed to do with the money. I am asking should we, in fact, instead of authorizing the second $350 billion pursuant to the TARP, look at reallocating those funds to HUD, or actually to the VA and the FHA, because, in fact, if we need to have people be able to remain in their homes, it is very clear that Treasury cannot and will not make the effort to keep people in their homes.

As I said more than 18 months ago, the chairman and I went to Cleveland. Mr. Chairman, I will be going to Cleveland after this hearing today because it happens to be both of our homes and the chairman's district, or historic home in my case. We saw that people in Cleveland were unable to keep their homes because the unwinding of the subprime began in those neighborhoods and those communities first. But it spread throughout the country. It wasn't until it spread to Wall Street that the administration came to us with the need for emergency funds.

I think Congress should have known, and the chairman and I, I think, did know, that there was something fairly disingenuous when it was a crisis related to home mortgage, but, in fact, was a crisis in Wall Street that prompted the action by Treasury.

I appreciate the witness being here today. I look forward to your testimony, although, quite frankly, knowing what your testimony is going to be, I look forward more to the questions we are going to ask and, in fact, shedding some light on the real question of should Congress trust this administration to spend one more penny, and, if we do, what will we get for that $350 billion that could well be spent, and the remaining few dollars that is destined to go to AIG and other programs and individuals and companies not envisioned in the original legislation.

Last, but not least, I will be asking two tough questions: Who have you sought to understand the complexity of the market that you clearly don't understand; and what are you going to do when you leave this hearing room today to live up to the expectation of Congress?

With that, Mr. Chairman, I thank you again for holding this hearing, and I yield back.

Mr. KUCINICH. I thank the gentleman.

The Chair recognizes the distinguished gentleman from Maryland, who has been very active on this subcommittee in pursuing the answers to the questions that Members of Congress perhaps should have been asking in the places like the Democratic Caucus. Mr. Cummings.

Mr. CUMMINGS. I want to thank you very much, Mr. Chairman, for holding this hearing this morning. I want to take just a moment, Mr. Chairman, to thank you for your leadership. I join with others in saying that you have done a phenomenal job taking on some issues that have not been the most popular, but I thank you. I know, as Mr. Issa has said, that you have consistently stood up for the American people, and I want to thank you.

I also, Mr. Chairman, I only have 3 minutes, but I——

Mr. KUCINICH. You have 5 minutes.

Mr. CUMMINGS. Thank you.

Mr. Chairman, I also want to just say, I cannot help, when I read this morning this statement, this article in the Washington Post, which says, "AIG to pay millions to top workers," I have to tell you, it made my heart ache.

Mr. Chairman, I just have to comment on this, and I hope you will hear me, Mr. Kashkari. I don't think AIG gets it. I really don't think they get it. They don't get that Americans are suffering. They don't get that Citicorp laid off 10,000 people; U.S. Steel, 675; Morgan Stanley, 10 percent of its workers, approximately 44,000 people are employed. That is quite a number. GM, 3,500; DHL, 12,000; Circuit City, 6,800; National City, 4,000. I could go on and on and on. These are announcements that have been made in the last month or so.

My point is simply this, that I think AIG has gotten to the point, and I have to believe that they just don't get what is happening in the rest of the country. AIG has come to this Congress—and I did vote for the bailout, by the way, and I voted for it because my people were suffering in my district. I voted against it when it was in the House. I voted for it when it came from the Senate. But the fact is that the people in my district are losing their houses, too. The people in my district are also losing their jobs. And we have an AIG that will go on these lavish junkets, and, as you probably know, because of this Congress, they canceled 160 junkets, and they averaged $200,000 to $250,000 apiece. That is a lot of money for a corporation that is supposed to be dying and would not be in existence. Then we open the paper today to hear they are going to pay millions, as if everything is just the same as it was, to their employees in bonuses.

Well, the problem is that a lot of the people that we represent won't even have a job at Christmastime and damn sure won't have a bonus. So, in some kind of way, I hope that we can get through to AIG and other companies, because it is bigger than AIG. I don't want these companies coming to the Congress with their hand out thinking that they can take the money, do whatever they want to do, and then have their little parties and have a good time, get their manicures, pedicures, massages, pay $1,600 a room, and then come dancing back to us and say, "give me more," when the American people's tax dollars are being wasted. It is very upsetting.

So, Mr. Chairman, this is an important addition to the full committee's investigation into what went wrong with the financial markets. We knew years ago that our economy was headed for trouble when the housing bubble began to burst. The first victims were everyday Americans who had been sold loans they could not afford from dishonest brokers.

We did all in our power to keep people in their homes and to keep the economy afloat, but we were fought at every turn by this administration. We asked the administration what authority they needed to keep the market from going bust, and their response was a nonresponse. They said, "We should let the markets be free. Let the invisible hand work it out."

Well, we know now that the invisible hand has failed. Wall Street has come to us, cashmere hat in hand, to ask us for a $700 billion bailout to recover funds lost from risky deals it made. When times are good, those risks resulted in windfall profits, and people got rich; but now that the tables have turned, the U.S. banking system is turning to the American taxpayer to bail them out, and the administration is fully behind them.

This administration wants to privatize Wall Street's gains and socialize Wall Street's losses. Sadly, the situation is at such a fever pitch that we simply cannot afford to ignore it. The risky bets made on Wall Street were so complex that every single segment of our economy could fail if we do not bail them out. Further, we are seeing, with the news of the rippling effect in the European and Asian markets, the global economy is also on the brink of failure.

It is for these reasons that I held my breath and voted for this bailout measure.

I am almost finished, Mr. Chairman.

I initially voted against it, because I thought the bill did not include sufficient oversight and did too little for Main Street and a lot of the people we are going to talk about today.

But as with Katrina, the war in Iraq and any number of smaller issues this administration has been charged with addressing, Congress has come along to clean up the mess. Unfortunately, we were not given sufficient time to fully examine what went wrong on Wall Street before we had to pass legislation.

But I appreciate the opportunity, Mr. Chairman, to take a look at these extremely complex issues. I know that with these hearings, we and the American people will gain a greater understanding of what went wrong, and as a result we will arm ourselves with the information necessary to fully address the economic crisis.

I anticipate that the $700 billion Band-Aid that we placed on this crisis will stunt the blow of Wall Street failures, but it will not be enough to insulate us from the failing markets.

With that, Mr. Chairman, I yield back. I want to thank you for your courtesy.

Mr. KUCINICH. The Chair would like to remind people in the audience that you are here as guests, and this committee is going to enforce proper decorum, and if we don't have it, you will be removed.

The committee and myself would like to greet you, Mr. Kashkari. Thank you for being here today. We are grateful for your presence.

I want to introduce Mr. Kashkari to the members of the committee and to the public. Mr. Neel Kashkari was designated as the Interim Assistant Secretary of the Treasury for Financial Stability on October 6, 2008.

The Chair is going to pause for a second. Mr. Bilbray, did you have an opening statement?

Mr. BILBRAY. No, I did not, Mr. Chairman.

Mr. KUCINICH. OK. Fine. I just wanted to show our colleague the courtesy.

So in this capacity, Mr. Kashkari, as the Secretary of the Treasury for Financial Stability, oversees the Office of Financial Stability, including the Troubled Asset Relief Program. Mr. Kashkari is also the Assistant Secretary of the Treasury for International Economics and Development.

He joined the Treasury Department in July 2006 as senior adviser to U.S. Treasury Secretary Henry Paulson. In that role Mr. Kashkari was responsible for developing and executing the Department's response to the housing crisis, including the formation of the Hope Now Alliance, the development of the Subprime Fast Track Loan Modification Plan, and Treasury's initiative to kickstart a covered bond market in the United States.

Prior to joining the Treasury Department, Mr. Kashkari was a vice president at Goldman Sachs & Co. in San Francisco.

Mr. Kashkari, thank you very much for appearing before this subcommittee today. It is the policy of the Committee on Oversight and Government Reform to swear in all witnesses before they testify. I would ask that you please rise and raise your right hand.

[Witness sworn.]

Mr. KUCINICH. Thank you, sir. Let the record reflect that the witness answered in the affirmative.

Mr. Kashkari, I ask, if you can, if you can keep your opening remarks to 5 minutes in length. Your entire written statement will be included in the record of this proceeding. We are very grateful for your presence. Please begin.

STATEMENT OF NEEL KASHKARI, INTERIM ASSISTANT SECRETARY OF THE TREASURY FOR FINANCIAL STABILITY AND ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL ECONOMICS AND DEVELOPMENT

Mr. KASHKARI. Thank you, Chairman Kucinich.

Mr. KUCINICH. Please pull that mic a little bit closer.

Mr. KASHKARI. Thank you, Chairman Kucinich, Ranking Member Issa, and members of the committee. Good morning, and thank you for the opportunity to appear before you today.

I would like to provide you with an update on the Treasury Department's actions to stabilize our financial markets and restore the flow of credit to our economy.

We have taken actions with the following three critical objectives: No. 1, stabilizing the financial markets; No. 2, supporting the housing market by avoiding preventable foreclosures and increasing mortgage finance; and, No. 3, to protect the taxpayers.

We have acted quickly and in coordination with the Federal Reserve, the FDIC and our colleagues around the world to help stabilize the global financial system, and it is clear that our coordinated actions are having an impact.

Before we acted, we were at a tipping point. Credit markets were largely frozen, denying businesses and consumers access to vital funding and credit. Financial institutions were under extreme pressure, and investor confidence in our system was dangerously low.

We recognize that a program as large and as important as this demands appropriate oversight. We are committed to transparency and oversight in all aspects of this program and continue to take strong action to make sure that we comply with both the letter and the spirit of the requirements established by the Congress, including regular briefings with the Government Accountability Office, the Financial Stability Oversight Board and the inspector general, and we are committed to continuing to meet all of the reporting requirements established by the Congress.

As the markets rapidly deteriorated in October, it was clear to Secretary Paulson that the most timely, effective step to improve credit market conditions was to strengthen banks' balance sheets quickly through direct purchases of equity. Working with our banking regulators, we have now approved literally dozens of applications from banks across the country, and we will very soon post the term sheet so private banks can participate. We feel very strongly that healthy banks of all sizes, both public and private, should use this program to increase lending in their communities. With a stronger capital base, our banks will be more confident and be better positioned to play their necessary role to support economic activity.

Further in support of this goal, just 2 days ago our banking regulators issued a statement underscoring the responsibility that banks across our country have in the areas of lending, dividend and compensation policies, and foreclosure mitigation. Treasury commends this action taken by the banking regulators and believes it is critical to focus on the importance of prudent bank lending to restore our economic growth so that we do not repeat the mistakes, the poor lending practices that are a major cause of our current economic problems.

On housing we have worked aggressively to avoid preventable foreclosures, to keep mortgage financing available, and to develop new tools to help homeowners. Here I will briefly highlight three key accomplishments.

No. 1, in October 2007, Treasury helped establish the Hope Now Alliance, a coalition of mortgage servicers, investors and counselors, to help struggling homeowners avoid preventable foreclosures. Through coordinated industrywide action, Hope Now has significantly increased the outreach and assistance provided to homeowners. Hope Now estimates that nearly 2.5 million, 2.5 million homeowners have been helped since July 2007, and industry is now helping about 200,000 per month avoid foreclosure.

No. 2, we acted earlier this year to prevent the failure of Fannie Mae and Freddie Mac, the housing GSEs that touch over 70 percent of mortgage originations. These institutions are systemically critical to financial and housing markets, and their failure would have materially exacerbated the recent market turmoil and profoundly impacted household wealth. We have stabilized the GSEs and limited systemic risk.

And No. 3, just 3 days ago, Hope Now, FHFA and the GSEs achieved a major industry breakthrough with the announcement of a streamlined loan modification program that builds on the mortgage modification protocol developed by the FDIC and IndyMac. The adoption of this streamlined modification framework is an additional tool that servicers will now have to help avoid preventable foreclosures, and potentially hundreds of thousands of struggling borrowers will be helped to stay in their homes.

On Wednesday, Secretary Paulson outlined three critical priorities and related strategies for the most effective deployment of remaining TARP funds: No. 1, further strengthening the capital base of our financial system; No. 2, supporting the asset-backed securitization market that is critical to consumer finance; and, No. 3, increasing foreclosure mitigation efforts.

These priorities are necessary to reinforce the stability of the financial system so that banks and other institutions critical to the provision of credit are able to support the economic recovery and growth and to help homeowners avoid foreclosure.

In conclusion, our system is stronger and more stable than it was just a few weeks ago. Although a lot has been accomplished, we have many challenges ahead of us. We will focus on the goals outlined by Secretary Paulson and develop the right strategies to meet those objectives. Foremost among these will be to ensure that the financial system has sufficient capital to get credit flowing to businesses and consumers.

Thank you for this opportunity. I would be happy to answer your questions.

Mr. KUCINICH. I thank the gentleman for his testimony.

[The prepared statement of Mr. Kashkari follows:]

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 A.M. EST November 14, 2008
CONTACT Jennifer Zuccarelli (202) 622-2960

TESTIMONY OF INTERIM ASSISTANT SECRETARY FOR FINANCIAL STABILITY NEEL KASHKARI BEFORE THE HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM, SUBCOMMITTEE ON DOMESTIC POLICY

Washington, DC—Chairman Kucinich, Ranking Member Issa, members of the Subcommittee, good morning and thank you for the opportunity to appear before you. I would like to provide an update on the Treasury Department's actions to stabilize our financial markets and restore the flow of credit to the economy. We have taken action with the following three critical objectives: one, to provide stability to financial markets; two, to support the housing market by preventing avoidable foreclosures and supporting the availability of mortgage finance; and three, to protect taxpayers.

We have acted quickly and in coordination with the Federal Reserve, the FDIC, OCC and colleagues around the world to help stabilize the global financial system and it is clear that our coordinated actions have made an impact. Before we acted, we were at a tipping point. Credit markets were largely frozen, denying financial institutions, businesses and consumers access to vital funding and credit. Financial institutions were under extreme pressure, and investor confidence in our system was dangerously low.

At the same time, we recognize that a program as large and important as this demands appropriate oversight. We are committed to transparency and oversight in all aspects of the program and continue to take strong action to make sure we comply with the letter and the spirit of the requirements established by the Congress, including regular briefings with the Government Accountability Office, the Financial Stability Oversight Board, and the Inspector General. We are also committed to continuing to meet all of the reporting requirements established by the Congress.

EQUITY PROGRAM

As the markets rapidly deteriorated in October, it was clear to Secretary Paulson and Chairman Bernanke that the most timely, effective step to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks. In early October, after consulting closely with Chairman Bernanke, Secretary Paulson explained that Treasury would use the financial rescue package granted by Congress to purchase equity directly from financial institutions – the fastest and most productive way to use our new authorities to help stabilize our financial system. Working with our banking regulators, we have now approved dozens of applications from banks across the country.

We will soon post the term sheet for private banks. We feel very strongly that healthy banks of all sizes, both public and private, should use this program to increase lending in their communities.

With a stronger capital base, our banks will be more confident and better positioned to play their necessary role to support economic activity. Further in support of this goal, just two days ago, our banking regulators issued a statement underscoring the responsibility that banks have in the areas of lending, dividend and compensation policies, and foreclosure mitigation. Treasury commends this action and believes it is critical to focus on the importance of prudent bank lending to restore our economic growth so that we do not repeat the poor lending practices that are a major cause of the current economic problems.

HOUSING/MORTGAGE FINANCE

On housing, we have worked aggressively to avoid preventable foreclosures, keep mortgage financing available and develop new tools to help homeowners. Here, I will briefly highlight three key accomplishments:

One, in October 2007, Treasury helped establish the HOPE NOW Alliance, a coalition of mortgage servicers, investors and counselors, to help struggling homeowners avoid preventable foreclosures. Through coordinated, industry-wide action, HOPE NOW has significantly increased the outreach and assistance provided to homeowners. HOPE NOW estimates that nearly 2.5 million homeowners have been helped by the industry since July 2007; the industry is now helping about 200,000 homeowners a month avoid foreclosure.

Two, we acted earlier this year to prevent the failure of Fannie Mae and Freddie Mac, the housing GSEs that affect over 70 percent of mortgage originations. These institutions are systemically critical to financial and housing markets, and their failure would have materially exacerbated the recent market turmoil and profoundly impacted household wealth. We have stabilized the GSEs and limited systemic risk.

Three, just three days ago, HOPE NOW, FHFA and the GSEs achieved a major industry breakthrough with the announcement of a streamlined loan modification program that builds on the mortgage modification protocol developed by the FDIC for IndyMac. The adoption of this streamlined modification framework is an additional tool that servicers will now have to help avoid preventable foreclosures. Potentially hundreds of thousands more struggling borrowers will be enabled to stay in their homes.

PRIORITIES FOR TARP

On Wednesday, Secretary Paulson outlined three critical priorities and related strategies for the most effective deployment of remaining TARP funds: one, to further strengthen the capital base of our financial system; two, to support the asset-backed securitization market that is critical to consumer finance; and three, to increase foreclosure mitigation efforts. These priorities are necessary to reinforce the stability of the financial system so that banks and other institutions critical to the provision of credit are able to support economic recovery and growth, and to help homeowners avoid preventable foreclosures.

Let me briefly discuss these three priorities and strategies. One, in order to continue their critical role as providers of credit, both banks and non-banks may need more capital given their troubled asset holdings, continued high rates of foreclosures, and stagnant global economic conditions. To do this, we are designing further strategies for building capital in financial institutions and are evaluating programs which would further leverage the impact of a TARP investment by attracting private capital, potentially through matching investments.

Two, we are examining strategies to support consumer access to credit outside the banking system, specifically, the asset-backed securitization market. This market has played a critical role for many years in lowering the cost and increasing the availability of consumer finance. However, the market is currently in distress and its illiquidity is raising the cost and reducing the availability of car loans, student loans and credit cards.

Three, we continue to aggressively examine strategies to mitigate foreclosures and maximize loan modifications, which are a key part of working through the necessary housing correction and maintaining the strength of our communities. The new program which I highlighted above with the FHFA, the GSEs, and HOPE NOW is just one example and we will continue working hard to make progress here.

CONCLUSION

Our system is stronger and more stable than just a few weeks ago. Although a lot has been accomplished, we have many challenges ahead of us. We will focus on the goals outlined by Secretary Paulson and develop the right strategies to meet those objectives. Foremost among these will be to ensure that the financial system has sufficient capital to get credit flowing to consumers and businesses. Thank you and I would be happy to answer your questions.

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Mr. KUCINICH. Without objection, members of the committee will be given 10 minutes each to ask questions in the first round, and 5 minutes each to ask questions in the second round of questioning. Without objection.

I also want to state for the purposes of your staff, Mr. Kashkari, that they might be prepared in the second round of questions to be ready to answer questions about the decision of Treasury with respect to National City Bank and PNC. So if you could be ready for that, that specific matter. We are going to have some broad questions now that relate to the overall economy, but in round two please be ready, because I am going to have some questions about that.

Mr. KASHKARI. I am ready.

Mr. KUCINICH. Thank you. I am glad you are.

Now, I heard your testimony, and I have to say that I am a little bit surprised, because it appears that testimony was prepared before Mr. Paulson's statement about the purposes of the Troubled Asset Relief Program and the Secretary's decision not to purchase mortgage assets through his decision.

Hasn't Treasury rendered obsolete entire sections of the Emergency Economic Stabilization Act, because there was no question about congressional intention, that Treasury use an asset purchase program to mitigate foreclosures. Do you have a response to that?

Mr. KASHKARI. Congressman, thank you for asking that. It is a very important topic.

We worked very hard with both Houses of Congress to design the legislation to provide a lot of flexibility, and we and the other regulators are using every tool at our disposal to get at this problem, stabilizing the financial system as well as helping homeowners. And Secretary Paulson and Chairman Bernanke and Treasury, we have been looking at how do we deploy these resources to first stabilize the system so we can get credit flowing to the entire economy, to our communities.

So Secretary Paulson made the determination that the best way to get at this problem, given how rapidly markets were deteriorating, was to lead with capital. But that doesn't mean that we don't care about other aspects that are very, very important. We are trying to use the right tool to solve the right problem.

Mr. KUCINICH. Well, it would appear, Mr. Kashkari, that Secretary Paulson has gutted section 109 of the act, which requires Treasury to undertake specified steps to mitigate foreclosures with respect to the mortgages it acquires, including working with other Federal regulators to identify troubled assets required for the loan modification efforts.

How do you reconcile this policy reversal with Congress' expectations laid out in the statute?

Mr. KASHKARI. Congressman, is a very good question, and I appreciate you raising it. There are the other sections of the act, as an example, that direct other government agencies, whether it is FHFA in its conservatorship of the GSEs, FHA, the Federal Reserve, to the extent that they own or control mortgages, to take action. So let me give you an example, Congressman, because this point is very important.

If we had spent all $700 billion buying loans, that would be around 3 million loans or so, depending on the value of the loan, but around 3 million, 3½ million. Instead, if you look at the actions that we took on Tuesday, by using the GSEs to now set a new industry standard for loan servicing, when the GSEs set a standard, other servicers around the country use that standard, whether it is for GSE loans or for other loans. Those actions and that protocol has the ability to influence servicing for almost every loan in America. There are 55 million residential mortgages in America, so we can touch 3 million, or 55 million.

Mr. KUCINICH. Sir, it has the ability. But the problem is that Treasury, by taking this action that deemphasizes loan modification, has essentially sent a signal to all the banks that this isn't particularly what you are concerned about. Even though you may maintain, oh, this is in there, look, I have the act. Here is the purposes. I want to spell them out. The purposes of the act are, "And No. 2, to ensure that such authority and facilities are used in a manner that protects home values." Then it goes on to section B, preserves homeownership.

Now, the Treasury just basically cut that out of the bill. What we have here is a situation where banks are hoarding the money that they are getting from the TARP. They are using the money to purchase other banks. We still have a credit freeze. I am looking at your testimony. You are saying credit markets were largely frozen, denying financial institutions, businesses, consumers access to vital funding and credit. Financial institutions were under extreme pressure. Investor confidence in our system was dangerously low.

Hello. Are we in a different universe here? The same situation prevails today, and yet your testimony acts as though, well, you know, we are just merrily skipping along our way here. We have millions of people threatened with losing their homes, and the underlying problem is that banks are now increasing their interest rates in order to get more customers.

Think about this now. It is counterintuitive to your Troubled Asset Relief Program. You are now saying we are going to put the money into the banks, into these financial institutions, shore up finance capital. Well, finance capital now is seeing that the only way they can survive is to start to raise their interest rates and give away some of the money that the government is giving to them. At the same time, you are picking winners and losers.

How do you reconcile these policy reversals? And why won't Treasury act swiftly and forcefully to maximize assistance to homeowners under TARP and play a significant role in modification of home loans at risk of imminent default? Why not?

Mr. KASHKARI. Congressman, I am glad you are raising this, because I personally have spent most of the past year and a half focused on ways to try to reach and help homeowners. That has been my primary focus within Treasury.

Mr. KUCINICH. Well, hasn't the Secretary listened to you? Do you feel frustrated that your position isn't being vindicated?

Mr. KASHKARI. Congressman, the Secretary is passionate about this as well.

Mr. KUCINICH. Passionate about what?

Mr. KASHKARI. Helping homeowners, Congressman.

Mr. KUCINICH. He is? Where? What country?

Mr. KASHKARI. Congressman, we are using all the tools available to the Federal Government to get at the credit crisis and try to help homeowners. Let me give you an example, please. We have different tools——

Mr. KUCINICH. Mr. Kashkari, I really respect your being here, but I am looking at a bill, section 109, that spells all this out. The Secretary just essentially took some scissors and cut it out and threw it away. Now, maybe this is just some kind of a game to some people in the administration. They are on their way out of office, and they just feel they can do whatever they want, pick winners and losers in the market. We have millions of people losing their homes.

Mr. Issa came to my district and saw some of our old neighborhoods, how they are just falling apart. And we have people that are holding on, hoping against hope that somebody is going to help them. We have millions of people in foreclosure, and if I read it right, Mr. Issa, in California there are millions more at risk of foreclosure with these jumbo mortgages and the Alt-A mortgages in 2009 and 2010, and all of a sudden the Treasury sent a signal to the banks, forget about it. We are going to give you the money that you want, and you do what you want with it.

Unless you direct it specifically, it is not going to happen. So tell me again, why isn't it happening? Not how passionate the Treasury Secretary is.

Mr. KASHKARI. Congressman, I believe it is happening. If you will permit me, I will walk you through it.

Mr. KUCINICH. Please, go ahead.

Mr. KASHKARI. The four banking regulators—the Treasury is not a regulatory agent—the banking regulators supervise the banks that are getting this capital. The four banking regulators put out a joint statement that is going to govern how they supervise these banks. One of the things that they are going to be looking very closely at and watching, not just executive compensation, not just dividend policies, is making sure lending is getting out there in our communities and foreclosure mitigation efforts.

The banking regulators are the supervisors of these institutions, and they have now put out a joint statement saying exactly what they are going to be looking at in their supervisory capacity. There is no one better positioned in the country than the banking regulators to do that. Treasury is not in a position to do that, but the banking regulators absolutely are. No. 1.

No. 2, Congressman, again, if you look at all the tools available to us, Housing and Urban Development has a very important role to play. This Congress. The President signed the Hope for Homeowners legislation, a $300 billion program to help housing, just in July, and, Congressman, that program is just getting up and running now. Treasury is involved in overseeing that program. That is making progress. The actions we are taking to get the industry to move, more loan modifications, a systematic approach, that just got announced on Tuesday. We have had numerous initiatives to try to get to the root of this problem.

But the most important benefit, Congressman, for homeowners is that we didn't allow the financial system to collapse. Imagine how many foreclosures we would have if the banking system had collapsed and mortgage finance was not available to our homeowners. That is the biggest benefit we have been able to achieve.

And, Chairman, we are not out of the woods yet, and I didn't mean to suggest that in my testimony, but I can walk through numerous statistics looking at the beginning of a healing credit market, which is the first step to getting through this problem.

Mr. KUCINICH. Again, there might be some philosophical divide here, because on one hand the Bush administration and Treasury seems to indicate that the trickle-down effect—give the money to the banks, and they are going to loosen up money and credit, and it is going to start to flow, and people are going to be protected. On the other hand, there is another model which says create a system where you get pools of mortgage-backed securities the government takes control over, and you direct loan modification, you know, lowering interest, lowering principal, extending the terms of payments to keep people in their homes. One model may keep several big banks afloat, but risks millions of people losing their home anyway, and the other model keeps people in their home.

See, you are talking about an if-come model that is based on the charitable sentiments, seemingly, of major Wall Street banks. But the truth of the matter is if you don't get the money into the grassroots and help on loan modification, the banks aren't going to get their money at the end anyhow, because one model percolates up; money goes to the banks and helps move money on Wall Street. The other one, you have this idea of trickle down, and the trickle never gets down. Everybody understands that. And yet Treasury seems to cling to this notion that only the regulators now are going to do their job.

Are you kidding me? Regulators? Look, Treasury has been given almost omnipotent power here, and you have, unfortunately, not exercised in the interest of homeowners.

Do you believe that Congress would have passed the EESA if it understood that none of the TARP funds would have been earmarked for asset purchase and subsequent mortgage loan modifications? This looks like classic bait-and-switch.

Do you want to respond to that?

Mr. KASHKARI. Congressman, I really appreciate and respect your perspective. We worked very hard, in the middle of a crisis, with the Congress to design the legislation to have broad flexibility so that we could adapt our strategies and our approaches based on what is happening in the markets and what we are seeing. And as we went to the Congress to ask for this authority and we negotiated the legislation, and I was very involved in all-night sessions with both Houses to do that, our credit markets were deteriorating much more quickly than we had expected. So Secretary Paulson had to take very aggressive action to stabilize the system.

Again, with deep respect, sir, if we had spent all $700 billion on loans, that would be around 3 million loans. There are 55 million mortgages in America; 25 million other Americans own their homes outright, so there are 80 million homeowners in America. We can benefit 3 million directly by buying all their loans, or we could benefit every American by not allowing the financial system to collapse. That was our highest priority, Congressman.

Mr. KUCINICH. Well, just a brief response, and then we go to Mr. Issa, and that is that we have foreclosures in the city of Cleveland. Are you aware that when you have a lot of foreclosures in a neighborhood, the value of everybody's property drops?

Mr. KASHKARI. Yes, sir.

Mr. KUCINICH. OK. Thank you.

Mr. Issa.

Mr. ISSA. Thank you, Mr. Chairman.

Mr. Kashkari, I appreciate that you were in on those negotiations with leadership. The majority of Republicans voted against it, once and twice. Mr. Kucinich wasn't in the meeting where Secretary Paulson came in with the Vice President and Fed Chairman Bernanke and made all these assurances that there was absolutely a critical immediate need to get rid of the corrosive derivative products, all the different names for this ubiquitous Sub-S retraded credit default swap, blah, blah, blah, blah. OK. But they talked about them as though they knew what the hell they were. You got the money, and you immediately said, what items, what auction?

Would you please respond, under oath, when did you go from what you told Members of Congress in open and closed sessions was the absolute reason to have this money immediately, to buy a specific group of assets, about $350 billion in the United States, about $350 billion held by other countries and other funds outside the United States, those assets were what you said was locking up and destroying the market—when did you first hear that money was not going to be spent that way?

Mr. KASHKARI. Congressman, the day—on October 3rd, the day that the Congress passed and the President signed the legislation, we immediately created several policy teams developing asset-purchase programs, all of the details, both mortgage-backed securities——

Mr. ISSA. That wasn't the question. I want to know the time and date, because I want to know whether Congress was lied to, or whether there was a team all along that had an alternate—one or more people that had an alternate idea of how this money would be spent?

Mr. KASHKARI. Congressman, forgive me. On October 3rd we created a team——

Mr. ISSA. No, that is not answering the question. And here is the reason I am asking a very directed question. You can create the team. You can put together all that.

Look, Circuit City, and I sold them for 20-plus years, so I am very sensitive to the trouble they are in, Circuit City announced that they were closing 155 stores and began that process. They never announced they were filing Chapter 11. But all of us looked and said, look, they are not going to renegotiate walking away from 155 leases without a bankruptcy. So in our minds we knew it is a question of time. Well, they don't tell you one thing, they do tell you another.

You never in any good faith explained why you formed these organizations, and now you say it is hopeless and impossible to buy these products that were the entire reason. You can't have the success for doing something different than you said without explaining why you didn't buy one of those assets. And when did somebody figure out—by date, when did you first learn that we were not going to buy these assets because we couldn't value them properly?

Mr. KASHKARI. First of all, Congressman, it is not a question of our ability to value them. The decision was made by Secretary Paulson very recently, earlier this week, late last week, when we had finished a lot of our work. It is not just a question of valuing the assets.

For asset purchases to work, it has to be done in scale, and when credit markets deteriorated that quickly, much faster than we thought in late September and early October, he made the decision with Chairman Bernanke to lead with equity. So now the $700 billion is no longer $700 billion of asset purchases. We have allocated $250 billion, so that is $450 billion, and we made the decision, as we have watched how this has worked and how the markets have responded, the markets may need more capital, and now you are left with an asset-purchase program that much smaller than the original $700 billion.

So we can do it. We have done all the work. We know how to do the asset-purchase program. But we want to use the capital to its maximum benefit for the financial system.

Mr. ISSA. Let me followup on what you now want to do, because I want to be respectful of the time of every Member up here.

First of all, let me ask you a question which is a fact-finding question. Organizations like the Professional Services Council, the Information Technology Association of America and others would like to help and have been reaching out to Treasury on helping you understand and model what you want to do with this. They believe they can, in fact, help you.

Have you met with any of these organizations?

Mr. KASHKARI. I don't know the organizations you named personally. We have teams of people who have met with dozens or hundreds of organizations, soliciting the best ideas and looking at the services they can provide, and we welcome ideas, and we get a lot of ideas every day and look at them very seriously.

Mr. ISSA. Would you commit to meet with these organizations to at least see what help they could give you to model the problem and perhaps find better solutions than you presently have?

Mr. KASHKARI. Absolutely. The only hesitation I offer is we have a very formal procurement process, and I don't want to do anything that would advantage or disadvantage anybody.

Mr. ISSA. The Information Association of America is a 501(c). They are not selling a product.

Mr. KASHKARI. Wonderful. Then I would be happy to.

Mr. ISSA. OK. Second, it has been said that your purchases of $250 billion-plus of preferred stock is at a price that would not be market competitive, meaning you paid too much. Tell me why I am to believe for a minute that those preferred stocks that you bought you could resell today for anything close? Remember, the market has improved. You have said that. Tell me what the profit would be on those preferred stocks if you began to even put $1 of them into the market today?

Mr. KASHKARI. Congressman, I don't know what the price would be.

Mr. ISSA. OK. You are from Goldman Sachs.

Mr. KASHKARI. I used to work there.

Mr. ISSA. Well, I am from Directed Electronics. You are from your last job. If you tell me that you have improved the market, then by definition those assets, if bought at par, have appreciated. Isn't that true?

Mr. KASHKARI. Well, again, with deep respect, Congressman, there are many different markets. There is the equity market, there is the credit market. I think there are strong signs, I can walk you through data showing the credit markets are improving. The equity markets, we purchased equity.

Mr. ISSA. You purchased a debt instrument.

Mr. KASHKARI. Well, it is tier one capital, Congressman.

Mr. ISSA. You know, we can go ring-around-the-rosy here, but you are here today because Congress is feeling that you played a bait-and-switch game, and you are not convincing anyone that you haven't. But let us just try to go to the fundamentals. You bought preferred stock.

Mr. KASHKARI. Yes, sir.

Mr. ISSA. Preferred stock is a debt instrument. You are capitalizing the company, but you are capitalizing with a debt instrument. Those instruments trade. I have BB&T, I have—well, I have a number of debt instruments of that sort. They have, in fact, appreciated from the time you bought until today in various portfolios. So I am looking at those, and I am following a lot more of those kinds of instruments. They have appreciated.

So my question to you today, under oath, as someone who should know about this, is are your purchases above par today, in your opinion?

Mr. KASHKARI. Congressman, I don't know. We have independent valuation firms that are going to provide regular reporting on the current valuation.

Mr. ISSA. Regular reporting starting when? You are here today. Do you have any regular reporting from the day you bought them until today?

Mr. KASHKARI. We have published the reports to the Treasury Web site within 48 hours of completing the transactions on the terms. Right now we are in the process. Just yesterday the equity asset managers' solicitations concluded, and we received, I think, hundreds of proposals. We will be engaging the equity asset managers, who will be providing us the valuation services and the reporting to the Congress on a go-forward basis.

Mr. ISSA. Wouldn't it be reasonable for us to believe here today that if, in fact, you have improved the market, that those assets that you purchased—we will call them equity since they are a hybrid—have appreciated?

Mr. KASHKARI. I think it would be reasonable relative to the day we bought them.

Mr. ISSA. OK. So if we find out on the next report, which I hope is forthcoming and we will be looking for it, that they are below par, then, in fact, you paid too much, right?

Mr. KASHKARI. Well, again, it depends, Congressman, what our objective was. Our objective was to create a program that would encourage thousands of banks across our country to voluntarily apply and to use the capital. So we intentionally made it attractive for them to want to apply.

Mr. ISSA. So you believe here today that you had authority to subsidize banks, including providing them this capital at a below par, a below fair market, of a market that should have existed but didn't exist?

Mr. KASHKARI. Well, Congressman, as you know, the market, when we did this, there was no market. Most banks couldn't raise private capital.

Mr. ISSA. But, no, we are in a better market today. Understand, one of the reasons for the question is you have thrown $350 billion, including AIG and so on, out there. You are coming back for another $350 billion. If, in fact, what we discover, and I believe here today, is that your $350 billion—and let us just look at $250 billion, we will leave AIG, which is a whole other can of worms, aside. If that money, in fact, is a subsidy arriving at a price below the fair market price, thus causing banks to choose you—including banks in my district—choose you instead of other capital, all you have really done is give them discount capital.

Now, the reason I ask that is how large is the capital base necessary for the banking industry in America? Do you have any idea? Isn't it about $55 trillion, plus or minus?

Mr. KASHKARI. In terms of assets or capital?

Mr. ISSA. The size of the market, if you will.

Mr. KASHKARI. That sounds about right. I don't have those numbers at my fingertips.

Mr. ISSA. So you would have to put several trillion dollars in to be the owner of that base, even with the multiple.

So the reason I am asking all of this—and I know I have extended my time, but just to followup one last time—if all you are doing is moving your money in at a discount to banks and entities like American Express and GMAC and everybody else who is rushing to become a bank holding company today as a result of this deal, then at the end of the day we would have bought stock at too high a price or debt at too low an interest rate, however you want to look at these preferred instruments, and we will have moved people to other capital where they can to get the returns they want because you are competing at a price that the market wouldn't accept the loans. You are giving them a deal that distorts the market.

Isn't that true, based on your background at Goldman?

Mr. KASHKARI. When you have a market that is dysfunctional, any deal that we would put in, because we would be then the only provider of capital, would—by definition, would be better than the nonavailable capital in the middle of a crisis.

So, yes, we did offer attractive terms to stabilize the market.

Mr. ISSA. Mr. Chairman, I would note that Warren Buffet weighed into this with billions of dollars. Wells did a deal. There have been dollars done. But those dollars, I believe, are not coming in until the United States quits subsidizing, in competition to private-sector dollars, that would ask for a better return and undoubtedly would say that dividends and excess compensation would have to be curtailed until they were getting their returns.

I yield back the balance of my time.

Mr. KUCINICH. I thank the gentleman. There was a reason why I voted with the gentleman twice on this same question, the bailout.

We now recognize, for a period of 10 minutes, Mr. Cummings of Maryland. You may proceed with your questions.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. Kashkari, I must say as I have sat here listening to your answers, I have been disappointed. I think that you have kind of skipped around the issues here. I say that because when I saw pictures of you, I said this looks like a guy who will be a straight shooter.

So I am going to ask you some questions, sir. I don't say that trying to embarrass you; I say it because life is short, and I don't have time to hear ring-around-the-rosy answers.

Let me go back to something that the chairman said. He asked about whether you understood that when foreclosures take place, did you realize that it also affects the housing in the communities? In other words, you sell a foreclosed house at a lower price, the price-values go down.

Let me ask you a followup question to that. You also understand that when price-value goes down, local government is affected because it is based upon—the tax dollars are based upon that. So—this goes on and on and on, so it is a very serious problem that we are dealing with here.

Every time I sit in these hearings I always try to put myself in the position of my constituents who are watching this, because when I come home—hopefully, I will get home about 3 today. I live in the inner city of Baltimore, and believe me, when I go to the supermarket tonight, when I take my daughter to the movies this evening, I promise you people are going to ask me about you. And what they are going to say is, "Cummings, we watched the hearing. We heard that guy Kashkari, but I'm losing my house today."

And they are going to ask the question. They are going to say, "We heard about the Citigroup thing where I have to be 3 months behind before I can get help. And we heard that guy Kashkari; we know that he is in charge of the $700 billion. What can he tell me today? I don't want a handout; I just want a hand. I want to pay my mortgage. I just need a little help because this Bush administration and its policies have put me in a position where I don't have a job or I'm now working a part-time job. Help me. Did I miss something, Cummings? What can Mr. Kashkari—did he say something to help me know how I can help my family?"

That's what they are asking. They are in pain.

You are on TV. You are the man. I don't know how much we are paying you, but you're our employee; and I'm asking you to look in the camera somewhere back here and tell those people what you are doing.

They hear about the bailouts of Wall Street. They hear that their tax dollars are being paid to AIG, and these people are going on junkets. They hear all of that. They feel like it is ring-around-the-rosy. They hear a lot of nice talk, but they are still being put out of their houses.

They hear Paulson talk about wonderful stuff, but they are worried whether they are going to come home and their stuff is going to be on the street. Those are the people that I represent. So I am begging you to please tell me exactly what is being done.

And then I want you to please do something else. With Fannie Mae announcing Monday that it lost $29 billion—and you talked about all of the wonderful things that Fannie Mae is going to do, I know that we have $100 billion that can go into their coffers—how does that affect them, helping that guy that I just talked about?

I hear you guys talk about the urgency of the market and all of that. But something tells me that you need—and I think this is where the chairman is coming from—you know, we can fix Wall Street. But it seems like there is a bucket down there at the bottom, these people who have been and are being thrown out of their houses, it is like a bucket with a hole in it.

So whatever you do for Wall Street, if you are not saving these mortgages and helping people stay afloat and saving some pain, it makes no sense.

Help me with that, because my people don't believe that you all care about them. I hate to tell you that, but they don't. And they are angry.

Mr. KASHKARI. Thank you, Congressman. I appreciate and share your perspective.

Let me say two things, please.

One, the legislation that we asked for, we asked for it to try to stabilize and prevent a complete financial collapse of our financial system. That was not to help Wall Street; that was to help every American.

Please, sir.

Mr. CUMMINGS. Let me tell you something. I understand that. That's why I voted for it. But let me tell you, when we gave the banks money, they still weren't loaning any money.

Mr. KASHKARI. Let's talk about that because we are passionate about getting the banks to loan money in our communities to help our small businesses and to help our homeowners.

First of all, we allocated $250 billion for banks of all sizes across the country, and just about half the money is out the door today. I think we are going to approve another 20 banks today, large and small, across the country.

Potentially thousands of banks are applying and it is going to take a few months to process the thousands of transactions to get the money out the door. So we are working as fast as we can. We are working around the clock to process and get the money in our community banks, first of all.

No. 2, our banks are still—we are still at a period of very low confidence in the system. It has gotten better in the last few weeks, but we have a long way to go. And as we see confidence begin to be restored in our system, we are going to see our banks feeling more confident in themselves and more willing to extend credit, and our businesses and consumers more willing to take on their own loans. Unfortunately, it is not going to happen overnight; but we are working very hard to get credit in our communities.

One other comment, respectfully: This legislation was focused on stabilizing the system for every American, but it is different than a plan. It is not a stimulus. It is not an economic growth plan. It is an economic stabilization plan to stabilize the financial system. I want to respectfully set expectations that we are trying to use these resources to stabilize the system for every American. But we also have real economic challenges that we all need to work through. And this, by itself, is not going to solve all of our economic challenges.

Mr. CUMMINGS. I got that. Let me ask you this.

I had a conversation yesterday with a fellow named Joe Haskins, who is head of the Harbor Bank, which is a small bank in Baltimore, an African American-owned bank in Baltimore. He was telling me yesterday that one of the problems is that you all are financing these big banks. And the little banks, the little community banks that did it right—in other words, they kept the loans, they didn't sell them, so you know how that works, they make sure that they make good loans. This stuff with all of these foreclosures, it doesn't affect them so much except for people who may have lost their jobs. But as far as not properly vetting people for these loans, they didn't have a problem with that.

But one of his problems is that while he did it right, you all are financing all of these other banks, these big banks, and he is worried that they then are going to try to acquire, using our taxpayer dollars, the guys who did it right. They will try to acquire the little banks. The guys who did it wrong will try to acquire the little guys who did it right.

Mr. KASHKARI. Let's talk about that because that is a very important point.

We have created a program for all banks of all sizes, big and small, the same terms. So the first nine banks that we funded have the same terms as No. 10, No. 100, No. 1,000. So the gentleman in your community, Harbor Bank in Baltimore, can apply, can download the application off the Treasury Web site or their regulated Web site, submit it to their primary regulator, and it will come into our process.

And we welcome it. We want banks of all sizes to use this program. They are the ones lending in our communities. We need them. We need the good banks to take the capital because they are in the best position to make new loans. That is exactly who we want in the program.

Mr. CUMMINGS. Yesterday we had Mr. Paulson right where you are sitting, the guy who made $3 billion last year on hedge funds.

Mr. KASHKARI. Mr. John Paulson?

Mr. CUMMINGS. Yes.

And we had George Soros and James Simmons and Philip Falcone and a fellow named Kenneth Griffin. You probably know those guys. One of things that they said yesterday when they were talking about what you all are doing, they said they need to be doing more and doing more and urgently getting—helping those folks who are losing their houses. They said, it just makes sense.

I am sitting here and saying, these are the billionaires, and they have figured it out. They showed tremendous sensitivity with regard to the folks at the bottom, the people who are losing their houses.

And then Mr. Issa asked you a great question; he apparently mentioned several organizations.

I am just wondering, who are you all seeking advice from? In other words, we want—as I close, Mr. Chairman, we want the rubber to meet the road, but I am wondering if the rubber ever really meets it.

In other words, going back to my initial statement, if people see their tax dollars being spent on everything else—and I get it, that's why I voted for it, the bailout. But they are not so much worried about themselves, because 95 percent of the people are fine with regard to their mortgages. They are worried about their neighbors. They are worried about the tax base.

I plead with you, we have to find a way to more rapidly help the little guy and lady who are trying so desperately to deal with their mortgages.

Mr. KASHKARI. Congressman, again, I share your perspective.

I have spent the last year and a half working with nonprofit counselors. When we first started working on this problem, we found that counselors had a lot of great ideas. The banks had their own ideas, and the two weren't talking to each other. One of the first things that I personally did, I said, look, we are all in this together. Let's get the best ideas on the table and let's not point fingers at who is at fault. Let's get the best ideas to try to reach and help homeowners. I personally feel passionately about that.

If you look at some of the statistics on the rate of loan modifications over the past year, we have more than tripled the rate from where it was when we started this a year ago. We have made a lot of progress, and people now are embracing loan modifications. We shouldn't underestimate how powerful the action on Tuesday is. We have now established an industry standard using Fannie and Freddie to push it out to the whole industry on a fast-track loan modification process to get homeowners into long-term, affordable mortgages.

It is not going to be perfect, but we are taking very aggressive action and trying to use the right tool for the right job.

Mr. KUCINICH. The gentleman's time has expired.

Mr. Bilbray.

Mr. BILBRAY. Thank you.

Mr. Kashkari, I guess you sort of get a taste of how Mel Gibson felt in the last scenes of Braveheart, huh?

Look, you're probably the best spokesman the administration has, and I want to compliment you on that. You come across with more credibility than anybody else that I have heard across this dais.

But let me tell you something, when you sit there and make a statement like the administration trying to communicate with the banking institutions, let me tell you, my constituents in northern San Diego County remember great communication between the administration and the bankers in 2005 and 2006 when they were given the OK to give loans to people who didn't have legal documentation or viable IDs, in violation of the RICO provisions. It was just, don't worry about it, you can open the bank account, give the loan, you don't have to check viable identification if they fall into a certain category.

I don't know when the law ever created a gap in the RICO provision for the administration to tell banks that they give out loans to people who did not have viable identification. Do you know of any time that there was?

Mr. KASHKARI. I do not, sir.

Mr. BILBRAY. OK, but you do know that was going on?

Mr. KASHKARI. I am as outraged as you are about the practices that were allowed to go on earlier in this decade. That's why we are here.

Mr. BILBRAY. Let me tell you, it was a hot issue in my district. And the administration itself said, no, this is OK for these guys to do it. They actually locked on and approved of a program that was identified as a violation of a RICO provision, breaking Federal law. And they basically said, this really isn't a breaking, we don't require viable identification for this segment of the population. And I didn't know there was any exemption there.

Mr. KASHKARI. Forgive me, but I'm not familiar with it. But I take your word, sir.

Mr. BILBRAY. The FDIC just announced that they want to come in with some kind of program to focus on homeowners on this. The feedback I have gotten is that the Treasury Department has some real problems with that.

What's your problem with that strategy?

Mr. KASHKARI. Sure. I will make a couple of points. We have worked closely and have a lot of respect for Chairman Bair and her ideas. Candidly, it was really her ideas that led to the development of the program that was rolled out on Tuesday.

Set that aside. The FDIC proposal, at the end of the day, is a spending proposal. When Secretary Paulson came to the Congress to ask for the authority for $700 billion, that was $700 billion to make investments. Whether it be buying assets or buying equity, it was buying a financial instrument that would offer a return that we could offer to sell over time, to hopefully make back the taxpayers' money.

That is fundamentally different than just having a government spending program; however well intentioned and designed it is, it is just very different. And this is something that Secretary Paulson thinks is a very interesting idea and that Congress should consider it.

But to take the $700 billion, when we told the taxpayers that we would be buying assets that we could then sell, it is just different than saying we are going to take $20 or $50 or $100 billion and spend it with no chance of ever getting that into the program.

So it is just very different than what the program was structured to be—investing versus spending—No. 1.

No. 2, Congressman, in all of these programs we have to look very carefully at who is helped by them. There are programs out there, when you actually scratch beneath the surface, that help homeowners. But maybe it ends up helping the banks a lot more than actually helping homeowners.

Sometimes Wall Street firms will bring us proposals. They couch them as homeowner preservation. They are helping the banks and helping mortgage-backed securities investors.

So we have to look at all of these very carefully to be sure who they are helping. But the biggest challenge is, it is fundamentally spending. You are not going to get the money back, versus investing. That is the difference——

Mr. BILBRAY. The TARP is not in isolation. We set the precedence with Freddie and Fannie. Now we are not bailing out Freddie and Fannie. Or are we doing an umbrella package there?

Mr. KASHKARI. On the institutions or the mortgages?

Mr. BILBRAY. The institutions.

Mr. KASHKARI. The institutions. Again, we are buying preferred stock in the institutions to stabilize the institutions. And the taxpayers have warrants on 79.9 percent.

Mr. BILBRAY. Is there a reason why we should be surprised that when we got to the TARP, you didn't take the same strategy?

Mr. KASHKARI. Our strategy evolved as conditions changed. And so when Fannie and Freddie deteriorated very quickly through July and August, and the Secretary came to the Congress to ask for that authority, the Congress provided it, and he took very bold action with Chairman Bernanke and Mr. Lockhart to stabilize them.

Similarly, we led with an asset purchase program because, in our judgment at that time, that was the best way to help the financial system. But market conditions deteriorated so quickly, we had to move with equity first.

Mr. BILBRAY. When we talk financial system, are we talking now that we are not going to pick and choose, we are going to get into Bank of America and credit card companies?

Mr. KASHKARI. Forgive me. With respect to what Secretary Paulson talked about on Wednesday in terms of consumer credit and making it available?

Mr. BILBRAY. Correct.

Mr. KASHKARI. That is a program that we are developing to get credit flowing directly to consumers, whether it is credit cards or auto loans or student loans—potentially, mortgages as well.

Mr. BILBRAY. So we are talking about moving into that field.

Mr. KASHKARI. We are looking at it. Right now the markets have frozen. Credit card rates are going through the roof, auto loan rates are going through the roof. And it is impacting families directly, and that is impacting our economy as a whole. So we are looking at a program that could unfreeze that market to get credit flowing again.

Mr. BILBRAY. So are we talking about the possibility of a 2 percent Federal loan to American Express?

Mr. KASHKARI. No. That program would be structured where, much like the Federal Reserve has set up a facility to get the commercial paper market going again, it is not directly going to the banks or the lenders of the commercial paper, the issuers. It is getting the market working again. We do something similar here to get the liquidity going in the asset-backed market.

So the credit card market, the auto loan market, this would help all of our auto dealers and it would help the auto companies and help all of the retail industry that relies on the credit card business to work. Right now—as the chairman said, credit card rates are being increased right now in large part because these markets are broken.

Mr. BILBRAY. Twenty-two percent.

Mr. KASHKARI. It is a big number.

We have the banking financial sector and the nonbanking sector. The banking sector provides about 60 percent of credit in our economy, the nonbanking, about 40 percent. Our initial actions have now stabilized the banking sector. We feel good about that.

There is more work to be done. But the nonbanking sector is now frozen, so we are looking at what actions we can take to get that working again.

Mr. BILBRAY. We are always going after the taxpayers' money as the only way we can interject and save the economy and whatever. There was a whole discussion about half a trillion dollars of American assets overseas that could come back if we held it harmless, the repatriation issue.

Have you been following what the IRS did with the grace period for repatriated funds?

Mr. KASHKARI. Forgive me. Not closely.

Mr. BILBRAY. They increased it from 6 months to 10 months. Do you have any idea why they would do that?

Mr. KASHKARI. I have not focused on those issues. I am spending 100 percent of my time executing the TARP.

Mr. BILBRAY. Mr. Chairman, we need to take a look at—and I think the IRS was on to something. It is always quick to use taxpayers' money to be able to go in there. And we are actually taking money coming out of our general fund to go after this. But we wouldn't hold harmless private money coming in from out of the country and investing back here, because we want our pound of flesh. And now the IRS has recognized that by at least extending the grace period, because there is a huge amount of assets.

To be blunt with you, as somebody who has worked with the Federal Government since 1976—the chairman and I were elected on the council and the mayors together back in 1978—the Federal Government does not manage assets very efficiently at all. That is one of our biggest frustrations that those of us in local government have: the fact that this is going to come back to bite us when we could allow private-sector funds to get in there and try to get involved if we just didn't want to take our pound of flesh and drag it into Washington, DC.

Mr. KASHKARI. I completely agree with you. Some of our plans are designed specifically to attract private capital to come in, because we don't think that the taxpayers should do all of this themselves. The private sector should be encouraged to do that.

One of the things that the Secretary talked about on Wednesday was a potential capital program that involved a matching component: if a firm went and raised a dollar of equity, that the government would provide some kind of matching as a carrot to go back and get the private capital coming back in our system.

So we agree 100 percent with the spirit of that.

Mr. BILBRAY. Let me tell you, as one Member, I saw the bailout of Freddie and Fannie come up, and said, oh, this will take care of it; then we take care of that. And all I have seen, Washington, including the administration talk about, is how we are going to spend taxpayer money, not how we are reforming the process.

We did the guarantees on the deposit insurance—that was a step. But that is a very small step compared to a whole lot of stuff that we have not touched base on. We haven't redefined mark to market yet. We are not even talking about that anymore. That is sort of left behind and don't worry about it.

There are some major issues that we need to talk about, and the administration is only talking about how we are going to spend the taxpayers' money, not about how we are going to avoid it. And that is one of those things that, as a father, if one of my children came in and said, Dad, I am deep in debt, I need you to bail me out, the first thing I'd do would not be to write a check, it would be to ask for the credit cards. And we are not asking for the credit cards, we are not asking for the reforms; we are basically just writing a lot of checks.

Mr. KASHKARI. Congressman, I share your frustration. Our energy is focused on stabilizing the financial system.

But there are profound regulatory and structural questions that we as a country have to ask and answer in the near future: what to do with Fannie and Freddie; what role the government should play in mortgage finance going forward.

What we have done in the case of Fannie and Freddie, which were on the verge of collapse, is to stabilize them, to buy us all time, so we as a country and the Congress and the next administration can have that debate and make a thoughtful decision.

But we need to stabilize the system. That is what our actions have been focused on.

We are all frustrated by the kinds of actions we need to take. We don't want to do these kinds of actions, but we have needed to stabilize the system. But we need to have that thoughtful discussion so we are not here again in the future.

Mr. BILBRAY. Thank you, Mr. Chairman.

Mr. Chairman, somewhere down the line we are going to have to talk about who has actually been subsidized on this. You have foreign nationals. You have people who are not legally present in the United States. I have a constituent who cries about a home being lost when it is their seventh home, that has two or three homes. You have people who have leveraged this. And then you have the innocent people who are basically just trying to play by the rules.

Somewhere down the line, I think the American people are going to ask us to separate these groups and make sure that our resources are going to those who deserve to be helped on this.

Mr. KUCINICH. I thank the gentleman.

We will move on to our second round of questioning. This will be a 5-minute round.

I indicated I will have some questions about the National City transaction. PNC took over National City with the help of the Treasury Department. When you look at the money that you are giving to banks and you are picking winners and losers, you picked a winner, PNC, and you picked a loser, National City Bank.

Now, were you aware at the time that National City Bank had a relative history prior to the transaction involving PNC of being under attack by short sellers? Did you know that?

Mr. KASHKARI. Congressman, with deep respect, it is not appropriate for me to speak about any individual institution, but I can talk generally.

Mr. KUCINICH. With deep respect, you put 4,000 people out of work in the city of Cleveland. Are you taking the fifth amendment here?

Mr. KASHKARI. No, sir. First of all, Congressman, I was born and raised in northeastern Ohio.

Mr. KUCINICH. I am the representative of northeastern Ohio, and I'm asking you a question. Can you answer the question: Did you know that National City was a target of short sellers?

Mr. KASHKARI. I think many financial institutions, including National City, were the target of short sellers.

Mr. KUCINICH. Did you know that National City stock had been undervalued, according to Oppenheimer?

Mr. KASHKARI. I did not know that.

Mr. KUCINICH. Did you know that National City's debt had been overstated, according to many analysts?

Mr. KASHKARI. I did not know that.

Mr. KUCINICH. Did you know that credit-rating agencies were given credit, literally, with pushing National city off a cliff? Did you know that?

Mr. KASHKARI. No, sir.

Mr. KUCINICH. Do you look at the role of credit-rating agencies in terms of determining who gets troubled asset relief and who does not?

Mr. KASHKARI. If you permit me to walk you through that process——

Mr. KUCINICH. I want to be careful about where you are walking me.

Can you answer the question about credit-rating agencies?

Mr. KASHKARI. We do not look at credit-rating agencies when deciding who to make an investment into.

May I, please, sir, walk you through the process?

Mr. KUCINICH. I am going to keep asking you questions.

On October 24th, National City Bank was bought out by PNC for $5.2 billion; and they used $7.7 billion of TARP funds.

Did Treasury give PNC $7.7 billion of TARP funds.

Mr. KASHKARI. PNC has not yet received any money from the Treasury Department.

Mr. KUCINICH. Did they agree to give them $7.7 billion?

Mr. KASHKARI. We have not—PNC has publicly stated that they received preliminary approval.

Congressman, the reason I am speaking this way——

Mr. KUCINICH. Isn't there a yes or no answer?

Mr. KASHKARI. We have a very strict process about the way we disclose information about individual institutions, and I want to respect those institutions.

Mr. KUCINICH. You are testifying before a congressional committee here. If you can't answer the question, you have a constitutional right not to answer. I can inform you of that.

Mr. KASHKARI. I do not want to put an institution at risk by revealing supervisory confidential information.

Mr. KUCINICH. Are you invoking your constitutional privilege?

Mr. KASHKARI. No, sir.

Mr. KUCINICH. Since you're not, you are saying you cannot tell this committee what actually went on?

Mr. KASHKARI. First of all, when a bank submits an application to apply for TARP funds in the Capital Purchase Program, that application is reviewed by its primary Federal regulator and then that regulator makes recommendation to Treasury.

I can tell you that we have never received an application from National City Bank to the Treasury to apply for TARP funds, and when we do receive recommendations from the regulators, we look very closely at those recommendations.

Mr. KUCINICH. You were saying National City never asked the Treasury for help?

Mr. KASHKARI. I have never seen an application from National City.

Mr. KUCINICH. You have no knowledge that regulators denied a request, saying the firm was too weak to save?

Mr. KASHKARI. Again, the regulators do go to some banks that they think are not solvent institutions and discourage them from applying to the program.

Mr. KUCINICH. Did you put any conditions on PNC with respect to the $7.7 billion?

Mr. KASHKARI. If a bank comes to us and wants to apply for funds as part of an acquisition, they will only get—if it is recommended by the regulator, they will only get the target share upon closing of the transaction. There are conditions.

Mr. KUCINICH. Can you tell this committee why you thought National City was too weak to save? Do you consider the negative effects on local employment and ripple effects of more layoffs in an economically depressed region?

You know, you think about it: Congress in its wisdom—and Mr. Issa and I talked about this; we fought for some provisions that would help inner cities that were suffering from the most foreclosures. Cleveland certainly qualified for that.

Don't you look at the impact of your decisions on regional economies? Do you give it any consideration at all?

Mr. KASHKARI. We review applications that the regulators submit to us with their recommendations. If a regulator does not submit an application to Treasury because a regulator deems a financial institution is going to fail, we can't review it. And I don't think it is a good use of taxpayer money to put taxpayer capital into a financial institution that is going to fail.

Mr. KUCINICH. Well, you know what, that statement that you just made, you will hear about for the rest of your career.

My time has expired. I am going to come back to this question. We are going to go to Mr. Issa.

Mr. ISSA. We won't just come back to it, I think we will stay with it for a moment. PNC has announced a price, and they are going to buy National City Bank. If they don't have your implicit money, then they must be doing it with their own money.

Now, if they do have your implicit support, then that means that, in fact, a little bit like a Goldman Sachs deal, they have the assurances that they have the money to go do a deal; they go do a deal, and then they get the money at closing.

Now you are sitting here today saying you can't reveal, but in fact, if there is an announced deal, either you are going to provide the money or you're not. It's that simple.

Now, I appreciate all of the confidentiality and all of those other statements, but we have a right to know whether or not there is an acquisition that is going to be done with other funds or the U.S. Government's funds. So I am going to ask you once again, in light of that, is that acquisition going to be done with the pledge that at closing they will be provided the funds they need? Or are they going somewhere else for the funds, as far as you know?

Mr. KASHKARI. Congressman, generically—please permit me to speak generically. I can be more candid if you'll allow me to speak generically.

Mr. ISSA. I don't want to speak generically because we have certain acquisitions—Wachovia, obviously, and National City Bank. These are banks where both of us are shaking our heads.

And by the way, I have nothing against the acquiring banks at all, but we are looking at the banks being bought and saying, if they got—in the case of National City Bank, if we bought $5.5 billion worth of preferred stock in that company, would they be viable? Do you have any knowledge to answer that question?

Mr. KASHKARI. The regulators, Congressman, are making judgments on which banks they deem to be healthy banks, viable banks, and making recommendations to us.

If a regulator determines that one of its regulated banks is not viable, and they do not submit their application to us, we can't invest in them. It wouldn't be prudent.

Mr. ISSA. You are basically following the FDIC's lead; is that right?

Mr. KASHKARI. All four banking regulators—the Fed, the FDIC, the OCC and the OTS—are the ones who review the initial applications and make the recommendation to Treasury. We then look at those recommendations and either go back for more information or make our own decision.

Mr. ISSA. You said "or make your own decision." So you could make an independent decision?

Mr. KASHKARI. Absolutely. Ultimately, it is Treasury's decision who to invest in and under what terms.

Mr. ISSA. So at the end of the day, Hank Paulson gets to decide who lives and who dies? Who buys whom?

He could potentially have looked and allowed the opposite, the regulators to go in and say to PNC, we don't think that you are going to make it, and therefore National City Bank is going to buy you out; and $7 billion could have gone the other way? That could have happened?

Mr. KASHKARI. In theory, yes. Ultimately, the regulators are the ones who have been supervising the institutions. They have people onsite, and they are in a much better place to make recommendations to Treasury about who is a healthy bank and who is not.

Mr. ISSA. Let's ask the question I have been wanting to ask.

During the bailout debate, we had Bill Isaac, a former FDIC chairman, who described to all of us—both sides of the aisle, a very bipartisan series of meetings; as a matter of fact, Mr. Kucinich and I—I had never been to a Progressive Caucus meeting, but I got to go to one because immediately following we had a series of questions and answers with Chairman Bill Isaac.

In his time in the Reagan administration, he was granted and used a system of buying subordinated debentures essentially in an exchange program that put zero dollars—zero dollars of the Federal Government's Treasury money in play because it was a credit default swap, if you will, in its own way, and that authority still exists today. It requires that the Secretary of Treasury make a finding, which we have effectively made, we have said there is an emergency, and then that tool is directly the responsibility of the agency, in this case the FDIC.

You said you are using all of the tools. Why are you not using that tool? Because that tool uniquely says you have to pay back all of the money. To get this increase in your capital base, you are putting your money at risk; essentially, you are putting your existing stockholders behind these because this is a better stock, if you will, a better debt stock.

Why are we not using that tool, and isn't that the tool that should be used in this case?

Mr. KASHKARI. Well, Congressman, let me say a few things. It is an important point.

First, the preferred stock that we are buying is senior to the common stock. So we get paid back before the equity owners of these institutions. So we are in a better position than their shareholders; and that is very important, No. 1.

No. 2, and I don't have all of the details on the gentleman's proposal, but I know that some of those proposals which didn't require any cash going into these institutions were basically a form of forbearance, pretending that the banks had more capital than they had. We need our banks raising real capital from the private sector, and also from the public sector; and recognizing their losses, not pretending that they have more capital than they do. We have to be very careful.

There were a lot of ideas tried in the 1980's that pretended we had more capital than we did, and it didn't work out very well.

Mr. ISSA. First of all, we are pretending that we have more capital than we have because simply moving negative net worth from a bank to the American people is, in fact, causing the American people to lose real capital. The wealth of our country is, in fact, in this case, being moved onto the taxpayers' rolls and off the banks' rolls. So let's not kid ourselves.

So if you overpay, you invest in somebody who otherwise would not be solvent, particularly if they are going to buy other banks that you've determined are not solvent, you have determined that you are going to spend the American people's money, indebt the American people in return for that.

So when you chose one instrument over another, as far as I can see here today, what you have done is, you've made a determination that you are going to put real money of the American taxpayers' dollars into these banks forever, because if you buy too cheap, you are giving them real money forever, instead of the alternative authority that already existed that we argued should have been used first, where you at least made sure that 100 cents on the dollar, real 100 cents on the dollar, would be fully repaid without any risk to the American people except an ultimate liquidation of that entity at a loss.

So I appreciate the fact that during the Reagan administration we may have invested in banks that, at the time, were—although viable going forward—in our opinion, were not viable at that moment. The difference was that those banks either became viable and paid back 100 cents on the dollar, or everyone lost everything, except we got paid first whatever was left. I appreciate that.

But when I asked you the questions earlier about par and where we were and whether we overpaid when we invested, you couldn't answer those questions because, in fact, your system puts us at a greater risk, as the American taxpayers, than the system that we suggested you could do without any authority under the TARP.

Mr. KASHKARI. There are very important taxpayer protections, not just the dividend rate that we are going to be earning on the preferred stock. The warrants, we are getting 15 percent of the value of the investment in the form of warrants in these institutions. So there are important taxpayer protections that we have designed in, so that this ends up being hopefully a good investment for the taxpayers.

This is not something that we wanted to do. Our first choice is not investing in banks. We felt like we had to stabilize the financial system, and so we have taken bold action to do that.

Mr. KUCINICH. Thank you.

Mr. Cummings, you may proceed.

Mr. CUMMINGS. Mr. Kashkari, I am still listening carefully.

One of the reasons I voted for the bailout very reluctantly—I held my nose, closed my eyes and prayed—is because President-Elect Obama at that time had assured me that if he were elected President he would work on making sure that the people that might be losing their houses through foreclosure would be helped.

If President Obama came to you—and I don't know how long you will be around, and I assume somebody is going to ask Secretary Paulson this question, but if President-Elect Obama came to you and said, give me your best advice as to how I can help people who are facing foreclosure, what would you tell him?

Mr. KASHKARI. Congressman, that is a very important question that I have spent a lot of time thinking about. The best thing I think we can do as a country to help the housing market and avoid foreclosures is to bring mortgage rates down for borrowers so they can refinance into long-term, sustainable mortgages that they can afford.

The way to do that partly was stabilizing Fannie and Freddie, was to stabilize mortgage finance; and some of the actions we are looking at, trying to get credit flowing again, is to bring rates down for our consumers. If we can bring mortgage rates down—and as you know, the Federal Reserve has been cutting interest rates, but that hasn't led to lower borrowing rates for consumers and borrowers because the markets are stuck.

So by trying to fix the markets, we are trying to get that directly to the consumers so they can get into mortgages that they can afford, and that will also support home values, to stop this falling knife that we have right now.

My judgment—I'm being very candid with you—is that bringing mortgage rates down for borrowers is the best thing we can do to try to help homeowners avoid foreclosures and stabilizing our housing sector.

Mr. CUMMINGS. Now, if President-Elect Obama asked you to stay on, would you stay on?

Mr. KASHKARI. Congressman, I would be honored if the President-Elect wanted me to be part of his team. I would have to talk to my wife, ultimately; this has been a hard 2½ years for her.

Mr. CUMMINGS. Let me go back to Fannie Mae and Freddie.

I asked you earlier about how this loss, this announcement on Monday, the $29 billion loss, affects, if at all, what you are trying to do to help the homeowner through Fannie Mae? Does it affect it?

Mr. KASHKARI. Not directly. When we took our actions in July and August to stabilize Fannie and Freddie, we expected big losses to come, and so we sized these $100 billion contracts to be big enough to deal with these losses. We were not surprised by it. We knew they were coming, and we don't think that directly affects what we can do with Fannie and Freddie.

Mr. CUMMINGS. Now, I was intrigued by Mr. Issa's questions, and I want to give you a broader question sort of hooked up with his.

You all had to made some tough decisions as to where this $700 billion is going; and the American people—and this is what I hear at the supermarket and at the gas station when I run into my neighbors—they think that there are a whole lot of people lined up with their hands out. They are looking at GM and they are looking at all of these other folks who are saying, government, bail us out.

I want to know two things. One, what goes into the decision-making with regard to, you know, the bailing out? I know you have certain structures you have to go by, but how do you all try to make sure that whatever the objective is, it happens? In other words, do you need more authority from us?

I have to tell you, one of the most disappointing things for me was when you all gave the banks money and then I read the next day that a lot of the banks were not going to be loaning money and that they were going to use the money to acquire other banks and they were going to use the money to not make the cuts that they needed to make and that kind of stuff.

So now we face a situation with GM, and a lot of us are saying, you know what, one out of every 10 jobs is connected with the automobile industry. We want to make sure that we don't lose a GM or lose any of our automobile companies because they are so important to our economy. But at the same time the American people are saying, and we want to make sure that if they got the money, that they move toward energy-efficient cars and they are competitive and all of that.

So how do you all say, we are going to give—like Mr. Issa, you are going to give to this company, this bank? What is the objective? How do you make sure that the objective is achieved; in other words, you can't guarantee, but create the best possible circumstance to have it achieved? And do you need more authority from us to achieve that?

I am going to tell you, the American people are running out of patience. And Mr. Issa and Mr. Kucinich voted against the legislation. I have to tell you, I venture to guess most of us wanted to vote against it, even those who voted for it.

So I am trying to figure out, tell me how do you do that. At some point the Congress is going to say, sorry, no more, because you know what, the American people are saying it already.

Mr. KASHKARI. Congressman, these are very good questions. I appreciate you asking these questions.

First of all, if you look at the capital program, we want to make sure that our banks are lending in our communities, so we designed in very specific contractual requirements to make sure that happens. Let me walk you through them.

One, no dividend increases. No. 2, restricting share repurchases. It doesn't make sense for us to put capital in and then have them pay it out to their shareholders.

Now, the capital is in the bank; if they don't put that money to work, their own returns are going to come down. And so there are very strong economic incentives to want to make them want to lend.

Having said that, it is not going to happen overnight because there is still a lack of confidence in our economy and in our system.

So we believe that the economic incentives are there and are very strong to get them lending in our communities. And the actions that the banking regulators are now taking, as their supervisors, are completely consistent with that objective and are going to be pushing the banks to lend, No. 1.

No. 2, I'll be candid with you, my phone is ringing off the hook. Many people around the country—individuals, businesses, local and State leaders—are calling and saying, we need help, our community is in trouble, our business is in trouble, can you help us.

I would first say, that is exactly why we are taking the actions we are taking. If we went out to each of the businesses and communities and helped them directly, the $700 billion wouldn't go far enough. So we are trying to take the $700 billion to stabilize the system as a whole, so credit can then flow out to everybody around the country who needs it.

We are trying to think every day if we have finite resources, how do we use those resources to the best possible benefit to the system as a whole, because that will help every American. And it is not perfect and it is not going to happen overnight, but that is our objective.

Mr. CUMMINGS. I thank you. My time is up.

Mr. KUCINICH. We are going to go to Mr. Bilbray, and then we will have a third round of questioning for Mr. Kashkari.

Mr. BILBRAY. Mr. Kashkari, as late at September 5th, the Secretary said that Freddie and Fannie were basically sound and encouraged Americans to purchase shares and invest in those two entities. These investments were wiped out when the Secretary took over the GSEs.

It appears to any reasonable person that the Secretary misled the public on September 5th. Is there any justification for how the Secretary could have made such a terrible mistake that impacted a whole lot of people that trust the word of their government when it came down to putting their hard-earned resources into these two entities and then watch it evaporate when the same Secretary took over control?

Mr. KASHKARI. Well, Congressman, first of all, Treasury is not the regulator, as you know, sir, of Fannie or Freddie. OFHEO and now FHFA is, and they have been releasing reviews of their capital levels and their position. And so any of the Secretary's comments, I think, were based on the regulatory supervision and the analysis that has been done by the regulators, No. 1.

No. 2, I don't think that the Secretary ever encouraged people to buy preferred stock in Fannie or Freddie or buy Fannie or Freddie shares.

Mr. BILBRAY. But he did make the statement that both of them were sound.

Mr. KASHKARI. Again, sir, I believe it was based on the analysis done in terms of the regulatory capital levels established by the Congress and looking at that analysis.

I don't think anybody was more disappointed than he was, or we at the Treasury were, that we had to intervene to stabilize these institutions or risk systemic risk across the world. There are $5 trillion worth of debt, as you know, sir, and mortgage-backed securities around the world. If they had been allowed to collapse, it would have been disastrous for our economy and our financial system. We had to take action to step in.

Once the decision was made to step in, our highest priority was stabilizing the situation and a close second was protecting the taxpayers as much as possible.

And so when we went in, when the regulator went in and put them into conservatorship, with the support of the Secretary and the Chairman of the Federal Reserve, the taxpayers received some protections, warrants for 79.9 percent of the company, dividends on the preferred stock, etc. So this is not action that any of us wanted to have to take.

Government action can have unintended consequences, as you know. Fannie Mae was created 80 years ago in the Great Depression. I don't think anyone would predict that it would grow to become a systemic risk for the entire country. But it did, and we had to take action.

Mr. BILBRAY. Within 2004 and 2005 that issue was raised. I remember Ed Royce was raising the issue that they had gone from 30 to 70 percent. Wasn't that kind of an indication that things were growing a little larger than anybody had predicted?

Mr. KASHKARI. I think you're right, Congressman; there were Members of Congress. And members of the administration, before my time, had been very focused on the systemic risk posed by Fannie and Freddie, and it was unfortunate that it came to what it came to, that we had to take this action.

And now Congress and the next administration and the American people will have a very important debate about what form they should take in the long term.

Mr. BILBRAY. So you are saying that basically the Secretary had no clue that both of these institutions were on the verge of falling off a cliff?

Mr. KASHKARI. I don't have my dates exactly, but I believe in July he came to the Congress to ask for specific authority to try to support Fannie and Freddie in the event that they ran into trouble. Again, markets—and I have said this a few times, not in this hearing—the one constant throughout the credit crisis has been its unpredictability. Fannie and Freddie's deterioration surprised even us, just as the credit market's deterioration surprised us in September and October.

Mr. BILBRAY. Shifting over, is the administration ready to go back and tighten up the enforcement of the RICO provision on who and where people get loans in this country? Are we willing to say now that we want to make sure that the people getting the loans are actually legal under the system and have a viable ID before they get that loan?

Mr. KASHKARI. Congressman, with deep respect, I am not deep in the policy process on that specific issue that you are referring to. I know it is an important issue. And we are passionate about making sure that we issue mortgages that people can actually afford, so we don't get back here again. But I am not deep in that policy piece.

Mr. BILBRAY. Mr. Chairman, we need to understand that this administration, more than any other administration, has specifically told lending institutions that they do not have to follow a guideline that every previous administration has followed to stop the racketeering; and especially in California and along the border region, where we have huge amounts of assets being laundered by drug cartels.

To sit there and say that we are not going to enforce RICO for certain institutions, I think that has opened up a lot of problems, not just RICO, but I think a lot with this.

Now is the time that the American people want to see us go back and reform and change our operational pattern to avoid future problems. I just hope the administration is brave enough to be able to say, we made a mistake here, we are going to send the signal that what we said in 2005 and 2006 is not going to be the rule from now on.

I think this administration ought to do the change before the new administration, because it is this administration that set the pattern that has created this problem; and I hope you understand that—mistakes are made; correct it before the new administration comes along.

Thank you, Mr. Chairman.

Mr. KUCINICH. We are going to go to a third round of questioning of Mr. Kashkari.

National City Bank, are you concerned when you pick winners and losers that you are increasing market concentration that may work against the interest of consumers in other industries? Are you concerned about that?

Mr. KASHKARI. We are not actively trying to consolidate the industry.

Mr. KUCINICH. When you talk to regulators, do regulators say it is OK to concentrate the markets?

Mr. KASHKARI. The regulators, I think, will say that if you have a failing institution that gets taken over by a healthy institution, that community is better off.

Mr. KUCINICH. I—not. OK, I want to go on to another question.

By my calculation, out of the first TARP tranche of $350 billion, $250 billion has already been spent or pledged, and you have another $40 billion for further aid to AIG, remaining $60 billion for new capital, a purchase plan for nonbank financial institutions.

Is it fair to say that you have already committed the entirety of the first tranche of $350 billion?

Mr. KASHKARI. The last $60 billion has not been committed.

Mr. KUCINICH. And none of the commitment was for the purchase of mortgage-related assets or conditioned on the recipients of the TARP funds undertaking any mortgage modifications; is that correct?

Mr. KASHKARI. Not contractually.

Mr. KUCINICH. Do you anticipate Congress is going to receive requests in the 65 remaining days of this President's administration for Treasury to get access to the second tranche?

Mr. KASHKARI. The Secretary has not made any determination on when he would make such a request.

Mr. KUCINICH. One of the things what strikes me in your testimony is your view that private views, up to and including the HOPE NOW streamline modification, are sufficient to stem the foreclosure crisis. It is interesting because we started there.

We started with the private sector and we ended up with subprime loans. We started with the private sector and we ended up with $684 trillion in derivatives. We have people losing their homes. And then we came up with the TARP, which is going to interfere in the marketplace, but promising us it is going to help homeowners.

And now we have reversed the course, and we are saying again it is going to be private efforts, loan modification with regulations. It is kind of like we are back to the future.

Now, you are still saying this, it is private efforts. Mortgage money is going to go to borrowers, you are going to stabilize mortgage rates, and people are going to be able to protect their homes.

But at the Financial Services Committee hearing on Tuesday, it became clear that the efforts by the private sector to remedy the problems, even efforts coordinated by Federal agencies, were insufficient. As our hearing witness Thomas Deutsch stated at the Committee on Financial Services, "Macroeconomic forces bearing down on our already-troubled housing market are simply too strong for the private-sector loan modification initiatives alone to counteract the nationwide increase in mortgage defaults and foreclosures."

Now, Mr. Kashkari, why do you have more confidence in the ability of the servicing industry to avoid a tsunami of foreclosures than these observers and, in fact, than the servicing industry has in itself?

Mr. KASHKARI. If you look at the data on what has been achieved: increasing modifications from 23,000 a month to 100,000 a month over the course of the past year; over 200,000 Americans are getting a form of loan workout every month. It is not enough, but a lot of progress has been made.

I would also very respectfully ask you to consider the incentives of some folks who are making these plans. There are some folks who would like nothing more than the government to provide guarantees for mortgage-backed securities. The investors would love that. Investors around the world would love it if the U.S. Government guaranteed all their mortgage-backed securities under the rubric of helping homeowners.

Mr. KUCINICH. If it gave loan modifications and directed lowering principal and interest rates and extending the terms of payments, maybe millions of homeowners would love it. I don't know if you have thought of that, though.

Can you point to anything in your HOPE NOW or any other private initiative that cures the problems of large proportions of negative equity that many borrowers face now that the housing bubble is deflating?

Mr. KASHKARI. Negative equity is a very tough problem. The Hope for Homeowners bill that was passed by this Congress and signed by the President is directed specifically at that problem, to encourage servicers to take write-downs to get them into mortgages that homeowners can afford with positive equity.

Mr. KUCINICH. I have been informed by staff there have only been 42 workouts. Just thought I would talk about a box score here.

I have a minute left, and in that final minute, I would like to apprise the members of the subcommittee. I just talked to Mr. Issa about this matter. We have many industries that are being looked at here. I am concerned that with all of this attention to finance capital, which has been unregulated, we are seeing our industrial capital crushed here; and we are seeing our industrial base threatened by credit freezes.

In Cleveland, for example, we have a steel mill that is on idle because orders have dropped, because there is a credit freeze. We have a credit freeze going on where consumers can't get auto loans, so you have people getting laid off in the auto industry. America's national security is at risk.

So this subcommittee is going to hold a hearing next Thursday on this specific issue, and we are going to ask people—I understand your time availability, but we are going to ask somebody from Treasury to be present to also discuss about what Treasury's plans are, if any, to deal with the fact that we have an industrial base that is in imminent peril.

When Mr. Cummings said earlier in questioning, and his comments are well taken because when we go back home, people are asking, what are you doing to keep us in our homes and what are you doing to help protect jobs. We have a whole way of life threatened in America; and one thing that this subcommittee can do is require people to come forward and answer questions, and try to use that information that we gain to suggest new initiatives. I want to thank Mr. Issa for his willingness to pursue that.

And so next Thursday, we will give you the exact time, but we will have a hearing on that because we are concerned about using the assets that the Federal Government has to protect an entire way of life. I just wanted to make that comment as the chairman.

We are now going to go to Mr. Issa for a continuation of the final round with Mr. Kashkari.

Mr. ISSA. Thank you, Mr. Chairman, and I will be brief. I don't think I will use the whole 5 minutes.

I don't know if you are aware, but later today I will be forming the Bank of the 49th Congressional District of California. I will be looking for $10 billion or $15 billion, and I hope I will be favorably received. I have no deficits, I don't have a negative net worth, and the viability of the real estate in California, if anything, has never been better, because it has never been lower than it is today. So hopefully someone from your staff will help my staff run through the application for a Federal charter so we can end this question of how we get money to creditworthy banks.

Certainly if National City Bank wasn't creditworthy and needed to go away, I am shocked that PNC would pay $5.5 billion for a company that was insolvent. That becomes one of the conundrums I find, is if somebody isn't worth investing in by the American people, but they are worth, when you invest in somebody else buying out for $5.5 billion, then my years in business were misspent, I guess.

Let me go into two questions.

One, earlier in your testimony, and I know you are the messenger and you are bullet-ridden at the end of this hearing, so I will try to make these last two a little more at the economics level and a little less at the level of why didn't you do what we asked you to do kind of level. You said earlier that if you just bought mortgages, you would have run out of money, and essentially what you are saying is you need to leverage it more. I don't have a problem with that concept. But let me go through a hypothetical for you real quickly, because I would like to make sure it goes back to Treasury with you.

If you had taken $50 billion and you put it into a fund and you said this fund exists for banks of exclusive refinance, meaning we will go to anybody where there is a deep discount for the existing homeowner to refinance his home, the bank that is walking away has to agree to be wiped out. But in return, they will get 100 percent of the current market for that product. The homeowner puts in whatever skin they can and refinances. You then take that refinanced package, understanding that the bank has lost nothing because they were going to foreclose and they were only going to get market anyway, you have a willing buyer in a sense of a refinance.

If those packages were packaged up, do you believe, or let me rephrase that, do you believe for a minute that you wouldn't be able to resell those packages and thus have that $50 billion be leveraged 10 or 15 or 20 times? Because every time you get $50 billion worth of these new packages and sell them on the market, you have your $50 billion again, the way originally subprime was done. And let's assume for a moment there is a small equity factor in there; in other words, a certain amount so you don't get it all back.

Do you believe for a minute you wouldn't be able to repackage those and leverage that $50 billion or $350 billion or $700 billion in order to get people to stay in their homes if they were able to make a mortgage at current value?

Mr. KASHKARI. Congressman, to make sure that I followed it and I got it right and I am reacting to what I think I am, let me just repeat it back to you. So if we bought mortgages and repackaged them and sold them, that would be a way of leveraging the TARP funds. Just to keep it really simple——

Mr. ISSA. Essentially, yes. Because when it was presented to us, it was we were going to do it one time originally.

Mr. KASHKARI. Right.

Mr. ISSA. My only question to you is, was that considered?

Mr. KASHKARI. It was, and I will talk you through it.

Mr. ISSA. Why isn't it being done?

Mr. KASHKARI. It is a lot of the work we are doing to reach where we are, in looking at that, the idea of buying loans, modifying them, repackaging them, to free up more space under the TARP. The challenges that we found is it is a very slow process, a few months it turns out to acquire, let's say, $50 billion worth of mortgages.

Mr. ISSA. OK, I will stop you because I want to be respectful of the time. I am not talking about the loans. I am talking about the houses. They are new loans. Whoever is foreclosing on Mr. Kucinich or my constituents, whoever is foreclosing is offered by the owner based on having gone to the Bank of the 49th Congressional District or the Ohio Bank of Reconsolidation, they say, look, I have a short sale effectively financed with this. This group is a willing buyer-willing seller situation. The homeowner is willing to put their name on the line, presumably a recourse loan, presumably fresh, but it is at a lower rate. It is a short sale, but it is a short sale to the person that is in the house at current market price.

Why wouldn't that system leverage the American taxpayers' dollars almost infinitely, because we are forcing the banks to recognize the real mark to market, but we are creating a market for the resale of that asset immediately so it provides real liquidity.

If your program to prop up the banks afterwards is still needed, that is fine. But why is it we aren't doing something like that with this huge amount of money that we gave you almost unlimited ability to use in different ways?

Mr. KASHKARI. Again, just to be clear, I want to make sure I am answering the right question. So the TARP would be providing the loan to the buyer at the current market price in a short sale?

Mr. ISSA. It would undoubtedly use a bank or some other entity.

Mr. KASHKARI. But it would be TARP funds going to the homeowner.

Mr. ISSA. It would be TARP funds.

Mr. KASHKARI. OK. And then we would package those up and sell them.

Mr. ISSA. And they would immediately be sold. Because they are not corrosive loans. They are not any of this other stuff. They are at the real market today, perhaps even with a Federal guarantee in case things go lower.

Why is it we are not doing that so we can get the leverage that the gentlemen to my left so desperately want?

Mr. KASHKARI. Right. Well, Congressman, at least as we have talked about it, that sounds an awful lot like the Hope for Homeowners program, where what ends up happening is the borrower gets put into a new loan that he can afford at today's market price for the house, and then those loans are securitized and sold off through Ginnie Mae. And the challenge is there are very complex incentives on the existing lender's willingness to mark down that loan into that loan that homeowner can now afford based on today's market price.

Mr. ISSA. I am going to cut you off because my time has been cutoff, appropriately. I think your problem is as long as you give the money to the banks without their fully availing themselves, what happens is you are discouraging that secondary behavior, because you are putting the money into their back pocket and causing them not to be desperate enough to use that other program.

I am going to close with one question I want back for the record real quickly. Currently, today, Treasury bills at 2 years are 1.22 percent; GSE's are 2.64 percent. Five years, 2.3 percent versus 2.65. Ten years, 3.72 versus 5.08.

Why has Treasury with their full faith guarantee of GSE not insisted in fact that they beat T bills? Why is it today that the American taxpayer is funding Fannie and Freddie at a rate, a cost of money rate, that is substantially higher to the American taxpayer because of what we did in taking it over, without getting T bill rates? Had you converted GSEs to T bills, you would have been able to get these rates. I would like an answer for the record.

Mr. KASHKARI. Of course, sir. First of all, we do not—Fannie and Freddie are not full faith and credit. We have provided very strong implicit support through these contracts that provides the Treasury's backing. But they are not the same thing as saying it is full faith and credit. It is darn close, but it is not quite full faith and credit, No. 1.

Mr. ISSA. It is not very close on the interest rate, I am afraid.

Mr. KASHKARI. No. 2, the Treasury lending authority, if we wanted to provide all the lending to them instead of them going to the market themselves, the Congress provided us authority through the end of 2009. So we need Fannie and Freddie to be able to access the markets directly for their long-term applications to continue to fund themselves. So we could step in on a short-term basis and provide liquidity, but it is not unlimited authority.

Mr. ISSA. Thank you.

Thank you, Mr. Chairman.

Mr. KUCINICH. I thank Mr. Issa for the final round of questioning of Mr. Kashkari.

The Chair recognizes Mr. Cummings. You may proceed.

Mr. CUMMINGS. Mr. Kashkari, in the neighborhood I grew up in the inner city of Baltimore, one of the things that you tried to do was make sure that you were not considered a chump. And what "chump" meant was that you didn't want people to see you as just somebody they could get over on. And I am just wondering how you feel about an AIG giving $503 million worth of bonuses out of one hand and accepting $154 billion from hard-working taxpayers?

I am trying to make sure you get it, you know? I mean, you know what really bothers me is all these other people who are lined up. They say, well, is Kashkari a chump? We can just go in there—and I am not saying they are. I don't know. We can go in there, we will get some money. And you know what AIG did? They will even tell you they are coming back for some more. And they have the nerve, the nerve, to grant some $503 million worth of bonuses.

I am just wondering, do you all say to yourself, boy, this doesn't look too good. And I am wondering about them, if it was simply from a PR standpoint, and I know nothing about PR, but one thing I do know, I wouldn't want to be asking my friend for some money to help me stay afloat and if I didn't get the money I would be out of business, and then for my friend, I say OK, I am really struggling. Then my friend, who can barely afford to go to McDonald's, then walks around and sees me in a restaurant costing $150 a meal. There is absolutely something wrong with that picture.

So I wonder, does that go through your head, or is it just me? Am I missing something?

Mr. KASHKARI. No, Congressman. I saw the same images that you saw of the parties and I share your frustration with that.

Mr. CUMMINGS. What about the $503 million worth of bonuses?

Mr. KASHKARI. Let's talk about that, because I heard about that this morning I think as you did in the paper, and I asked my colleagues to check on it. I said, what is this, because I was outraged when I saw the headlines.

What was explained to me is that this was money apparently, and I am not defending it, but this was money that had already been paid to employees that was set aside in a separate fund that they would get if they left AIG, and we need AIG to keep running as a company so it can sell off its assets and pay back the taxpayers.

So from what has been explained to me is this money that has already been paid but set aside to the employees was now released so that the employees did not have an incentive to quit, because we need them to keep working so that they can sell off the assets and pay back the taxpayers.

Mr. CUMMINGS. We need them to keep working, but guess what? There are a whole lot of people that can replace them because there are so many people losing their jobs. This is an employer's market today.

Mr. KASHKARI. That is true, sir.

Mr. CUMMINGS. Come on now. I guarantee you there are people lined up saying, please quit so I can get a job. And that is what the American people are looking at, and they are frustrated.

Now, let me go to another question. You said something very interesting. And, by the way, I thank you. You have a tough job. The $350 billion that is left, you said that Mr. Paulson has not made a decision on that. I mean, I don't want to be considered a chump either. You cannot convince me that Paulson is not coming back for the $350, I know you say he has not made a decision, that he is not coming back for the $350 billion, because you have said here several times that the $700 billion if you don't do it this way or don't do it that way, you can't achieve but so much. So obviously you need that.

I mean, what would be the logical argument to get the $350 billion, if you were advising Mr. Paulson to go after the $350 billion?

Mr. KASHKARI. It would be the priorities that he has outlined. So, No. 1, additional capital for all sorts of financial institutions, not just banks, because many of them provide credit to our communities. No. 2, getting consumer credit flowing again.

I talked about auto loans, credit cards, student loans, etc. Those markets are frozen today. So to get at those problems, that is part of what we would want to use the second $350 billion for, if he makes that determination. So that is what I would be talking to him about, sir.

Mr. CUMMINGS. So last but not least, a lot of times when we have these hearings, and I will close with this, and I walk away from the hearing, I often ask myself, does the witness then go to his friends and his employees and say, we got through that one, and then go back to business as usual?

I am praying, and I am talking about constituents, man. I mean, I am talking about people who are hurting. I am praying that you will never be the same after this hearing. I am serious. And I know you have been reaching out.

In other words, I want you to go back with a little bit more fire. I am not saying you haven't had the fire, but I want it to be hotter, to try to help these people who are losing out. These are the people that I face.

I go home every night. I live in Baltimore, so I see my constituents every day. So they need help, and they are begging for help. And I just hope that when you go back you don't say, got past Kucinich, got past Issa and Cummings. It was a little rough, but, OK, boys, let's go back to business as usual.

We can't afford it, nor can we afford to be chumps. We can't afford it. It is too much. People are hurting and they are in pain.

So I hope that while we are looking at Wall Street and we are looking at all the folks that have their hands out and we are looking at all the AIG officials as they go on their little junkets or whatever, that you keep in mind, as I know you have been doing, but I want you to do it more, that every decision you make, you think about those folks who are losing their jobs and who are in pain and who are not going to have a decent Christmas. They are going to probably be sitting around the Christmas tree with no presents. You know why? Because they won't have a job.

All of these people, as I hope as they are coming to you begging for the taxpayers' money, that you will remind them of all the people who are suffering and that are in pain, and tell them that it cannot be business as usual.

Thank you very much, Mr. Chairman.

Mr. KUCINICH. Thank you, Mr. Cummings.

Mr. Kashkari, do you have any response?

Mr. KASHKARI. Thank you for the opportunity to be here today. Just to Mr. Cummings, I don't know how to work any harder than we are already working, and I take your feedback very seriously. That is why we are working as hard as we are, and we are going to keep doing it and trying to accomplish it and meet your expectations.

Mr. CUMMINGS. Thank you very much.

Mr. KUCINICH. If I may take the prerogative as Chair to say I don't think anyone questions, Mr. Kashkari, that you are working hard. Our question is who are you working for.

That will conclude this first panel. I want to thank you for your presence, sir. As Mr. Cummings said, I know that it cannot have been easy. You have been answering questions for over 2 hours and the committee will take note that you have engaged in a thoughtful Q and A here. So we appreciate it. I just want you to know it is much appreciated and we understand the burdens of your office.

So we are going to thank Mr. Kashkari for his presence here and we are going to move on to the second panel. I would ask the witnesses from the second panel to come to the committee table.

Thank you again, Mr. Kashkari, for your presence here.

The committee will take a 5 minute recess while the table is set up for the second panel.

[Recess.]

Mr. KUCINICH. The committee will come to order.

We are fortunate to have an outstanding group of witnesses on our second panel. Professor Michael Barr teaches financial institutions, international finance, transnational law and jurisdiction and choice of law and co-founded the International Transactions Clinic at the University of Michigan Law School. He is also a senior fellow at the Center for American Progress.

Professor Barr conducts large scale empirical research regarding financial services in low and moderate income households and researches and writes about a wide range of issues and financial regulation.

Professor Barr previously served as Secretary Treasury Robert Rubin's special assistant and Deputy Assistant Secretary of the Treasury.

Professor Anthony Sanders. Professor Sanders is a professor of finance and real estate at the W.P. Carey College of Business of Arizona State University where he holds the Bob Herberger Arizona Heritage Chair. He has previously taught at the University of Chicago Graduate School of Business, University of Texas at Austin McCombs School of Business, Ohio State University Fisher College of Business. In addition, he has served as director and head of asset backed and mortgage backed security research at Deutsche Bank in New York City. He has served as a consultant to various firms such as Merrill Lynch, UBS, Bank of Scotland, Nationwide Insurance and Deutsche Bank on the subject of mortgage design, mortgage-backed securities and commercial mortgage-backed securities, loan servicing and risk management.

Ms. Alys Cohen is a staff attorney at the National Consumer Law Center, where she focuses on homeownership and other low income consumer credit issues. She is contributing author of the "Cost of Credit and Truth in Lending" manuals, provides training and consumer law to attorneys and other advocates, and participates in NCLC's advocacy records.

Prior to joining the NCLC staff, Alys worked as an attorney in the Federal Trade Commission's Bureau of Consumer Protection Division of Financial Practices where she specialized in credit discrimination and high class lending issues.

Mr. Larry Litton is the president and chief executive officer of Litton Loan Servicing, overseeing the day-to-day operation of Litton's $75 billion mortgage servicing portfolio. As a founding member of the company, Mr. Litton has been involved in every aspect of the business since its inception in 1988 with more than 20 years of experience in mortgage servicing. He is considered an expert in the field of credit sensitive mortgage loans, was appointed and served on the Mortgage Bankers Association Residential Board of Governors, Board of Directors of the Texas Mortgage Bankers and served on the State of Ohio Foreclosure Prevention Task Force.

Mr. Stephen Kudenholdt serves as chairman of the Structured Finance Practice Group of the law firm of Thacher Proffitt & Wood based in New York, a leader in residential mortgage loan securitization. His areas of practice include residential and commercial mortgage-backed securities and other asset-backed securities, primarily focusing on residential mortgage loan securitization as well as resecuritization transactions involving various classes of mortgage-backed securities.

Mr. Kudenholdt has helped develop many transaction structures and formats that have become industry standards, including shifting interest subordination techniques.

Mr. Thomas Deutsch. Mr. Deutsch is deputy director of the American Securitization Forum, a leading trade organization of all parties to mortgage-backed securities. Prior to joining the American Securitization Forum, Mr. Deutsch held the position of associate in the Capital Markets Department of Cadwalader, Wickersham & Taft LLP, where he represented issuers and underwriters in various structured finance offerings, including residential mortgage-backed securitizations and credit card securitizations.

Prior to Cadwalader, Wickersham & Taft LLP, Mr. Deutsch was an associate at McKee, Nelson LLP, where he focused on residential mortgage-backed securitizations.

So this is a panel of experts and we appreciate their presence here.

I would inform the witnesses, as I did the last witness, that it is the policy of the Committee on Oversight and Government Reform to swear in all the witnesses before you testify. I would ask that each of you rise.

[Witnesses sworn.]

Mr. KUCINICH. Let the record reflect that each and every witness has answered in the affirmative.

Now, as with panel I, I am going to ask that each witness give an oral summary of your testimony. I would ask you to keep this summary to about 5 minutes in duration. Your complete statement will be in the written record. We do this in order to have a little bit more time for Q and A and interact.

Professor Barr, let's proceed with you. I want to thank you for your presence here and I want to thank you for your patience, too. The questioning of the first witness, as you might expect, went an extended period of time, but we know that your time is valuable as well. Thank you for your patience.

Please, Professor Barr, you may proceed.

STATEMENTS OF PROFESSOR MICHAEL BARR, FORMER DEPUTY ASSISTANT SECRETARY FOR COMMUNITY DEVELOPMENT, DEPARTMENT OF TREASURY, UNIVERSITY OF MICHIGAN LAW SCHOOL & CENTER FOR AMERICAN PROGRESS; PROFESSOR ANTHONY B. SANDERS, W.P. CAREY SCHOOL OF BUSINESS, ARIZONA STATE UNIVERSITY; ALYS COHEN, STAFF ATTORNEY, NATIONAL CONSUMER LAW CENTER; LARRY LITTON, JR., PRESIDENT AND CEO, LITTON LOAN SERVICING LP; STEPHEN S. KUDENHOLDT, CHAIRMAN, THACHER PROFFITT & WOOD; AND THOMAS DEUTSCH, DEPUTY ASSISTANT DIRECTOR, AMERICAN SECURITIZATION FORUM

STATEMENT OF PROFESSOR MICHAEL BARR

Mr. BARR. Thank you very much, Mr. Chairman, Ranking Member Issa and distinguished members of the committee. It is my honor to be here today to testify about Treasury's progress in preventing foreclosures.

There is bipartisan agreement today that stemming the tide of foreclosures and restructuring troubled mortgages would slow the downward spiral harming financial institutions and the real American economy. The Federal Government has a range of authority to take action, but what has been missing is a way to get servicers who control most of these loans on behalf of mortgage-backed securities investors to restructure the loans themselves or sell the loans to the Treasury at a discount so they can be modified.

To date, Treasury's efforts have largely failed. Owing a duty to countless investors with conflicting interests, servicers have largely been paralyzed by a fear of liability, of restrictive tax and accounting rules, and the wrong financial incentives. Instead of restructuring loans, most servicers are foreclosing at alarming rates, as you have seen yourselves in your own communities.

As I will explain further in a moment, what we need now is new legislation to unlock the securitization trusts so that servicers can modify loans or sell them to Treasury at a steep discount. Treasury can then restructure those loans, including a shared equity feature to protect taxpayers, issue new guarantees on the restructured loans along the lines that the ranking member has suggested, and selling them back into the market. This would help homeowners and restore liquidity and stability to our markets.

In the meanwhile, the administration can act now. They should use a full court press to help troubled homeowners. They should stabilize their financial markets and jump-start our economy. In particular, Treasury can guarantee home mortgages held in trust and in portfolios in exchange for real restructuring. They can pay servicers to restructure loans as well. Treasury can contract with the FDIC to implement a restructuring program, enlist Fannie and Freddie and bolster FHA. Let me talk about this in a little bit more detail.

After nearly a year of hoping that the private sector would stem foreclosures, and in a hurried series of weeks, lurching from bailout to bankruptcy and back to bailout again, Treasury finally declared that the time had come for congressional authorization of a program, the Troubled Asset Relief Program, with the dominant rationale that Treasury would buy tranches of securities and collateral debt obligations in order to jump-start credit markets. But the administration's proposal left intact the conflicts of interest and legal barriers blocking real home mortgage structuring.

Moreover, the administration's rationale for the program shifted significantly between proposal and enactment, and after enactment the administration put on the back burner its plans to buy mortgage-backed securities, instead focusing on capital injections, hoping that banks would increase their lending. Instead, capital has been deployed largely to shore up the capital base against further decline in asset values as well as, the committee noted, to engage in merger and acquisition activity, and new capital has gone to AIG as well.

Just this week Treasury announced formally what we already knew, it had abandoned the idea of buying troubled assets under the Troubled Asset Relief Program. Despite the limitations of the approach taken by the administration thus far, the Emergency Economic Stabilization Act's potential is significant. Under section 109 of the act, the Treasury Secretary is authorized to use loan guarantees. Under section 101 of the act, the Secretary is authorized to make and fund commitments to purchase troubled assets, including home mortgage loans. These authorities can be deployed now to help homeowners. Here is how.

First, guarantee home mortgages in exchange for real restructuring. Treasury can offer to guarantee troubled loans held by servicers if they modify troubled loans to bring debt-to-income ratios in line with prudent underwriting and sustained affordability.

Second, pay servicers. Right now, trusts pay servicers for the extra work of foreclosing on homes but largely not for modifications. Treasury could pay servicers to make loan modifications that meet Treasury guidelines.

Third, let the FDIC act now. The FDIC has led the way in seeking to end this crisis, as you know, and has put forward a plan for guaranteeing troubled loans. Treasury could just say yes.

Bolster the FHA, in need of real resources. Enlist Fannie Mae and Freddie Mac beyond the announcement Tuesday that largely reflected existing practice.

Private label securitization, not the GSEs, however, hold most of the troubled subprime and Alt-A mortgages. We need to find a way to unlock those pools. Here is how. There is a three-part plan.

First, preserve REMIC tax benefits. Servicers managing pools of loans are generally barred from selling the underlying mortgage loans, but the trust agreements provide that servicers must amend the new agreements if doing so would be helpful or necessary to maintain Real Estate Mortgage Investment Conduit status. These rules provide important benefits for the trusts. Through a legislative fix, we can effectively require the trusts to change their practices.

Second, indemnification of servicers.

Excuse me, Mr. Chairman. I notice my time is up. May I finish?

Mr. KUCINICH. Sure.

Mr. BARR. Thank you.

Second, we should indemnify servicers. Legislation could provide a narrowly tailored indemnification of servicers who reasonably pursue loan modifications or sales under Treasury programs.

And, third, we need to provide legal certainty under accounting standards. Because selling home mortgage loans to Treasury would advance important public interests and not conflict with the underlying purposes of Statement 140, the Financial Accounting Standards Board should modify the statement to provide servicers with legal comfort in broadly modifying and selling mortgage loans under Treasury's programs.

Until we provide real home mortgage relief, our economy is going to continue its vicious downward spiral of foreclosures, home price implosions, credit illiquidity and decline. We need to end the crisis now.

[The prepared statement of Mr. Barr follows:]

Oral Testimony
Michael S. Barr
Professor of Law, University of Michigan Law School
Senior Fellow, Center for American Progress Action Fund
Before the Committee on Oversight & Government Reform
Subcommittee on Domestic Policy
U.S. House of Representatives
November 14, 2008

Chairman Kucinich, Ranking Member Issa, and distinguished members of the Committee, it is my honor to be here today to testify about Treasury's progress in preventing foreclosures under the Emergency Economic Stabilization Act of 2008.

There is bipartisan agreement today that stemming foreclosures and restructuring troubled mortgages would slow the downward spiral harming financial institutions and the real American economy. The federal government has a range of authorities to take action. But what has been missing is a way to get servicers, who control most of these loans on behalf of mortgage-backed securities investors, to restructure the loans themselves or sell the loans to the Treasury at a discount, so the loans can be refinanced.

To date, Treasury's efforts have largely failed. Owing a duty to countless investors with conflicting interests, servicers are paralyzed by fear of liability, restrictive tax and accounting rules, and the wrong financial incentives. What's more, contracts typically bar servicers from selling underlying mortgage loans out of loan pools. Instead, servicers are foreclosing at alarming rates, dragging down our economy with them.

As I will explain further in a moment, we need new legislation to unlock the securitization trusts so that servicers can modify loans or sell them to Treasury at a steep discount. Treasury can then restructure them, include a shared equity feature to protect taxpayers, issue new guarantees on the restructured loans, and sell them back into the market, helping homeowners and restoring liquidity and stability to our markets.

In the meanwhile, the Administration should use a "full-court press" to help troubled homeowners, stabilize financial markets, and jump-start our economy. In particular, Treasury can guarantee home mortgages held in trusts and in portfolios in exchange for real restructuring, and pay servicers to restructure loans. Treasury can contract with the Federal Deposit Insurance Corporation to implement a restructuring program, enlist Fannie Mae and Freddie Mac, and bolster the Federal Housing Administration.

The Emergency Economic Stabilization Act

After nearly a year of hoping that the private sector would stem foreclosures, and then a hurried series of weeks lurching from bailout to bankruptcy and back to bailout again, Treasury finally declared that the time had come for congressional authorization of a $700 billion "troubled asset relief program," with the dominant rationale that Treasury would buy tranches of "toxic" mortgage-backed securities and collateralized debt obligations on the books of financial institutions in order to jump-start credit markets.

But the administration's proposal left intact the conflicts of interest and legal barriers in the secondary markets blocking real home mortgage restructuring.

Moreover, the administration's rationales for the program shifted significantly between proposal and enactment. After enactment, the administration put on the back burner its plans to buy mortgage-backed securities, and instead focused on using the emergency funds to inject $250 billion in capital into the banking system. The administration hoped that the capital injections would induce banks to increase their lending. Instead, capital has been deployed to shore up the capital base against further declines in asset values, and to engage in merger-and-acquisition activity. New capital has gone to AIG as well.

Just this week, Treasury announced formally what we already knew: it had abandoned the idea of buying troubled assets under the troubled asset relief program.

Despite the limitations of the approaches taken by the administration thus far, the Emergency Economic Stabilization Act's potential is significant. Under Section 109 of the act, the Treasury Secretary is authorized to "use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." Under Section 101 of the act, the Secretary is authorized to "make and fund commitments to purchase" troubled assets, including home mortgage loans. These authorities can be deployed now to help homeowners and stabilize our markets.

Next steps to resolve the home mortgage crisis

The administration should not wait any longer to help homeowners. There are key steps the administration should take now under existing authorities. In particular:

Guarantee home mortgages in exchange for real restructuring. Treasury can offer to guarantee troubled loans held by servicers in portfolio or trusts, if they modify troubled loans to bring debt-to-income ratios in line with prudent underwriting and sustained affordability. The guarantee on restructured loans would provide a new tool for servicers to act in the investors' best interests in modifying loans. The FDIC has proposed a plan to use the guarantee authority, and the administration should implement it.

Pay servicers to restructure loans. Servicers get paid by the trusts for the extra work of foreclosing on homes, but not for loan modifications. Treasury could pay servicers using existing authorities to make loan modifications that meet Treasury guidelines.

Let the FDIC act now. The FDIC has led the way in seeking to end this crisis, has put forward a plan for guaranteeing troubled loans, and has the demonstrated expertise in loan restructuring when acting as receiver of failed banks. Treasury could contract with FDIC to run loan guarantee and restructuring efforts now.

Bolster FHA. FHA currently lacks the staffing, management, technological platforms, and budget to cope with the range of difficult tasks that it will necessarily need to undertake in the months and years ahead. Investing now in FHA infrastructure is critical.

Enlist Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac should be engaged systematically to refinance troubled mortgages according to standard criteria and should transparently report on their efforts on loans held in portfolio or in securitization trusts.

Tuesday's announcement by the Federal Housing Finance Agency and the GSEs of a streamlined modification program largely reflects activities that the GSEs have been engaged in for some time. In addition, there are key questions not yet answered, including whether sustainable interest rate reductions over the life of the loan will be utilized, whether the affordability matrix is sufficient, and whether enough borrowers will qualify. FHFA should insist on real-time transparency regarding modifications.

Private label securitizations, not the GSEs, hold most of the troubled subprime and Alt-A mortgages, so the administration needs to find effective means to get these private label securitization trusts to engage in broad-scale restructuring of troubled loans.

New legislation to unlock securitization trusts

Since January of last year, the Center for American Progress has been arguing for a modern-day Home Owners Loan Corporation, which helped American homeowners out of the Great Depression. That can work today, but to do so, we need to provide servicers with the legal authorities and incentives to sell mortgage loans to Treasury out of the securitized pools and loan portfolios, so the loans can be restructured.

Although Congress added provisions to the bailout bill to require Treasury to use its new authorities to exhort servicers toward more loan restructurings, we need to free servicers from the conflicting requirements and give them an incentive to sell mortgages to Treasury for refinancing and foreclosure avoidance. Here's how it would work:

Preserve tax benefits. Servicers managing pools of loans are generally barred by contract from selling the underlying mortgage loans, but the trust agreements also provide that servicers must amend the agreements if doing so would be helpful or necessary to stay in compliance with tax rules under the Real Estate Mortgage Investment Conduit, or REMIC, statute, which provide important benefits for the trusts and their investors. We propose to modify the REMIC rules to ensure that servicers have the authority and incentive to sell the mortgages to Treasury.

Legislation would provide that REMIC benefits would be denied going forward if the securitization's contract provisions have the effect of barring servicers from selling or restructuring loans under Treasury's programs. Servicers would have a legal obligation to their investors to modify the agreements to stay in compliance. Servicers could then sell loans to Treasury at a steep discount. Participation in the Treasury program would remain voluntary, but the key legal impediments to participation would be removed.

Indemnify servicers. Legislation could provide a narrowly tailored indemnification for servicers who reasonably pursue loan modifications or sales under Treasury programs.

Provide legal certainty under accounting standards. Because selling home mortgage loans to Treasury would advance important public interests and not conflict with the underlying purposes of Statement 140, the Financial Accounting Standards Board should modify the statement to provide servicers with legal comfort in broadly modifying and selling mortgage loans under Treasury's mortgage restructuring programs.

Authorize judicial modifications in bankruptcy. Legislation should provide bankruptcy judges with the authority to modify home mortgages under circumstances in which the homeowner's income is insufficient to cover mortgage payments. Mortgage loans could be reduced to the current value of the property.

Pause foreclosures. While the administration is putting these systems in place, they could seek a pause in foreclosures in order to provide time for the programs to work.

Conclusion

Until we provide real home mortgage relief, our economy is going to continue its vicious downward spiral of foreclosures, home price implosions, credit illiquidity and decline.

We need to end the crisis, and then undertake fundamental regulatory reform to restore integrity to our financial markets. If we do so, we can expect our financial system once again to be vibrant and strong.

Testimony

OF

Professor Michael S. Barr
University of Michigan Law School
Senior Fellow, Center for American Progress Action Fund

Domestic Policy Subcommittee
Oversight & Government Reform Committee
Friday, November 14, 2008
2154 Rayburn HOB
10:00 a.m.

Chairman Kucinich, Ranking Member Issa, and distinguished Members of the Subcommittee, it is my honor to be here today to testify about the ongoing crisis in our housing and financial markets and Treasury's progress in preventing foreclosures under the Emergency Economic Stabilization Act of 2008.

There is bipartisan agreement today that stemming foreclosures and restructuring troubled mortgages would slow the downward spiral harming financial institutions and the real American economy. The federal government has a range of authorities to take action. But what has been missing is a way to get servicers, who control most of these loans on behalf of mortgage-backed securities investors, to restructure the loans themselves or sell the loans to the Treasury at a discount, so the loans can be refinanced.

To date, Treasury's efforts have largely failed. Owing a duty to countless investors with conflicting interests, servicers are paralyzed by fear of liability, restrictive tax and accounting rules, and the wrong financial incentives. What's more, contracts typically bar servicers from selling underlying mortgage loans out of loan pools. Instead, servicers are foreclosing at alarming rates, dragging down our economy with them. Subprime loan modifications have been too small scale to date to achieve the goal of keeping large numbers of homeowners in their homes.

As explained further below, we need new legislation to unlock the securitization trusts so that servicers have the authorities they need to sell loans to Treasury at a steep discount. Treasury can then restructure them, include a shared equity feature to protect taxpayers, issue new guarantees on the restructured loans, and sell them back into the market, helping homeowners and restoring liquidity and stability to our markets.

In the meanwhile, Treasury can get the ball rolling with existing authorities. In particular, Treasury can guarantee home mortgages held in trusts and in portfolios in exchange for real restructuring, and pay servicers to restructure loans. Treasury can contract with the Federal Deposit Insurance Corporation to implement a restructuring program, enlist Fannie Mae and Freddie Mac, and bolster the Federal Housing Administration, so that the Bush administration uses a "full-court press" to help troubled homeowners, stabilize financial markets, and jump start our economy.

Overview of the current crisis

The U.S. economy is caught in a vicious downward spiral of declining home prices, escalating foreclosures, rising losses on mortgage-backed securities, and disappearing liquidity. The crisis spread rapidly from the mortgage market to engulf other forms of consumer credit, commercial real estate, and municipal debt, and reached far beyond American soil. Major financial institutions failed. The risk of sustained global economic crisis remains high.

We must act aggressively to contain the crisis, reform our home mortgage system, and develop new approaches to broad-scale housing and financial-sector reform—beginning with a clear understanding of the problem itself.

Lax regulation, supervisory neglect, lack of transparency, and conflicts of interest all undermined the foundations of our financial system. Financial innovations in securitization and other factors brought increased liquidity, but also broadened the wedge between the incentives facing brokers, lenders, borrowers, rating agencies, securitizers, loan servicers, and investors. The lack of transparency and oversight, coupled with rising home prices, hid the problems for some time. When home prices and other assets imploded, credit woes cascaded through the financial system, and the lack of trust in the system meant that even sound financial institutions faced contagion from the crisis. That is why we need fundamental change in our system of financial regulation.

Alarmed by the specter of a prolonged economic slowdown, both the Federal Reserve and Congress acted aggressively to stimulate demand through monetary and fiscal levers. For too long, the U.S. Department of the Treasury simply pressed mortgage holders to restructure mortgages and suspend foreclosures on a voluntary basis. But continuing turmoil in financial markets confirmed that these actions were not enough. Restoring confidence and liquidity in credit markets required, and still requires, bold action to restructure distressed assets and contain the effects of the downward spiral in financial markets.

Rather than a measured market correction warranted solely by the underlying quality of assets, we have seen a freefall in mortgage-related financial assets and in U.S. home prices, with the crisis in credit quality extending like a contagion across the financial sector. The total inventory of homes in foreclosure reached 2.75 percent by June 2008, and delinquencies reached 6.41 percent of all mortgages. More than 2 million foreclosures are anticipated within the next two years. As of September 2008, home prices had already fallen by approximately 20 percent from their peak two years ago, and the median home price has fallen for the first time since the Great Depression. Sharply falling home prices put a growing number of homeowners underwater, with nearly 10 million households already facing home mortgage debt levels that exceed the value of their homes. Negative equity is a strong predictor of default and foreclosures.

As the crisis spread, it helped to slow the U.S. and global economies and bring down major U.S. financial institutions. The investment banking firm, Bear Stearns Cos., with significant exposure to the subprime mortgage sector, failed, and was acquired by JP Morgan Chase & Co. with the support of Treasury and the financial backing of the Federal Reserve. IndyMac Bank, a federally insured depository and major subprime lender, faced an old-fashioned bank run and was taken over by the Federal Deposit Insurance Corporation. The vaunted home mortgage giants Fannie Mae and Freddie Mac, with $5 trillion in debt and mortgage-backed securities outstanding, succumbed to the crisis and were put into conservatorship by Treasury, with promises from the department to provide up to $100 billion in capital to each institution. Soon after, Wall Street investment bank Lehman Brothers Holdings Inc. went bankrupt, and rival Merrill Lynch & Co. sold itself to Bank of America to avoid the same fate. The global insurance firm American International Group, Inc. succumbed the next day, and the Federal Reserve agreed to loan the company up to $85 billion on an emergency basis as it sought to sell off its assets—with new loans and equity investments continuing even this week to attempt to separate out AIG's bad assets from the rest of the firm.

After a run on historically "safe" money market mutual funds, which operate outside the FDIC-insured banking system, Treasury announced that it would extend the safety net by offering insurance to this entire industry for funds in place as of September 19. And the Fed and Treasury announced an array of programs designed to bolster the commercial paper market. By the end of that week, the last two remaining independent investment banks, Morgan Stanley and Goldman Sachs Group, Inc., converted to Bank Holding Companies subject to the prudential supervision of the Federal Reserve. Washington Mutual Bank went into FDIC receivership and was sold to JP Morgan, and after a rescue offer by Citi and the FDIC, Wachovia Bank merged with Wells Fargo.

In the meanwhile, Treasury, the Federal Reserve, and the FDIC's board signed off on invoking the FDIC's "systemic risk" exception under which the FDIC has now guaranteed interbank lending, senior unsecured bank debt, and uninsured depositors holding funds in non-interest bearing accounts.

The scope of federal intervention thus far has been unprecedented. Yet millions of American homeowners remain struggling to meet their home mortgage obligations.

Legislative Steps to Resolve the Crisis

Legislation enacted in July 2008 aimed at restructuring troubled mortgages to prevent avoidable foreclosures and the resulting harm to neighboring homes and communities. Under the Housing and Economic Recovery Act of 2008, an estimated 400,000 at-risk mortgages could be restructured on affordable terms with credit enhancement from the Federal Housing Administration under the "Hope for Homeowners" program. Only loans on owner-occupied homes would be eligible for restructuring, and speculators would be excluded. Refinanced loans would take the form of new fixed-rate 30-year mortgages. Borrowers would pay insurance premiums to the FHA and would share equity appreciation in their home values. Lenders, participating on a voluntary basis, would negotiate to extinguish any second liens on the homes, agree to write down sufficient principal to meet loan-to-value and affordability guidelines, and pay a one-time insurance premium to the FHA.

This "Hope for Homeowners" program began insuring loans in the fall of 2008, but as of mid-October had only processed 42 loans. It remains to be seen whether a sufficient number of loans will be restructured to mitigate the crisis in foreclosures, and at the same time whether the federal government will be left with an adversely selected portfolio of the riskiest loans, with unknown exposure to the FHA and, potentially, taxpayers.

The legislation also included $3.9 billion for a Neighborhood Stabilization program based on a concept first published by Center for American Progress Action Fund Senior Fellow David Abromowitz. These funds are available to help hard-hit states and localities purchase abandoned and foreclosed properties and put them to reuse as affordable housing. The legislation also includes funds for homeowner counseling and new flexibility for the Federal Housing Administration's core programs. Implementation of these programs will undoubtedly take further time and attention.

Significantly, the legislation put in place a new regulator—the Federal Housing Finance Agency—for the government-sponsored enterprises (Fannie Mae, Freddie Mac, and the Federal Home Loan Bank system), along with special authority for the government to backstop these agencies in the event of their inability to raise adequate capital to maintain mortgage market liquidity. But the new Government Sponsored Enterprises' authorities did little to stem the GSE's problems, and in September 2008, Treasury and the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship. The FHFA is now responsible for running the these entities. Treasury committed to cash infusions of up to $100 billion for each entity in the event that their liabilities exceed their assets, and Treasury is to receive stock senior in priority to all other equity, stock warrants representing 80 percent of the two companies' common stock, regular dividends, and commitment fees in exchange for Treasury's financial backing. Treasury also agreed on a temporary basis to purchase GSE mortgage-backed securities on the open market in the interest of market stability.

Finally, Treasury declared that the time had come for congressional authorization of a $700 billion program to have Treasury buy tranches of "toxic" mortgage-backed securities and collateralized debt obligations on the books of financial institutions. The administration's proposal failed to include provisions required to help homeowners restructure their troubled mortgages, and left intact the conflicts of interest and legal barriers in the secondary markets blocking restructuring.

Moreover, the administration's rationales for the program shifted significantly during the course of congressional deliberation and after enactment. The administration put on the back burner its plans to buy mortgage-backed securities, and instead has focused on using the emergency funds to inject $250 billion in capital into the banking system. The administration hoped that the capital injections would induce banks to increase their lending. However, with the economy still reeling, many potential borrowers in financial straits, troubled assets still on the books of financial institutions, and capital needs still significant given those uncertainties, the capital infusion does not yet appear to have fostered further lending expansion. Rather, capital has been deployed either to shore up the capital base in the event of further declines in asset values or to engage in merger-and-acquisition activity.

Despite the limitations of the approaches taken by the administration under the Emergency Economic Stabilization Act thus far, the act's potential is significant. Under Section 109 of the act, the Treasury secretary is authorized to "use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." Under Section 101 of the act, the secretary is authorized to "make and fund commitments to purchase" troubled assets, including home mortgage loans. These authorities can be deployed now to help homeowners and stabilize our markets. In addition, the administration has at its disposal the restructuring efforts of the FDIC, the capacity of Fannie Mae and Freddie Mac over which the Federal Housing Finance Agency is serving as conservator, and the Federal Housing Administration. These tools need to be deployed as soon as possible to assist in restructuring troubled loans.

Next Steps to Resolve the Home Mortgage Crisis

The administration should not wait any longer to help homeowners. There are key steps the administration should take now under existing authorities. In particular:

Guarantee home mortgages in exchange for real restructuring. Treasury can offer to guarantee troubled loans held by servicers in portfolio or trusts, if they modify troubled loans to bring debt-to-income ratios in line with prudent underwriting and sustained affordability. The guarantee on restructured loans would provide a new tool for servicers to act in the investors' best interests in modifying loans. The FDIC has proposed a plan to use the guarantee authority, and the administration should implement it.

Pay servicers to restructure loans. Servicers get paid by the trusts for the extra work of foreclosing on homes, but generally get little or nothing for successful loan modifications. Treasury could pay servicers using existing authorities to make loan modifications that meet Treasury guidelines.

Let the FDIC act now. The FDIC has led the way in seeking to end this crisis, has put forward a plan for guaranteeing troubled loans, and has the demonstrated expertise in loan restructuring when acting as receiver of failed banks. Treasury could contract with FDIC to run loan guarantee and restructuring efforts now.

Enlist Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac should be engaged systematically to refinance troubled mortgages according to standard criteria and should transparently report on their efforts on loans held in portfolio or in securitization trusts.

The announcement this Tuesday of a new streamlined modification program by the Federal Housing Finance Agency and the GSEs is an encouraging sign, but largely reflects activities that the GSEs have been engaged in for some time. Under the program, the GSEs would direct servicers to modify troubled home mortgage loans that the GSEs own or guarantee. A streamlined modification process would result in reductions of debt-to-income ratios down to 38 percent. While there are difficult technical issues yet to be specified in the program description, including whether sustainable interest rate reductions over the life of the loan will be utilized, whether the affordability matrix is sufficient, whether enough borrowers will qualify for the program given net-present-value calculations, and other essential matters, the GSE announcement is an encouraging sign for restructuring loans going forward. Now, FHFA and Congress should insist on real-time transparency regarding the GSE's modification results.

Moreover, FHFA should develop a program under which the GSEs purchase troubled home mortgage loans from other market participants, at a discount, in order to restructure them and resecuritize the loans with the GSE guarantee.

Lastly, private label securitizations, not the GSEs or bank portfolios, hold most of the troubled subprime and Alt-A mortgages, so the administration needs to redouble its efforts to find effective means to get these private label securitization trusts to engage in broad-scale restructuring of troubled loans.

Bolster FHA. The administration should dramatically increase the staffing, administrative, and technical support necessary to ensure FHA can play a strong role alongside the GSEs, Treasury, and the FDIC in restructuring troubled loans. FHA currently lacks the staffing, management structure, technological platforms, and budget to cope with the range of difficult tasks that it will necessarily need to undertake in the months and years ahead. Investing now in FHA infrastructure is critical.

New Legislation to Unlock Securitization Trusts and Other Key Legislative and Regulatory Steps to Encourage Broad-Scale Restructuring of Mortgages

Since January of last year, the Center for American Progress has been arguing for a modern-day Home Owners Loan Corporation, which helped American homeowners out of the Great Depression. That can work today, but to do so, we need to provide servicers with the legal authorities and incentives to sell mortgage loans to Treasury out of the securitized pools and loan portfolios, so the loans can be restructured.

Although Congress added provisions to the bailout bill to require Treasury to use its new authorities to exhort servicers toward more loan restructurings, we need to free servicers from the conflicting requirements and give them an incentive to sell mortgages to Treasury for refinancing and foreclosure avoidance. Here's how it would work:

Preserve tax benefits. Servicers managing pools of loans for investors are generally barred by contract from selling the underlying mortgage loans, but the trust agreements also provide that servicers must amend the agreements if doing so would be helpful or necessary to stay in compliance with tax rules under the Real Estate Mortgage Investment Conduit, or REMIC, statute, which provide important benefits for these securitization trusts and their investors. We propose to modify the REMIC rules to ensure that servicers have the authority and incentive to sell the mortgages to Treasury.

Legislation would provide that REMIC benefits would be denied going forward if the securitization's contract provisions have the effect of barring servicers from selling or restructuring loans under Treasury's programs. Servicers would have a legal obligation to their investors to modify the agreements to stay in compliance. Servicers could then sell loans to Treasury for restructuring. Participation in the Treasury program would remain voluntary, but the key legal impediments to participation would be removed.

Indemnify servicers. Legislation could provide a narrowly tailored indemnification for servicers who reasonably pursue loan modifications or sales under Treasury programs.

Provide legal certainty under accounting standards. Because selling home mortgage loans to Treasury would advance important public interests and not conflict with the underlying purposes of Statement 140, the Financial Accounting Standards Board should modify the statement to provide servicers with legal comfort in broadly modifying and selling mortgage loans under Treasury's mortgage restructuring programs.

Authorize judicial modifications in bankruptcy. Legislation should provide bankruptcy judges with the authority to modify home mortgages under circumstances in which the homeowner's income is insufficient to cover mortgage payments. Mortgage loans could be reduced to the current value of the property.

Pause foreclosures. While the administration is putting these systems in place, they could seek a pause in foreclosures in order to provide time for the programs to work.

Broad-Scale Housing and Financial Market Reforms in the New Congress and New Administration

The housing crisis we face today stems from serious systemic problems in the subprime and alternative lending markets that show our system of home mortgage regulation is seriously deficient and must be reformed. We need to fill what the late Federal Reserve Board Governor Ned Gramlich aptly termed "the giant hole in the supervisory safety net."[i] Banks and thrifts are subject to comprehensive federal regulation and supervision, but their affiliates far less so, and independent mortgage companies not at all. Moreover, many market-based systems designed to ensure sound practices in this sector—broker reputational risk, lender oversight of brokers, investor oversight of lenders, rating agency oversight of securitizations, and so on—simply did not work. Conflicts of interest, inadequate capital adequacy rules, lax regulation, and the "boom times" covered up the abuses—at least for a while. But no more.

The new administration, Congress, and the bank regulators could do much to restore integrity to mortgage markets and reduce the likelihood of such a crisis in the future. Federal regulation is necessary to combat abusive practices and restore integrity to our credit markets. We need to ensure that all participants in the mortgage process have the right incentives to engage in sound lending practices and are subject to regulatory oversight.

The House of Representatives in 2008 passed important legislation to clean up the mortgage process and regulate mortgage brokerage to drive out abuses, but the Senate has not followed suit.[ii] While there are certainly improvements that could be made in the legislation, it forms a sound basis for the new administration and Congress to enact mortgage reform early in the next congressional session. Legislation should include provisions for judicially supervised modifications of home mortgages in certain narrow circumstances. In addition, the Federal Reserve's rulemakings to bar unfair and deceptive mortgage practices and to improve disclosures should be implemented immediately while the Fed works to strengthen them further. And to increase transparency, all borrowers need to be able to get firm price quotes on loans and settlement services in order to comparison shop.

Congress also should develop a new standard for truth in lending so that mortgage brokers and lenders do not have incentives to get around disclosure rules. Under this approach, an agency could determine whether a creditor's disclosure was objectively unreasonable, in that the disclosure would fail to communicate effectively the key terms and risks of the mortgage to the typical borrower. A new disclosure approach should require brokers and lenders to disclose all information favorable to the borrower so that borrowers are no longer easily steered into loans that cost more than the loans for which they would qualify. The new law also needs to increase public disclosure of broker and lender conduct and regulatory monitoring of credit standards.

To repair the broken trust and realign good incentives in our system, brokers should not be permitted to earn so-called yield spread premiums for steering borrowers into higher-cost loans. Instead, we need a system under which brokers are accountable to borrowers. Over the long run, we could shift to a system under which borrowers paid for mortgage-broker services and brokers owed a fiduciary duty to borrowers, in a similar way that financial advisers owe such duties to their investment advisory clients. In the meanwhile, enhanced disclosures and barring yield spread premiums could help to reduce abuses.

Moreover, we need to ensure that our capital market regulations—across all financial sectors—provide for transparency, appropriate capital adequacy standards, and rules regarding conflicts of interest. Congress and the new administration need to reform our secondary market regulations as well as our tax and accounting rules so that securitizations enhance liquidity and transparency even in crises, rather than serving as obstacles to crisis resolution.

There is a long history of sound lending to low- and moderate-income borrowers. Banks and thrifts expanded their prime mortgage lending, consistent with safe and sound banking practices, under the Community Reinvestment Act, or CRA. The results were impressive.[iii] We should not blame the poor and learn the wrong lesson from the current crisis. Rather, we need to ensure that our mortgage finance system works for all creditworthy households.

In addition to reforming the mortgage market by taking on bad practices, we should take this opportunity fundamentally to rethink our approaches to regulation based on insights from behavioral economics. Harvard economist Sendhil Mullainathan, Princeton psychologist Eldar Shafir, and this author have argued for a new, opt-out mortgage plan.[iv] While the causes of the mortgage crisis are myriad, a central problem is that brokers and lenders offered loans that looked much less expensive than they really were because of low initial monthly payments and hidden costly features. As Ned Gramlich asked, "Why are the most risky loan products sold to the least sophisticated borrowers?"[v] Many borrowers took out loans that they did not understand and could not afford, with predictable results.

In retirement policy, behavioral research led Congress to promote "opt-out" plans under which employers sign workers up for retirement benefits unless the worker chooses not to participate. This policy has significantly improved people's retirement savings. Under an opt-out home mortgage plan, borrowers would be offered a standard set of mortgages, with sound underwriting and straightforward terms. And that is the mortgage they would get, unless they opted out after clear disclosures. Lenders and brokers would face increased scrutiny and the potential for liability if they provided alternative loans without reasonable disclosure. An opt-out system would mean borrowers would be more likely to get appropriate loans, without blocking beneficial financial innovation.

Congress and the new administration should begin right away the process of developing a home mortgage finance system for the 21st century, including evaluating the role of the GSEs and other participants in the system. Any such review would need to take account of the historically important role the GSEs and government agencies played in developing and sustaining a home mortgage system that, prior to the current crisis, had been the envy of the world. In particular, we need to ensure that our system continues to sustain the market for 30-year, fixed rate, self-amortizing mortgages; provides liquidity throughout all regions of the country, including during economic crises; and promotes standardization of mortgage products in the interests of home mortgage borrowers.

These proposals should also include appropriate incentives for screening, monitoring, and enforcement for consumers, investors, and other stakeholders in the system. And they should improve the alignment of the mortgage finance system with the public interest, and reduce systemic financial risk and the potential risk to taxpayers if the system fails. Developing principles based on what we need our financial system to do will help guide the process of figuring out how to get from our current crisis posture to that point.

More broadly, Congress and the new administration will also face important decisions regarding broad-scale financial reforms. The current U.S. home and global credit crises reveal significant weaknesses and glaring inconsistencies in our system of financial supervision. The government's response to the crisis raised new questions regarding moral hazard created by repeated government bailouts of a wide array of financial institutions, from deposit-taking commercial banks subject to comprehensive supervision and examination, to government-sponsored enterprises with historically weak oversight, to investment banks not generally subject to prudential supervision.

The federal government now has served as a lender of last resort to a broad array of institutions that, prior to the interventions, had no explicit authority to borrow and no comprehensive prudential supervision or serious capital requirements to contain the consequences of failure, or to protect the financial system and taxpayers. Ad hoc intervention, even if necessary, is no substitute for a system of financial regulation. Now there is no way to put the genie back in the bottle. Congress and the new administration should enact regulatory rationalization, prudential supervision, transparency, and capital requirements across the financial sector.

Conclusion

The new administration and Congress should undertake a series of initiatives to restore integrity and stability to our financial markets. Innovation is a hallmark of America's financial system, and with needed changes in governmental policies and regulatory supervision, we can expect our financial system once again to be vibrant and strong.

Endnotes

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[i] Edward M. Gramlich, "Booms and Busts: The Case of Subprime Mortgages," Paper presented at the Federal Reserve Bank of Kansas City symposium, "Housing, Housing Finance, and Monetary Policy," in Jackson Hole, WY, August 31, 2007, available online at http://www.kc.frb.org/PUBLICAT/ECONREV/PDF/4q07Gramlich.pdf.

[ii] *The Mortgage Reform and Anti-Predatory Lending Act of 2007*, HR 3915, 110th Cong., 1st sess.

[iii] Michael S. Barr, "Credit Where it Counts," New York University Law Review 80 (2) (2005): 513-652.

[iv] Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir, "Behaviorally Informed Home Mortgage Regulation," Working Paper (Joint Center on Housing Studies, November 2007).

[v] Gramlich, "Booms and Busts."

Mr. KUCINICH. I thank the gentleman.

Professor Sanders, you may proceed. Thank you.

STATEMENT OF PROFESSOR ANTHONY B. SANDERS

Mr. SANDERS. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, thank you for the invitation to testify before you today.

Housing prices in many areas of the United States have slowed or declined dramatically over the past 2 years. This decline is partly responsible for the large increase in subprime mortgage delinquencies over the same period. According to Hope Now Alliance Survey data, 14.4 percent of subprime mortgages are 60 days or more delinquent over the third quarter of 2008, and while 2.3 percent of prime mortgages are 60 days or over delinquent in the same period, that rate is almost double from the third quarter of 2007 at 1.26 percent. From the third quarter of 2007 to the third quarter of 2008, there were many, many, many foreclosure sales, of which over half were subprime borrowers.

But as Adam Smith's invisible hand, we used to term it as, that has been replaced by the invisible foot, where homeowners are being booted out of their houses at record rates.

We are in the midst of a subprime meltdown and the second wave of Alt-A, the low documentation mortgage ARMs and related mortgages, and those are beginning to reset. Therefore, it is of critical importance to find ways to slow down the delinquency in foreclosure waves if economically viable.

This urgency is reflected in the announcement by the Federal Housing Finance Agency on Wednesday that Fannie and Freddie announced accelerating their loan modification activities. While Secretary Paulson has announced that TARP will not be used to purchase troubled loans from banks, it is still of tantamount importance to stabilize the housing and mortgage markets, and loan modifications are one of the best tools available to Treasury, even if they decide in the short run not to deploy them.

Hopefully, the acceleration of loan modifications by Fannie and Freddie will help stabilize the market, but it is dangerous strategy to rely on the banking system when called to unjam pipes, particularly with an overwhelmed servicing industry.

Once again, it is important to note that Fannie and Freddie, while Congressman Cummings pointed out maybe 70 percent of the loans are being touched by Fannie and Freddie, that is the low hanging fruit. We are not talking about the whole loans, subprime and Alt-A that are really the source of the problem in the housing market in the United States.

There are several loan modifications that are currently being deployed by loan servicers. These include loan rate reductions, loan rate freezes, amortization period extensions, principal reductions. While the first two are the most common, principal reductions have been much less so. In fact, only Ocwen currently has been a major force, with approximately 70 percent of the total principal modifications done to date. According to Credit Suisse, the average balance decline for first lien principal modifications is approximately 20 percent, and 55 percent for second lien principal modifications.

As housing prices begin to fall and the number of borrowers experiencing negative equity continues rising, the demand for such modifications is growing. Principal modifications serve to reduce the monthly payments and reduce negative equity. Thus, principal modifications should increase the willingness of borrowers to stay in the home.

Loan modifications may help keep borrowers in their home and increase the probability that they will be able to cure their delinquency. Foreclosure involves multiple transaction costs, including legal filings and selling expenses that can reach almost 50 percent loss severity on each loan. So during the current housing and mortgage crisis, the capacity of loan servicers to process additional foreclosures has been limited, resulting in an increase in the effective cost to cure delinquencies and a reduction in the number of households that have been able to obtain a modification.

In summary, preventative principal reductions can actually serve to stave off defaults and help stabilize the housing and mortgage market. Waiting until the borrower goes 60 to 90 days delinquent is dangerous, since the longer a servicer waits to modify a loan, the more likely the loan is to go into default, generating enormous costs for the lenders and servicers. Thus, loan modifications are not a bailout of borrowers per se; rather it is an attempt to reduce costs to lenders and investors while at the same time preserving homeownership and reducing systemic risk in the economy.

Thank you for your willingness to let me share my thoughts with you.

[The prepared statement of Mr. Sanders follows:]

Testimony

Of

Professor Anthony B. Sanders

Domestic Policy Subcommittee
Oversight and Government Reform Committee
Friday, November 14, 2008
2154 Rayburn HOB
10:00 a.m.

"Is Treasury Using Bailout Funds to Increase Prevention as Congress Intended?"

Chairman Kucinich, Ranking Member Issa and Members of the Subcommittee:

Thank you for the invitation to testify before you today.

Housing prices in many areas of the United States have slowed or declined dramatically over the last two years. This decline is partly responsible for the large increase in subprime mortgage delinquencies over the same period. According to the Hope Now Alliance Survey data[1], 14.44% of subprime mortgages are 60 days or more delinquent as of the third quarter of 2008. And while 2.38% of prime mortgages are 60 days or more delinquent over the same period the rate has almost doubled since the third quarter of 2007 (1.26%). From the third quarter of 2007 through the third quarter of 2008, there were 1,000,033 foreclosures sales of which 565,125 were subprime borrowers.

We are in the midst of the subprime meltdown and a second wave of ALT-A (e.g., low documentation mortgages) adjustable rate mortgages (ARMs) are beginning to reset. Therefore, it is of critical importance to find ways to slow down the delinquency and foreclosure waves if economically viable. This urgency is reflected in the announcement by the Federal Housing Finance Agency on Wednesday that Fannie Mae and Freddie Mac announced will be accelerating their loan modification activities.[2] While Secretary Paulson has announced that TARP will not be used to purchase troubled loans from banks, it is still of tantamount importance to stabilize the housing and mortgage markets and loan modifications are one of the best tools available to Treasury even if they decide in the short run not to deploy them. Hopefully, the acceleration of loan modifications by Fannie Mae and Freddie Mac will help stabilize the housing and mortgage market, but it

[1] See HOPE NOW Alliance Survey, Mortgage Loss Mitigation Statistics, 2008.
[2] Fannie Mae and Freddie Mac will be targeting borrowers that are 90 days late and a 38% mortgage to income ratio. They will be modifying interest rates and, in selected circumstances, principal reductions.

is a dangerous strategy to rely on the banking system to unclog the jammed pipes, particularly with an overwhelmed servicing industry.

The "38% Solution" of Hope Now and the FHFA represents a relatively simple approach to loan modification. It is achieved by stretching the mortgage life from, say, 30 years to 40 years. Certainly, certain borrowers may suddenly have a more "affordable" mortgage and the hope is that this modification will slow down the default waves and stabilize the financial and housing market. But it is important to recognize two problems with simple mortgage extensions. First, mortgage extensions simply substitute one risk for another. While "affordability" increases, the loan balance amortizes more slowly creating greater risk to the lender/investor. Second, it ignores the negative equity problem which is growing quite severe. Hence, I urge Congress and the incoming administration to look beyond expedient solutions and consider other loan modification strategies.

Regarding loan modifications, there are two objectives. The first is home preservation where loan modifications are used to keep borrowers in their home. The second is stemming systemic risk where loan modifications are used to minimize the severe costs of default and foreclosure. These objectives can be compatible if we accept that premise that borrowers must be employed (or a high likelihood of employment in the short run) and have their income verified. This is especially important when dealing with the ALT-A mortgage loans where income verification was not required. But it is clear that home preservation and solving systemic risk problems can be accomplished with a sensible loan modification template if Treasury decides to deploy it.

Loan Modifications and Principal Reductions

There are several loan modifications that are currently being employed by loan servicers. These include loan rate reductions, loan rate "freezes," amortization period extensions and principal reductions. While the first two are the most common, principal reductions have been much less so. In fact, only Ocwen currently has been a major force with approximately 70% of the total principal modifications.[3] According to Credit Suisse, the average balance decline for first-lien principal modifications is approximately 20% and 55% for second-lien principal modifications. As house prices continue to fall and the number of borrowers experiencing negative equity continues rising, the demand for such modifications is growing. Principal modifications serve to reduce the monthly payments and reduce negative equity. Thus, principal modifications should increase the willingness of borrowers to stay in the home.

Principal reductions can be structured in many ways. One is a simple principal reduction with no strings attached. A second is a principal reduction where the homeowner must pay capital gains taxes on the reduction. A third way is to grant a homeowner a principal reduction in exchange for a shared appreciation mortgage (SAM).[4] A fourth way is to

[3] See "Subprime Loan Modifications Update," Credit Suisse, 01 October 2008.
[4]There is some interesting moral hazard problems associated with SAMs. See Frank Page and Anthony B. Sanders, "On the Pricing of Shared-Appreciation Mortgages," *Housing Finance Review*, Vol. 5, 49-57,

reward borrowers that are "upside down" on their mortgage by reducing their principal with each timely mortgage payment; these principal "draw downs" give an incentive for borrowers to make timely mortgage payments. A fifth way is what can call the "market to market" mortgage where loans are market to market rather than book value; this occurs in "short sales" when lender/servicers acknowledge that the mortgage value is actually the current house price. Going forward, mortgage lenders should consider designs where the mortgage can be refinanced at the current mortgage value rather than the amortized book value.

Loan Modifications and Foreclosures

Loan modifications may help keep borrowers in their homes and increase the probability that they will be able to cure their delinquency. Foreclosure involves multiple transaction costs, including legal filings and selling expenses that can reach almost 50% loss severity on subprime loans.[5] During the current housing and mortgage crisis, the capacity of loan servicers to process additional foreclosures has been limited, resulting in an increase their effective cost to cure delinquencies and a reduction in the number of households that have been able to obtain a modification.

Loan modifications are especially appropriate when borrowers are facing a short-term financial crisis, such as a temporary illness. Such borrowers may be willing to pay their mortgage, but need some time-limited relief in order to resume payments. However, even in the case of a permanent reduction in ability to pay, modifications may still be beneficial to both borrower and lender.

But there are cases where the lender can implement a modification even when the financial crisis is not short-term. Suppose the lender is certain that the borrower will be able to meet their obligations immediately, as long as payments are reduced. Also, suppose the borrower will hold the loan for the full remaining term. Substantial reductions in principal would be of greater financial benefit to the lender, as they avoid all of the transaction costs. While this is still a substantial loss to the lender, it is nonetheless much preferable to foreclosure.

Pursuing foreclosure is most beneficial only when cure is unlikely, even with modification. If borrowers are simply unwilling to pay their mortgage on a property, or are unable to pay a reasonable amount, then modifications simply delay the inevitable. There are several disadvantages to such delays in the foreclosure process. Delinquent owners tend to not maintain their properties, so the longer the property remains in the hand of a delinquent owner, the more the underlying collateral tends to lose value. Such properties can also become a source of blight for their neighborhoods.

1986 and Anthony B. Sanders and Carlos Slawson, "Shared Appreciation Mortgages: The UK Experience," *Journal of Housing Economics*, Vol. 14, 178-193, 2005.

Identifying borrowers that have a high likelihood of cure is mandatory for TARP loan modifications to work. A recent study states that 40% of homeowners seeking counseling claimed that the reason they have defaulted on their mortgage was due to a reduction in or loss of income.[6] An excellent example of a statistical model that helps predict a delinquent borrower's likelihood of cure is Freddie Mac's Early Indicator. Servicers use Early Indicator as a tool for quickly identifying and contacting borrowers that are likely to become seriously delinquent and to determine appropriate loss mitigation strategy when necessary.

NPV Tests for Loan Modifications

Loan servicers can employ a series of net present value (NPV) test to ascertain if a loan modification makes economic sense. First, the loan servicer determines if the net present value of the liquidation proceeds from sale of the property if the servicer were to foreclose on the loan. Second, the servicer determines if the NPV of the cash flows expected from a loan modification that under the assumption that it works. Third, the servicer determines if the borrower can afford to make the monthly payments according to the recommended loan modifications. This straightforward approach to loan modifications allows for greater volume if servicers can agree on a unified methodology for its implementation. However, there still must be employment and income verification, or the strong possibility of employment in the short-run.

Current Loans or Troubled Loans Only

Typically, servicers wait until a borrower has gone 60 days or more delinquent before engaging in the loan modification decision. However, there are a considerable number of borrowers that are "upside down" on their mortgage loans (meaning that the house value is less than the outstanding loan balance). While these borrowers may be making timely mortgage payments, some percentage of these borrowers may simply walk away from their loans if housing values continue to fall. This is especially true in states like Arizona and California where there is limited or no deficiency judgments (where a decline in a borrower's credit score is virtually the only penalty to default). At a minimum, borrowers in areas such as Arizona that purchased or refinanced their homes after 2006 should be placed on a "watch list" since they are more likely to move to default than borrowers in stable housing markets. But we are in unchartered territory to the extent that there has never been a period in our history where homeowners could be as much as 50% upside down on the mortgage. This housing crash and corresponding spike in delinquencies and default were not anticipated by the banks, investment banks and MBS and ABS investors.[7]

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[6] National Foreclosure Mitigation Counseling Program, Congressional Update, Activity through September 15, 2008

[7] See Anthony B. Sanders, "The Sub Prime Crisis and its Role in the Financial Crisis," *Journal of Housing Economics*, 2008 (forthcoming) for a discussion of the dramatic change in late 2006 between house prices and subprime mortgage delinquencies and defaults.

The downside of a principal reduction policy is that borrowers with the ability to pay their mortgage payments would have a financial incentive to become delinquent on their loans. In effect, they would trade a decrease in their credit score for the reduction in their payment. Consequently, it is vital for lenders to distinguish borrowers who are genuinely unable to repay their original mortgage from those that are simply 'modification shopping.' Failing to make this distinction could inspire a flood of delinquencies.

In summary, preventive principal reductions can actually serve to stave off defaults and help stabilize the housing and mortgage market. Waiting until the borrower goes 60 to 90 days delinquent is dangerous since the longer a servicer waits to modify a loan, the more likely the loan is to go to default generating enormous costs for the lender/investor.[8] Thus, loan modifications are not a bailout of borrowers; rather, it is an attempt to reduce costs to lenders/investors while at the same time preserving homeownership and reducing systemic risk in the economy.

Thank you for your willingness to let me share my thoughts with you.

[8] See "Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs" by Amy Crews Cutts and William A. Merrill, March 2008, Freddie Mac Working Paper #08-01

Mr. KUCINICH. Ms. Cohen, you may proceed.

STATEMENT OF ALYS COHEN

Ms. COHEN. Chairman Kucinich, Ranking Member Issa, thank you for inviting me to testify at today's hearing on the Treasury Department's TARP program.

On a daily basis, the National Consumer Law Center's attorneys provide legal and technical assistance on consumer law issues to legal services, government and private attorneys representing low income consumers across the country. From this vantage point, we are seeing the devastating effects of escalating foreclosures on families and communities. There is no doubt bold and immediate action is needed to save homes and neighborhoods.

Treasury's recent announcement makes clear, however, that stopping foreclosures and saving homes and neighborhoods is not a priority of the current TARP program. We appreciate the FDIC's announcement today on the use of the TARP guarantee program. Such a plan with would be a substantial step in the right direction.

Congress must insist that Treasury use the broad powers provided by TARP to mandate affordable modifications through every means available. Only such a plan will get at the root cause of this entire crisis, defaults and foreclosures engineered by overreaching mortgage loan originators and investors, and thus stabilize the housing market.

To the extent Treasury provides funds to firms providing non-mortgage credit, there should be a quid pro quo for reforming mass abuses in those industries, including auto, finance, private student loans and credit cards.

On mortgages, Treasury should develop a loan modification program that can be routinized and applied on a large scale basis. It should condition any purchase of an equity interest in a financial institution on a rigorous loan modification plan. It should provide guarantees only for affordable loan modifications, and it should purchase a sufficient stake in assets to enable the implementation of an aggressive modification program through the purchase of whole loans, second mortgages, securities or servicing rights. An effective TARP program for homeowners lies in the mechanics of its loan modification program. The following principles should apply to such a program.

One, a mechanized program of affordable and sustainable modifications is essential to process the many homeowners facing foreclosure.

Two, the affordability analysis in any loan modification program must be both objective and have a safety valve for homeowners in special situations.

Three, loan modifications should include principal reductions to 95 percent LTV so borrowers are invested in long-term homeownership and so they can refinance to make needed repairs, obtain a reverse mortgage or relocate.

Four, second liens should be bought out at a nominal pricing. Without addressing second liens, a program can go nowhere.

Five, loan modifications should be available to homeowners in default as well as for those for whom default is reasonably foreseeable.

Six, late fees and all default servicing fees should always be waived in loan modifications. As servicers profit enormously from such fees, they are often out of proportion to the loan balance.

Seven, any shared loss guarantee should favor the most needed loan modifications.

Eight, loan modifications should not cost servicers more to do than foreclosures.

In addition, Congress should pass legislation to allow loan modifications through bankruptcy, reform the servicing industry by requiring loss mitigation prior to any foreclosure, and remove tax consequences for loan modifications.

Why do we need these measures? While the servicing industry stands at the center of the foreclosure crisis and thus is in the best position to turn the situation around, the basic structure of the servicing business requires us to recognize we cannot leave it to this industry to lead the way out of the foreclosure nightmare. Even the streamlined modification program is limited in terms and has been announced by private sector servicing firms that have a dismal record of providing efficient and fair service.

In the interest of maximizing profits, servicers have engaged in a laundry list of bad behavior which has considerably exacerbated foreclosure rates, including cascading fees imposed upon homeowners in default. Servicers profit from levying fees and keeping borrowers in the sweat box of default contrary to the interests of homeowners and investors. While clarifying a servicer's duty to the entire investor pool and allowing for clear decisionmaking capacity by servicers will help, more substantial intervention will be needed to rescue homeowners from a broken system that works against their interests.

Thank you for the opportunity to testify before the committee today. A strong loan modification program under TARP is essential, as is passage of legislation to allow for loan modifications in bankruptcy, to reform the servicing industry and to address the tax consequences of loan modifications.

Thank you. I look forward to your questions.

[The prepared statement of Ms. Cohen follows:]

Testimony

Of

Ms. Alys Cohen

On behalf of the
Low Income Clients of the
National Consumer Law Center
And
National Association of Consumer Advocates

Domestic Policy Subcommittee
Oversight and Government Reform Committee
Friday, November 14, 2008
2154 Rayburn HOB
10:00 a.m.

"Is Treasury Using Bailout Funds to Increase Foreclosure Prevention as Congress Intended?"

TARP and Loan Modifications of Troubled Mortgages

I. Introduction and Summary of Recommendations

Chairman Kucinich, Ranking Member Issa, and members of the subcommittee, thank you for inviting me to testify at today's hearing on the Treasury Department's Troubled Asset Relief Program ("TARP") program. I am a staff attorney at the National Consumer Law Center and testify here today on behalf of the National Consumer Law Center's low-income clients[1] as well as the National Association of Consumer Advocates.[2]

On a daily basis, NCLC's attorneys provide legal and technical assistance on consumer law issues to legal services, government and private attorneys representing low-income consumers across the country. From this vantage point, we are seeing the devastating effects of escalating foreclosures on families and communities. There is no doubt: bold and immediate action is needed to save homes and repair neighborhoods.

Congress must insist that Treasury use the broad powers provided by TARP to mandate affordable modifications through every available means. It will take an extraordinary effort to stem the rising tide of foreclosures, save homes for families across the nation and, in turn, preserve the safety and value of America's communities. Treasury should develop a loan modification program that can be routinized and applied on a large-scale basis; condition any purchase of an equity interest in a financial institution on a rigorous loan modification plan; provide guarantees only for *affordable* loan modifications; and purchase a sufficient stake in assets to enable the implementation of an aggressive modification program through the purchase of whole loans, second mortgages, securities, or servicing rights.

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[1] The **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 sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (6th ed. 2007), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), 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 address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. This testimony was written by Alys Cohen, Staff Attorney, Margot Saunders, Of Counsel, and Tara Twomey, Of Counsel.

[2] The **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.

An effective TARP program for homeowners lies in the mechanics of its loan modification program. The following principles should be the basis for the federal loan modification program under TARP:

1. **A mechanized program is essential to process the many homeowners facing foreclosure,** and it also must include a safety valve for homeowners with special needs. In this way, the one size fits all approach is the default program applied to all homeowners, while those with special circumstances are still able to have their needs addressed. The modifications also need to be permanent and sustainable, to ensure that the foreclosure is not simply postponed to a later day.

2. **The affordability analysis in any loan modification program must be both objective and flexible.** It is essential to orient loan modifications toward an affordable debt to income ("DTI") ratio, such as 38%[3] including taxes and home-related insurance, and to do so as much as possible on a mechanized basis.

3. **Loan modifications should include principal reductions to 95% LTV.** While a homeowner with affordable payments who is underwater can retain the home, the homeowner will not, if circumstances require, be able to refinance to make needed repairs, obtain a reverse mortgage, or relocate.

4. **Second liens must be addressed.** Loan modifications that address first liens but omit any treatment of second liens simply are setting up homeowners for failed loans and lost equity. The holder of a sleeping second mortgage lien could, after years of good faith payments on the modified first mortgage, seek to collect on the lien, robbing the homeowner of any homeownership gains acquired through the loan modification process. Second liens should be bought out at a nominal price.

5. **Loan modifications should be available to homeowners in default as well as for those for whom default is reasonably foreseeable.** Many homeowners are scraping by on their payments – borrowing money from family members, draining savings, foregoing payment on other debt or utilities, running up their credit cards. These families also should have a chance to obtain sustainable loan terms and regain financial stability.

6. **Fees should be waived as part of the loan modification.** Late fees and all default servicing fees should always be waived in loan modifications. As servicers profit enormously from such fees, they often are out of

[3] While we believe that DTI analyses always benefit from the addition of a residual income analysis, in the context of mass loan modifications a front end debt-to-income analysis may be the most efficient way to provide relief to a broad swath of homeowners.

proportion to the loan balance. When fees are capitalized into the loan balance, the loan principal increases substantially. Neither servicers nor homeowners benefit from a system that requires homeowners to challenge the legitimacy of default servicing fees in court proceedings in order to receive a sustainable and affordable loan modification.

7. **Any shared loss guarantee should favor the most-needed loan modifications.** Any loan modification guarantee should be based on the degree of concessions offered, with greater concessions leading to more significant guarantees.

In addition, as further detailed in Section IV in which we explain each elements of the loan modification recommendations, it is essential that Treasury adopt procedural rules to assure the integrity of the loan modification program, including:

- Specificity and transparency must be applied to the definition of net present value. Reimbursements to servicers for loan modifications should be equivalent or more than foreclosures.
- Data and reporting are essential. Any loan modification undertaken by the federal government should gather detailed records regarding loan modifications as well as re-defaults.
- Reimbursements to servicers should encourage loan modifications by ensuring that servicers are paid the same or more than when they pursue foreclosures.

Even if TARP, as well as Hope for Homeowners and the new GSE loan modification program, reach their maximum potential, further action must be taken by Congress to help homeowners keep their homes.[4] In addition to the steps below, Congress should consider legislation to facilitate the mass restructuring of loans, to the extent that further action is needed to expand the reach of modifications.[5]

1. Congress should allow bankruptcy courts to modify home mortgage loans just as they can do for virtually every other kind of secured and unsecured debt.
2. Congress should enact H.R. 5679, which aligns mortgage servicers' interest with those of homeowners and requires that reasonable loss mitigation efforts be made before a foreclosure can initiated.

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[4] These recommendations only address how to limit the millions of foreclosures on the horizon. This testimony does not address the steps policymakers will need to take to prevent such a crisis from happening again.

[5] *See, e.g.,* Michael Barr & James A. Feldman, *Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages,* Center for American Progress (Apr. 22, 2008), *available at* http://www.americanprogress.org/issues/2008/04/reimc_brief.html; Robert Kuttner, *It's Time to Save the Housing Sector*, Boston Globe (January 24, 2008), available at http://www.boston.com/realestate/news/articles/2008/01/24/its_time_to_save_the_housing_sector/ (discussing the Home Owners Loan Corporation of the New Deal era).

3. Congress must continue the fix of the tax code, to ensure that loan modifications do not give rise to taxable income. Principal reductions, or, in some cases, interest rate reductions, can lead to imputed taxable income to the homeowner when the loan that is modified was *not* used to purchase or substantially improve the home. Congress should amend the Mortgage Debt Forgiveness Relief Act of 2007[6] to protect homeowners from tax consequences in all loan modifications.

II. The Foreclosure Crisis Calls For Bold Action

As is apparent from the constant stream of stories in the news, we are facing the greatest foreclosure crisis since the Great Depression. The statistics are grim. For the second quarter of 2008, foreclosure filings nationwide were up 121% over the second quarter of 2007.[7] In the same time period, nearly a quarter of a million properties were foreclosed.[8] As of July 2008, REO, or creditor-owned, property represented more than 16 percent of the inventory of existing homes for sale.[9] In some communities, creditor-owned properties make up nearly 40 percent of existing inventory.[10]

In the prime market as well as the subprime market, seriously delinquent[11] loans have continued to rise at an alarming rate, increasing three-fold since early 2006.[12] By mid-2008, nearly one-third of subprime ARMs were more than 90 days late or in foreclosure.[13] Nationwide, it is estimated that 6.5 million foreclosures may be completed by 2012.[14]

The consequences of this foreclosure crisis have not only ripped through Wall Street, they are taking a heavy toll on communities across America. The abuses in the

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[6] Pub. L. No. 110-142.

[7] RealtyTrac, Inc., *Foreclosure Activity Up 14 Percent in Second Quarter* (July 25, 2008), *available at* *http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4891&accnt=64847*.

[8] *Id.* (reporting 222,391 REO properties for the quarter).

[9] RealtyTrac, Inc. has reported more than three quarters of a million properties are in its active REO database. *See* RealtyTrac, Inc., *Foreclosure Activity Increases 8 Percent in July* (Aug. 14, 2008), available at http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5041&accnt=64847; National Association of Realtors, *July Existing-Home Sales Show Gain* (Aug. 25, 2008)(reporting total housing inventory at the end of July at 4.67 million existing homes for sale), *available at* http://www.realtor.org/press_room/news_releases/2008/july_ehs_show_gain

[10] Kelly Bennett, *Local Prices Down 30 Percent from Peak* (Aug. 27, 2008)(reporting 135 of 337 properties listed for sale on Aug. 21 and 22, 2008 in San Diego area were bank repossessions), available at http://www.voiceofsandiego.org/articles/2008/08/27/housing/869dataparty082708.txt.

[11] The category of seriously delinquent loans includes loans that are at least 90 days delinquent plus the loans in foreclosure inventory.

[12] National Delinquency Survey, Mortgage Bankers Association. The seriously delinquent rate for subprime loans, both fixed and adjustable in the first quarter of 2006, was 6.22%. By the second quarter of 2008 that number had grown to 17.85%. Similarly, in the prime market the number of seriously delinquent loans has climbed from .77% in the first quarter of 2006 to 2.35% in the second quarter of 2008.

[13] *Id.*

[14] Reuters, *Foreclosures to Affect 6.5 million by 2012* (Apr. 22, 2008), available at http://www.reuters.com/article/bondsNews/idUSN2233380820080422 (discussing Credit Suisse report based on Mortgage Bankers Association data).

subprime market have undermined the efforts of hardworking families to acquire and retain the dream of homeownership –

- Instead of building wealth, families are losing equity.[15]
- Worse yet, some foreclosed families are unable to find replacement shelter and become homeless.[16]
- Renters suffer, too, as lenders quickly evict tenants from foreclosed homes.[17]
- More and more Americans are being driven into bankruptcy.[18]
- Neighborhoods are deteriorating as foreclosed homes are boarded up and left vacant.[19]
- Crime in high-foreclosure neighborhoods is on the rise.[20]
- Overgrown lawns and trash-strewn yards symbolize growing community abandonment and disinvestment.[21]
- Not only is this a community issue, it is a civil rights issue. Subprime loan originations to borrowers of color have drastically outnumbered those to white borrowers. For example, in 2006 and 2007, African Americans and Latinos were approximately 2.5 times more likely than whites to receive subprime loans. African Americans alone comprise almost half of all subprime borrowers.[22]

While the servicing industry stands at the center of the foreclosure crisis, and thus is in the best position to turn the situation around, the basic structure of the servicing

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[15] Ellen Schlomer, et al., *Losing Ground, Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending (Dec. 2006) at 3 (estimating that foreclosures will cost homeowners as much as $164 billion, primarily in lost home equity).
[16] *See* Erlenbusch, et al., *Foreclosure to Homelessness: The Forgotten Victims of the Subprime Crisis*, National Coalition for the Homeless (Apr. 15, 2008).
[17] It is estimated that 18% of the foreclosure started in the third quarter 2007 were not occupied by the owners. *See* Jay Brinkmann, An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and other Loss Mitigation Activities in the Third Quarter of 2007, Mortgage Bankers Association (Jan. 2008), *available at* http://www.mortgagebankers.org/files/News/InternalResource/59454_ LoanModificationsSurvey.pdf; *see also* Testimony of Sheila Crowley to the Financial Services Committee, U.S. House of Representatives (April 10, 2008)(discussing the affects of the foreclosure crisis on renters), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/crowley041008.pdf; John Leland, *As Owners Feel Mortgage Pain, So Do Renters, New York Times* (Nov. 18, 2007);
[18] The number of bankruptcy filings is projected to top more than one million filings for 2008—the highest number of filings since the 2005 amendments to the Bankruptcy Code. See Posting of Robert Lawless on *Credit Slips* blog, Bankruptcy Filings Reach New High in August, http://www.creditslips.org/creditslips/2008/09/bankruptcy-fili.html#more (Sept. 2, 2008).
[19] *See* 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.; Brad Heath and Charisse Jones, *Mortgage defaults force Denver exodus*, USA Today (Apr. 1, 2008)(in some Denver neighborhoods as many as one-third of residents have lost their homes).
[20] *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).
[21] *See* Daphne Sashin and Vicki Mcclure, *Foreclosure leave painful ripple effect*, Orlando Sentinel (Oct. 15, 2007) (describing a once safe neighborhood now dotted with empty homes and overgrown lawns).
[22] Center for Responsible Lending, 2008.

business requires us to recognize that we cannot leave it to this industry to lead the way out of this foreclosure nightmare; Congressional action is needed.

III. The Servicing Industry Cannot Be Relied upon to Meet the Needs of Homeowners.

Mortgage servicers are the link between mortgage borrowers and the mortgage owners. Since the 1990s, mortgage servicing has become an increasingly specialized and lucrative industry, driven in part by the need for one party to coordinate the distribution of mortgage revenues to the investors in securitized loans. Despite the important functions of mortgage servicers, borrowers 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 behavior, *which has considerably exacerbated foreclosure rates.*[23] The most common abuses in loan servicing include misapplication of payments, use of suspense accounts, failure to make timely escrow disbursements, and cascading fees imposed upon homeowners in default.[24] These abuses exist because there are market incentives rather than deterrents for this type of behavior.[25] Any loan modification program must account for these dynamics and move beyond them.

A. Cutting Cost, Cutting Service.

As with all businesses, servicers add more to their bottom line to the extent that they can cut costs. Servicers have cut costs by relying more on voicemail systems and less on people to assist borrowers, by refusing to respond to borrowers' inquires and by failing to resolve borrower disputes. Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate. As a result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead borrowers are being pushed into short-term modifications and unaffordable repayment plans. These "kick the can" approaches to solving the foreclosure crisis do not provide real solutions for those affected borrowers. Instead, they merely postpone the day of reckoning.[26] Moreover, creating affordable and sustainable loan modifications for distressed borrowers on a loan-by-loan basis is labor intensive.[27] Under many pooling and servicing agreements, additional labor costs incurred by servicer's engaged this process are not compensated by the loan owner. By

[23] *See* National Consumer Law Center, *Foreclosures*, Ch. 6 (2d ed. 2007)(describing the most common mortgage servicing abuses).
[24] *Id.*
[25] *See* Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 Housing Pol'y Debate 279 (2007).
[26] *See* Jay Brinkmann, An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and other Loss Mitigation Activities in the Third Quarter of 2007, Mortgage Bankers Association (Jan. 2008), *available at* http://www.mortgagebankers.org/files/News/InternalResource/59454_LoanModificationsSurvey.pdf. (tables 2 and 3 show that a large number of foreclosures result from failed repayment plans).
[27] Joseph R. Mason, *Mortgage Loan Modification: Promises and Pitfalls*, at 7(Oct. 3, 2007), *available from SSRN at* papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.

contrast, most servicers are paid a fee to foreclose on a borrower. Under this cost and incentive structure, it is no surprise that servicers continue to push borrowers into less labor-intensive repayment plans or towards foreclosure.

B. Maximizing Income is a Servicer's Main Goal.

Customarily, the servicer collects a monthly fee in return for the services provided to the trust (or investors). The servicing fee provides the largest income stream for servicers. The fee is based on the unpaid principal loan balance and typically ranges from 25 basis points (prime loans) to 50 basis points (subprime loans). In addition, ancillary fees are imposed on borrowers to compensate servicers for the occurrence of particular events. The most common ancillary fee is a late fee, although a variety of other "servicer" fees exist. Such fees are a crucial part of the servicers' income because servicers are typically permitted under PSAs to retain such fees.

IV. Despite Recent Governmental Measures More Needs to Be Done.

A. HERA's Modest Steps

In July 2008, the President signed into law a wide-ranging housing bill, the "Housing and Economic Recovery Act of 2008."[28] A key component of the law is the "HOPE for Homeowners Act of 2008."[29] The HOPE for Homeowners Act creates a new, temporary program authorizing FHA to refinance homeowners into 30-year fixed rate FHA mortgages. The bill also included a safe harbor for servicers of residential mortgage securitizations clarifying that, where the servicer owes a duty to maximize recoveries, this duty is owed equally to all investors in the pool rather than any specific investors, and that a servicer is deemed to act in the best interests of all investors if it agrees to a modification or workout plan where default has occurred or is reasonably foreseeable, the property is owner occupied, and the anticipated recovery under the modification or workout exceeds on a net present value basis, the anticipated recovery through foreclosure. The program has been expected to serve approximately 400,000 homeowners. Unfortunately, the pitfalls are also large and so far business has been slower than expected. The largest obstacle to achieving the promise of HOPE for Homeowners is that industry participation in the program remains entirely voluntary.

B. Voluntary Measures Can Not Stand Alone

For the last couple of years, the financial services industry has been encouraged to meet the growing foreclosure crisis by scaling-up voluntary loan modification efforts. In May 2007, Senate Banking Committee Chairman Dodd announced a set of servicing principles aimed at long-term affordability.[30] In June 2007, Chairman Sheila Bair of the

[28] Pub. L. No. 110-289 (2008). Certain new disclosure provisions for real estate loans also were included in the bill, as well as an increase in statutory damages for TILA claims on real estate loans.
[29] Title IV, Pub. L. No. 110-289 (2008).
[30] Senator Dodd Unifies Industry Members, Consumer Representatives to Help Preserve the American Dream of Homeownership (May 2, 2007), *available at* http://dodd.senate.gov/index.php?q=node/3863/print

FDIC called for automatic loan modifications for borrowers with subprime ARMs.[31] Like Senator Dodd's servicing principles, Chairman Bair emphasized the importance of providing sustainable loan modifications. A report from the Joint Economic Committee also suggested that automatic loan modifications were needed.[32] In September 2007, the federal and state banking regulators issued a joint statement on loss mitigation strategies, referencing earlier guidance and encouraging use of loss mitigation authority available under pooling and servicing agreements.[33] In October 2007, Treasury Secretary Paulson sought voluntary commitments from servicers to contact borrowers and explore new loan modification approaches.[34] Then in December, 2007, Secretary Paulson announced a plan for "fast track" loan modifications.[35]

The data available thus far support the conclusion that little is being done by the financial services industry to help homeowners facing foreclosure. While loan modifications are increasing, they are still outpaced by foreclosures. Moreover, few permanently change the loan terms and many actually increase payments for homeowners.[36] A report by Credit Suisse finds that loan modification progress is slow and that plans with higher payments are more common than modifications with lower payments. As of August 2008 modifications accounted for just 3.5 percent of the loans that are delinquent for sixty days or more. Moreover, after modifications that freeze the interest rate at the pre-reset amount, the most common form of modification was one where the payment *increased*. These higher-payment modifications had a re-default rate of 44%. In contrast, reset modifications re-defaulted at a 15% rate and principal reduction modifications re-defaulted at a 23% rate.[37]

Mortgage modifications that do not reduce principal balances, and certainly those that do not even reduce monthly payments delay, do not prevent foreclosures. While voluntary measures may be able to help some borrowers, structural barriers inherent in the mortgage servicing industry will hamper the effectiveness of any voluntary programs, including the HOPE for Homeowners program. While limiting the reductions in loan principals ("haircuts") under the H4H program is apparently under consideration, such a

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[31] Remarks of FDIC Chairman Sheila C. Bair, American Securitization Forum (ASF) Annual Meeting (June 6, 2007).

[32] *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here*, Report and Recommendations by the Majority Staff of the Joint Economic Committee (Oct. 2007)(one of the key policy recommendations put forth in the report was to direct servicers and lenders to make safe and sustainable loan modifications).

[33] Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages (Sept. 2007), *available at* http://www.occ.treas.gov/ftp/bulletin/2007-38a.pdf.

[34] Associated Press, *Paulson to Mortgage Industry: Help Curb Defaults* (Oct. 31, 2007), *available at* http://money.cnn.com/2007/10/31/real_estate/paulson_housing.ap/.

[35] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*, Executive Summary (Dec. 6, 2007), *available at* http://www.treas.gov/press/releases/hp706.htm.

[36] *See* Alan M. White, *Rewriting Contracts: Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports, available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538.

[37] Rod Dubitsky et. al, *Subprime Loan Modifications Update*, Credit Suisse Fixed Income Research (Oct. 1, 2008) at 1-2.

measure will not change barriers to participation related to servicer incentives. The need for further action is urgent.

V. EESA/TARP Must Prioritize Effective, Sustainable Assistance to Homeowners.

The Emergency Economic Stabilization Act of 2008 ("EESA") provides the Treasury Department with broad authority to remove distressed assets from financial institutions and resell those assets without typical market constraints or to guarantee such assets. Treasury should –

- Develop a loan modification program that can be routinized and applied on a large-scale basis;[38]
- Condition any purchase of an equity interest in a financial institution on a rigorous loan modification plan;
- Provide guarantees only for *affordable* loan modifications; and
- Purchase a sufficient stake in assets to enable the implementation of an aggressive modification program through the purchase of whole loans, second mortgages, securities, or servicing rights.

An effective TARP program for homeowners lies in the mechanics of the loan modification program. The following principles should be the basis for the federal loan modification program under TARP:

1. **A mechanized program is essential to process the many homeowners facing foreclosure,** and it also must include a safety valve for homeowners with special needs. In this way, the one size fits all approach would be the default program applied to all homeowners, while those with special circumstances would still be able to have their needs addressed. Further, loan modifications need to be geared toward providing real and permanent relief for homeowners, with the goals of minimizing the disruption of families, maximizing their return on investment, and promoting long term stability of neighborhoods. Servicers and lenders should be required to design long-term sustainable loan modifications that allow families to remain in place and preserve their investment in their home.

2. **The affordability analysis in any loan modification program must be both objective and flexible.** It is essential to orient loan modifications toward an

[38] While claims have been made that various accounting and contractual issues stand in the way of engaging in loan modifications en masse, these claims are not clearly supported. For example, while servicers have claimed that Pooling and Servicing Agreements generally limit loan modifications to 5% of a pool, a Credit Suisse report indicated that most PSAs actually don't have such a limitation. *See* Rod Dubitsky, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Credit Suisse Fixed Income Research (Apr. 5, 2007) at 5, 7. Two thirds did not limit the percent of loans that could be modified and almost half had no restrictions on loan modifications at all. There is no empirical evidence to support the claim that most PSAs contain such a limitation. To the extent that concerns regarding structural issues, such as PSAs and accounting rules, themselves present barriers to loan modifications, Congress or Treasury should address these issues directly.

affordable debt to income ("DTI") ratio, such as 38%[39] including taxes and home-related insurance, and to do so as much as possible on a mechanized basis. Such an approach provides administrative ease, consistency, transparency and fairness. Interest rate reductions, waiver of late fees and default servicing charges, and principal reductions can turn many currently unaffordable loans into affordable ones. Nonetheless, even after these measures, the payments on some loans may still exceed 38% of the homeowners' income. While some homeowners may be facing job loss or other devastating life changes that limit their ability to make any reasonable payments on the loan, others may be able to make the payments at a slightly higher DTI ratio and should be given an opportunity to show that the payment would be affordable. A mechanized program is essential in order to process the many homeowners facing foreclosure; it must also have a safety valve for those homeowners who otherwise could obtain an affordable loan modification. Thus, homeowners whose payments would fall into some slightly higher range, for example 39% to 45%, should be eligible for a trial loan modification, which could be made permanent after three months of payments. In addition, a homeowner who could not qualify for a loan modification but who later was able to obtain employment or was otherwise able to afford a modification after the initial analysis and before the foreclosure process was final, should not be barred from reapplying for a loan modification. A mechanized process may also produce instances where homeowners are offered a modification that, while feasible on paper, is not sustainable in practice. In these cases, if the servicer did not exhaust its tools for making the loan affordable, the homeowner should be eligible for a second look.

3. **Loan modifications should include principal reductions to 95% LTV.** While a homeowner with affordable payments who is underwater can retain the home, the homeowner may have less financial incentive to remain in the home and will not, if circumstances require, be able to refinance to make needed repairs, obtain a reverse mortgage, or relocate. Principal reduction is more likely to lead to successful foreclosure avoidance. As Federal Reserve Board Chairman Bernanke has noted:

> With low or negative equity . . . a stressed borrower has less ability (because there is no home equity to tap) and less financial incentive to try to remain in the home. In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure.[40]

[39] While we believe that dti analyses always benefit from the addition of a residual income analysis, in the context of mass loan modifications a front end debt-to-income analysis may be the most efficient way to provide relief to a broad swath of homeowners.

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

A related issue is the question of whether loan terms should be stretched to 30 or to 40 years. While a 40 year mortgage may be a last resort to get to affordability, it substantially decreases a homeowner's chance at increasing equity. Consider the relatively *small* amount of monthly savings achieved from a 40 year mortgage at a 7% interest rate compared to a 30 year loan, especially in light of the huge extra expense in the long run incurred in interest and lost equity.

Comparison Between 30 and 40 year Terms

	Loan Amount	Interest Rate	Monthly Payments	Finance Charge	Balance end Year 5	Balance end Year 10	Balance end Year 20
30	$200,000.00	7%	$1,330.60	$279,017.80	$188,263.18	$171,624.77	$114,600.16
40	$200,000.00	7%	$1,242.86	$396,574.03	$194,544.91	$186,811.65	$160,307.53

In this example, the 40 year amortization only yields a savings in the monthly payment of $87, but will cost over $100,000 over the life of the loan. Indeed, just for saving $87 a month, this homeowner will make an extra ten years of payments – totaling over $138,000 (even after the monthly savings are counted). However, the benefits of a 40 year mortgage over a 30 year term do improve when the interest rate is lowered. The difference in the monthly payment rises, and the difference in the balance at points along the term is reduced. In sum, we strongly urge 40 year terms only be used when accompanied by very low interest rates. Otherwise, the extra costs in the long run outweigh the minimal immediate benefits.

4. **Second liens must be addressed.** Loan modifications that address first liens but omit any treatment of second liens simply are setting up homeowners for failed loans and lost equity. If a homeowner is offered a loan modification on her first mortgage, where she is currently underwater and where the second lien holder therefore has no reasonable expectation of repayment, a second lien holder could block the modification, even where it has no foreseeable recovery in foreclosure, where it views its position as impaired, for example in recapitalization of arrears. In addition, if a second lien holder doesn't block the modification, it could choose to forgo collection until the property value rises and then seek to collect or foreclose based on years of accumulated interest and fees. Thus, a sleeping lien could awake just in time to rob the homeowner of any homeownership gains acquired through the loan modification process and the subsequent years of good-faith payments. Loan modifications that ignore second liens could do long-term damage to housing stability and equity. Subsequent lien holders should be bought out at a nominal rate for a complete release of the claim, comparable to the

expectancy interest matrix used pursuant to Hope for Homeowners.[41] The buyout would ensure that no junior liens—secured or unsecured—remain and that a homeowner could truly benefit from a loan modification on the primary lien.

5. **Loan modifications should be available to homeowners in default and for those for whom default is reasonably foreseeable.** Many homeowners are scraping by on their payments—borrowing money from family members, draining savings, foregoing payment on other debt or utilities, running up their credit cards. These families also should have a chance to obtain sustainable loan terms and regain financial stability. Understandably, those in default may be the first homeowners to receive loan modifications, but the program should not stop there. Borrowers for whom default is reasonably foreseeable could make an application for a loan modification in which they would explain their particular circumstances, how they have been able to make payments, and why default is on the horizon. Many families would benefit from such a program. For example, we recently spoke with one family that spends 75% of its monthly income on its mortgage payment. It spends another 10% on its monthly car payment. The family is paying for basic expenses with credit cards. This is an unsustainable loan that warrants a decent loan modification.

   The definition of for whom default is reasonably foreseeable must include, and look beyond, the group of homeowners facing resets and recasting of Option ARMs. Borrowers with ARMs suffer a high rate of foreclosure prior to reset; default and foreclosure in many instances may be independent of payment shock.[42] This problem is compounded by the fact that most borrowers facing resets are not actually receiving rate freezes. In one analysis, half of those with impending resets received loan modifications with higher payments.[43] Any homeowner currently paying more than 60% of income for a house payment should per se be regarded as one for whom default is reasonably foreseeable.

[41] Under the Hope for Homeowners rules, second lien holders obtain 9 for CLTVs above 135% or 12% for those below 135%. 73 FR 58418, 58419 (Oct. 6, 2008) (Hope for Homeowners Program Regulations).
[42] Morgan J. Rose, Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category 25, 32 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (average purchase money ARM that entered foreclosure did so only 12.4 months after origination); Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases during the first two years, even before any payment shock); Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12 (Apr. 5, 2007), *available at* http://www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (increase in early payment defaults within four months of origination); Lynne Dearborn, Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000, at 23 (July 2003) (from 1996 to 2000, the proportion of foreclosure judgments attributable to ARMs increased from 11% to 30%; at the same time, the median age of the loan entering foreclosure declined from 4.1 years to 2.06 years, with default occurring three months typically before the initiation of foreclosure).
[43] Alan White, *Rate Freeze Mods—Not So Much*, Public Citizen Consumer Law and Policy Blog (Oct. 31, 2008), *available at* http://pubcit.typepad.com/clpblog/2008/10/rate-freeze-mod.html (based on research that will appear in a forthcoming paper).

6. **Fees should be waived as part of the loan modification.** When structuring a loan modification, late fees and other fees charged pursuant to default should be waived. While late fees are being waived in various loan modification programs now, waiver should include all default servicing fees. Such fees, even more than ordinary late fees, are the product of the unsustainable loan and its resulting default. Therefore, they are obvious candidates for exclusion in developing a fair and sustainable loan modification. Moreover, as discussed above, servicers profit enormously from such fees and thus they often are quite out of proportion in comparison to the loan balance. Where fees are capitalized into the loan balance, the loan principal could increase substantially. Many of these fees have a questionable legal basis; often, when a homeowner is able to challenge the fees in a court proceeding, the servicer will withdraw the fees. Neither servicers nor homeowners benefit from a system that requires homeowners to challenge the legitimacy of default servicing fees in court proceedings in order to receive a sustainable and affordable loan modification.

7. **Any shared loss guarantee should favor the most-needed loan modifications.** One pitfall in any program offering guarantees for loan modifications is that if loan guarantees are provided on a uniform basis while the magnitude of concessions for loan modifications varies widely, it could incentivize more limited concessions. Accordingly, any loan modification guarantee should be based on the degree of concessions offered, with greater concessions leading to more significant guarantees. All guarantees should be provided within pre-established boundaries of affordability and sustainability to ensure that any guarantee is provided in exchange for a meaningful, sustainable loan modification. This would promote those modifications most needed by borrowers rather than favoring those that are the easiest and least risky for servicers to provide.

8. **Specificity and transparency are needed in defining net present value.** Sections 109 and 110 of EESA temper the emphasis on providing loan modifications with a requirement to consider net present value to the taxpayers. Accordingly, the government's definition of net present value, and the extent of its application, should be made available to the public. To the extent that re-default rates are being used to define net present value, they should not be based upon re-default rates for existing modifications that have not been tested for affordability. As noted above, loan modifications with higher payments are prevalent and they re-default almost half of the time.[44]

   Moreover, as part of defining net present value, it is essential to properly define the value of the proceeds from the foreclosure, compared to the value of the loan with a loan modification. This begins with the foreclosure value of the home. Historically, this has been determined using a percentage of the current market

[44] Rod Dubitsky et. al, *Subprime Loan Modifications Update*, Credit Suisse Fixed Income Research (Oct. 1, 2008) at 1-2.

value. In this environment, however, determining current value, and then the appropriate percentage, is difficult. One approach could be to look at comparable properties and the amount they yielded at a foreclosure sale. From the foreclosure value of the home, several items would be subtracted: all amounts owed to the servicer for default servicing and other fees; all costs associated with executing the foreclosure; and all costs associated with the REO status of the property. It is this final number that should be compared to the proceeds expected from a loan that has received a loan modification. In our experience, borrowers seeking loan modifications often face huge obstacles obtaining a decent deal, even when it is clear that the net present value would be maximized by such a modification rather than by proceeding to foreclosure. This may be in part because the basis of most servicer income is a percentage of the outstanding balance owed on the loan. Thus, even when a rigorous net present value analysis would dictate a principal reduction, many servicers may be reluctant to offer a principal reduction. Care must be taken to ensure that servicers' incentives are aligned with the stated goals of EESA.

9. **It should not cost a servicer more to provide a loan modification than it does to execute a foreclosure.** As discussed above, servicers now have numerous incentives to move homeowners toward foreclosure rather than to provide loan modifications. One way to address this is to ensure that loan modifications do not cost more than foreclosures. This could be accomplished both through direct payments for loan modifications that are competitive with those for foreclosures and short sales, and by addressing how servicers recover advance payments that are made to the investors when the loan is in default and foreclosure. While such fees are recoverable early on in the context of foreclosure, when a loan modification is provided, repayment of those advances occurs over a longer period. While these issues could be addressed in new servicer legislation, they also could be included in guidelines under the TARP program.

10. **Data and reporting are essential.** Any loan modification undertaken by the federal government should gather detailed records regarding categories of loans or borrowers for which modifications are offered or not offered, and obtained or not obtained, and the types of terms associated with any loan modifications that are finalized, including the length and terms of the modifications. Studies of re-default also are crucial. Such information is not currently and freely available to the public from any source.

VI. Congress Also Must Take Further Action.

Because of systemic problems in the mortgage servicing industry, voluntary, large-scale, affordable loan modifications are an aspiration rather than a reality. While the TARP program potentially can have some real impact if used aggressively, it will provide only limited assistance if the breadth of direct assistance to homeowners is narrow or if the programs developed do not ensure affordable loan modifications. If the loan modifications are temporary or unaffordable, the program could potentially harm homeowners and their communities.

Even if TARP, as well as Hope for Homeowners and the new GSE loan modification program, reach their maximum potential, further action must be taken aimed more directly at helping homeowners keep their homes.[45] NCLC recommends several steps that can be taken to address the still growing foreclosure crisis; these steps allow homeowners to act directly to save their homes and address various incentive issues related to loan modifications. In addition to the steps below, Congress should consider legislation to facilitate the mass restructuring of loans, to the extent that further action is needed to expand the reach of modification programs.[46]

A. Congress should allow bankruptcy courts to modify home mortgage loans just as they can do for virtually every other kind of secured and unsecured debt.
B. Congress should enact H.R. 5679 that aligns mortgage servicers' interest with those of homeowners.
C. Congress must continue the fix of the tax code, to ensure that loan modifications do not give rise to taxable income.

A. Congress Should Allow Bankruptcy Courts To Modify Home Mortgage Loans, As They Can Do For Virtually Every Other Kind of Secured and Unsecured Debt.

To help families save their homes from foreclosure, Congress must amend the Bankruptcy Code to give bankruptcy courts the same authority to modify home mortgage loans as they have for virtually every other kind of secured and unsecured debt. This recommendation does not attempt to revisit the changes to the Code made by the 2005 amendments. Rather, it addresses the limitations in current Chapter 13 based on the special protection afforded to home mortgage lenders by the 1978 Bankruptcy Code. Importantly, a foreclosure moratorium or deferment only will be effective if, in the meantime, measures such as this bankruptcy relief are passed so that homeowners will be able to obtain affordable loans as the moratorium or deferment expires.

A fundamental goal of chapter 13 has always been to provide an opportunity for consumers to repay their obligations. Unfortunately, this has become exceedingly difficult in recent years because our bankruptcy laws have not kept pace with the enormous changes in the mortgage marketplace that have occurred since those laws were

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[45] These recommendations only address how to limit the millions of foreclosures on the horizon. This testimony does not address the steps policymakers will need to take to prevent such a crisis from happening again.

[46] *See, e.g.,* Michael Barr & James A. Feldman, *Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages,* Center for American Progress (Apr. 22, 2008), *available at* http://www.americanprogress.org/issues/2008/04/reimc_brief.html; Robert Kuttner, *It's Time to Save the Housing Sector*, Boston Globe (January 24, 2008), available at http://www.boston.com/realestate/news/articles/2008/01/24/its_time_to_save_the_housing_sector/ (discussing the Home Owners Loan Corporation of the New Deal era).

first enacted. New non-traditional loan products have challenged the ability of hard-working families who have fallen on difficult times to effectively use chapter 13 to save their homes.[47]

Generally, section 1322(b)(2) of the Bankruptcy Code permits debtors to modify the rights of secured and unsecured creditors. Some of the ways that secured claims may be modified include altering the payment schedule, reducing the contract interest rate, or "stripping down" the amount of the claim.[48] These modifications can be applied to loans secured by cars, boats, second homes and vacation homes. However, an exception to this general rule restricts modification of "a claim secured only by a security interest in real property that is the debtor's principal residence."[49] This limitation can make it nearly impossible for debtors with unaffordable mortgage payments to save their homes from foreclosure through the bankruptcy process.[50] To bring the treatment of family homes in line with the provisions applicable to cars, boats and vacation homes we recommend the following:

Repeal Special Protection for Home Mortgages in Section 1322. This change will permit some borrowers who were provided unaffordable loans to lower their monthly payment to an amount they can pay and to keep that payment amount permanent by converting their ARM to a fixed rate mortgage. It will help borrowers blunt the devastating effect of future rate adjustments which were often not properly considered by lenders when assessing ability to repay at the time the loans were made. For high LTV loans made based on the lender's careless underwriting decisions and inflated or fraudulent appraisals, and which have prevented borrowers from refinancing out of unaffordable loans, borrowers who file Chapter 13 to deal with a foreclosure would have the right to reduce the mortgage claim to the value of the property. This change will extend to low- and middle-income consumers the same protections that are afforded family farmers, corporations, and wealthy individuals who own investment properties.

Amend Section 1322 to Permit Reamortization. Permitting modification by itself does not fully address the problem based on the current structure of the Code. This is because modified secured claims in Chapter 13 must be paid in full during the three to five years of the plan. For home mortgages with large outstanding balances, this is impossible for most borrowers and they would not benefit from the change permitting modification. To address this, we propose a solution which Congress has already

[47] *See* John Eggum, Katherine Porter and Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 Utah L. Rev. __ (forthcoming September 2008).
[48] "Stripping down" or bifurcating a secured creditor's claim means to divide the claim into two parts: the secured portion, which is equal to the value of the collateral, and the unsecured portion represented by any amount owed over the value of the collateral. 11 U.S.C. § 506(a). Through this process, the secured creditor's rights in the collateral are preserved, but its rights to the debtor's property other than the collateral are limited and no greater than those of other creditors. Thus, the Code prevents the secured creditor from obtaining an unfair advantage in the bankruptcy case over the unsecured creditors out of proportion to the true value of its security interest.
[49] 11 U.S.C. § 1322(b)(2); *Nobleman v. Am. Sav. Bank*, 508 U.S. 324, 332, 113 S. Ct. 2106 (1993).
[50] In order to retain a home in bankruptcy, the Code generally requires debtors to make ongoing monthly mortgage payments as well as additional monthly payments to make up any arrearage on the mortgage loan.

provided for family farmers in Chapter 12 cases. Section 1322 should be amended to include a provision similar to section 1222(b)(9) which permits the borrower's loan to be reamoritized based on the modified terms and paid over a period beyond the plan term, generally up to thirty years.

B. Congress Should Enact H.R. 5679 To Align Mortgage Servicers' Interests With Those of Homeowners.

Congresswoman Waters has introduced a bill that recognizes the shortcomings of the mortgage servicing industry and that would align mortgage servicer interests with those of homeowners trying to save their homes. Passage of this measure would serve to reform mortgage servicing practices as we move ahead and would ensure that servicers to provide reasonable loss mitigation prior to foreclosure.

Getting to Affordable Loan Modifications Takes Work. Creating affordable and sustainable loan modifications for distressed borrowers is labor intensive. It is no surprise, then, that servicers continue to push borrowers into less costly repayment plans and short-term modifications. H.R. 5679 would align mortgage servicer incentives with those of the homeowner seeking to prevent a foreclosure. Section 2(a) of the bill creates a duty to provide reasonable loss mitigation prior to any foreclosure and prioritizes "home-saving" loss mitigation options over those that result in loss of the home. Any loss mitigation must be based on an affordability analysis that considers the borrowers debt to income ratio and residual income—to ensure enough actual dollars for non-housing expenses—as well inclusion of the borrower's full debt profile, including junior liens on the property.

Mandating Borrower Access to a Decision Maker. 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. H.R. 5679, section 2(a) requires mortgage servicers to provide borrowers with contract 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."

Requiring Information and Dispute Resolution Prior to Foreclosure. While the Real Estate Settlement Procedures Act currently requires servicers to respond to borrowers' 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. H.R. 5679 ensures that borrowers facing foreclosure are no longer at the mercy of their servicer. Section 2(c) provides transparency to the servicing process by allowing the homeowner to obtain key information about the loan and its servicing history. The section also prohibits servicers from initiating or continuing a foreclosure proceeding during the period in which and outstanding request for information or dispute is pending.

Curbing Opportunities for Abuse. Loan modification or forbearance agreements often contain a waiver of claims provision that purports to release the servicer and holder from any past or future claims that the borrower may have. Broad release language potentially cuts off all claims the borrower may have related to the origination or servicing of the loan and is inappropriate in the context of a loan modification or forbearance agreement. H.R. 5679, Section 2(a) nips this pernicious practice in the bud by banning such waiver of rights in loan modification or forbearance agreements. The section also prohibits the equally abusive practice of forcing borrowers to arbitrate any disputes with the lender or servicer.

C. Loan modifications should not give rise to taxable income.

Loan modifications can create adverse and unexpected tax surprises for homeowners. Principal reductions, or, in some cases, significant interest rate reductions, can lead to imputed taxable income to the homeowner. This is often the case even if, as is the case under Hope for Homeowners, the homeowner may have a future obligation to repay some of the forgiven debt. Loan modifications when the homeowner is near default should not give rise to taxable income and should be excluded both from taxable income and from all reporting requirements.

The Mortgage Debt Forgiveness Relief Act of 2007[51] did not, contrary to popular belief, protect homeowners from tax consequences in all loan modifications. A majority of the subprime loans are home equity loans, for refinance purposes, and not to purchase the home.[52] The Act only applies to the amount of purchase money debt forgiven. While, under the Act, refinanced purchase money mortgage debt may be eligible for exclusion from taxable income, this only applies to the amount of principal refinanced, not any of the fees and costs associated with the refinancing. Few homeowners are likely . to have the documentation years later of their principal balance immediately before the refinancing. Moreover, before any refinanced forgiven debt is exempted from taxable income under the Act, all other debt consolidated with the purchase money mortgage, whether for routine home repairs, medical expenses, or student loans, and all fees, must first be forgiven. Nor does all purchase money debt forgiven come in for exclusion—it must be forgiven either because of the homeowner's financial status or a decline in the property value. While this covers many situations, it does not cover the all too common situation where the home was initially overappraised or cases where the house is underwater due to a negative amortization feature on the loan rather than a market decline.

Even for homeowners whose discharged debt fits into the narrow coverage of the Act, the Act's relief is chimerical. The Act does not excuse homeowners from filing a

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[51] Pub. L. No. 110-142.

[52] Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 Fed. Res. Bank of St. Louis Rev. 31, 41-43, (2006); Ctr. for Responsible Lending, Subprime Lending: A Net Drain on Homeownership 5 (CRL Issue Paper No. 14, Mar. 27, 2007), *available at* http://www.responsiblelending.org/pdfs/Net-Losership-3-26.pdf (in 2006, even at the height of the subprime market, only 44% of all subprime lending was for purchase money mortgages).

special form, Form 982, with the IRS in order to exclude the discharged debt. The IRS estimates that it will take most homeowners upwards of 10 hours to complete Form 982, including record keeping and learning about the law. Despite recent revisions to the form, it remains cumbersome and unfamiliar to most homeowners. The IRS forbids its free tax preparation sites, the Tax Assistance Centers, Volunteer Income Tax Assistance sites, and Tax Counseling for the Elderly sites, from assisting with discharge of indebtedness issues.[53] Thus, for many homeowners the reporting requirement is a nearly impossible hurdle to clear even if they are eligible to exclude forgiven debt under the Act.

VI. Conclusion

Thank you for the opportunity to testify before the Committee today. The foreclosure crisis is continuing to swell and the need to act is great. A strong loan modification program under TARP is essential, as is passage of legislation to allow for loan modifications in bankruptcy, to reform the servicing industry, and to address the tax consequences of loan modifications. Together, these measures will save many homes and stabilize the market. We look forward to working with you to address the economic challenges that face our nation today.

[53] 2007 Nat'l. Taxpayer Advocate Ann. Rep. 28.

Mr. KUCINICH. Thank you very much for your testimony.
Mr. Litton.

STATEMENT OF LARRY LITTON, JR.

Mr. LITTON. Yes, sir. Mr. Chairman, I just want to thank you very much for the opportunity to be here today.

I am responsible for running a mortgage servicing company that is right on the front lines of this crisis. We service 450,000 loans——

Mr. KUCINICH. Hold on, is your mic on now? OK. We want to make sure——

Mr. LITTON. I talk so loud I wasn't able to hear myself anyway through the microphone.

Mr. KUCINICH. When I was on the City Council in Cleveland years ago, my mic used to be cutoff, so I learned to talk loud as well. But here they need to pick up the sound of your voice.

Mr. LITTON. There you go.

Mr. KUCINICH. Are we all set now on the technical side? Good.

Mr. LITTON. To top it off, I even have a cold.

Mr. KUCINICH. Thank you for being here. Go ahead.

Mr. LITTON. I would like to thank you again for the opportunity to address the committee.

I run a mortgage loan servicing company that services 450,000 loans totaling about $75 billion of product. I was asked here today to provide some insight into the performance of loan modifications and to explore additional ways that servicers can help homeowners stay in their homes during these very difficult times.

As a servicer, we are the intermediary between investors in mortgage loans and mortgage-backed securities as well as homeowners. Servicers perform a host of duties. We are responsible for collecting monthly payments from the customer. We are responsible for forwarding those payments on to the investor. We handle taxes, insurance, as well as other things. We are also responsible for working with delinquent customers, and we are also responsible for creating workout opportunities and modifying those loans when we can do so.

Litton has been a strong proponent of responsible loan modifications since my father founded the company in 1988, and I am very proud to say, by the way, that I am still working with my dad 20 years later. As a servicer, we not only have a contractual obligation to our investors, but we also have a responsibility to provide options that give homeowners a second chance.

In the past year, we have observed several notable trends that are presenting increased challenges to servicers as well as homeowners.

First of all, default rates have increased and have continued to do so at an accelerated rate.

Second, redefault rates on loans that have been previously modified have gone up and are going up at an accelerating rate.

Third, fewer customers are accepting the loan modifications that were being offered, including preapproved streamlined loan modifications.

Fourth, foreclosures on vacant properties have doubled from this time last year.

And, finally, our customers are facing tremendous economic head winds driven by higher incidences of job loss, wage compression and a host of other economic issues.

It is clear to me that we as a servicing industry need to continue to be even more aggressive than we have been with modifying loan terms and finding new ways to get homeowners' payments down even further than we have done already. We believe that this is good both for homeowners and communities, and it is also good for investors whose loans we are servicing.

Over the past 12 months, I am proud to say that we have modified more than 41,000 loans. That represents 12 percent of our portfolio and it represents 38 percent of loans that were 60 days or more past due. Whenever we modify a loan, we consider all of the following approaches. We will write down principal, we will waive part or all of the arrearage that has accrued on the loan. We will look at decreasing the interest rate, and we will also look at extending the term. However, despite that work, despite all the loan modifications we have done, we have not seen an appreciable decline or any decline whatsoever in new foreclosure starts over this same period.

In response to this, it is clear to me as an asset manager responsible for 450,000 mortgage loans, that we have to do more, and the more that we are doing is we have implemented at Litton a new debt-to-income standard of 31 percent on our loan modifications. Our belief is that using this standard will allow us to do more loan modifications and provide greater payment relief to borrowers and provide a more long-term sustainable solution. We believe that our investors will benefit tremendously from this and we are confident that we will be able to demonstrate that by decreasing future default rates.

Thank you, Mr. Chairman, for the opportunity to address the committee, and I look forward to answering additional questions that you may have.

[The prepared statement of Mr. Litton follows:]

Statement

Of

Larry B. Litton, Jr.,
President and Chief Executive Officer of Litton Loan Servicing LP

Domestic Policy Subcommittee
Oversight and Government Reform Committee
Friday, November 14, 2008

10:00 a.m.

"Is Treasury Using Bailout Funds to Increase

Prevention as Congress Intended?"

Thank you Chairman Kucinich and Ranking Member Issa for the opportunity to address the Members of the Subcommittee.

My name is Larry B. Litton, Jr. I am the Chief Executive Officer of Litton Loan Servicing, which manages a portfolio of 450,000 mortgage loans totaling $75BB of predominantly subprime mortgages.

I was asked to provide insight into how loan modifications are performing in today's environment and ways servicers can help homeowners stay in their homes during these difficult times. I hope my statements provide the committee with a better understanding of what's happening on the front lines as we work toward reducing mortgage defaults and preserving homeownership whenever possible.

Role of Servicers.

Servicers are a key participant in efforts to help individual homeowners as the intermediary between investors in mortgage loans and the homeowners. The servicer performs a number of administrative tasks, such as collecting monthly payments, escrowing and paying property taxes and homeowners insurance, and sending out year-end tax information to the borrower and to the IRS. In addition, the servicer forwards borrower payments to the lender who made the original loan or to the investors who bought the loan from the originator. Servicers also have a contractual duty to maximize the recovery of principal and interest for investors.

In these trying economic times, a servicer's focus should shift primarily to determining how to cure defaulting mortgages and to how to modify these loans to make them perform again. Modifications are a component of what our industry calls loss mitigation, and we believe modifications are the best way to prevent or cure defaults and help customers continue to pay their mortgages and stay in their homes.

Litton has been a strong and consistent proponent of responsible loan modifications since my father founded the company in 1988. As a servicer, we believe that our contractual obligation to maximize the recovery of principal and interest for the investors whose loans we service is compatible with offering a host of options that afford struggling homeowners a second chance to keep their homes. We make this part of our everyday business practices.

Observations on Today's Environment.

In the past year, we have observed four notable trends that are presenting increased challenges to servicers, and more importantly, homeowners:

- An increase in default rates
- An increase in re-default rates
- A decrease in customers accepting loan modifications

- An increase in the foreclosures of vacant properties

As this crisis has unfolded, default rates increased to more than 40% today, up from 35% over the past 12 months. Also, we have seen a slow but steady rise in re-default rates associated with modifications accepted by homeowners. Twelve months ago our re-default rate averaged about 30%. Today the rate is in excess of 40%.

We also have observed an incremental decrease in the frequency of homeowners accepting loan modifications. Twelve months ago, more than 40% of our customers accepted pre-approved modifications. Today this number is around 20%.

In regard to vacant properties, today we know that at least 25% of the loans we service that go into foreclosure are vacant, which is a 100% increase over where we were 12 months ago. Many times these homeowners did not respond to loan modification offers and have simply walked away from their homes.

It is clear that our customers are facing tremendous economic head winds driven by higher instances of job loss, wage compression, high debt loads, and other issues. It is also clear that the mortgage servicing industry needs to continue to do more and adjust to these conditions. With house values, loan performance, and the overall economy on the decline, this is the time we need to be more aggressive with the terms of our loan modifications and find ways to get homeowners' payments down further. We believe this is good for both homeowners and investors.

Litton's Response on Loan Modifications.

Over the past 12 months, we are proud to report that we have modified more than 41,000 loans. This represents 12% of our portfolio and 38% of loans that were 60 days or more past due. When we modify loans, we consider the following approaches: writing down principal, waiving all or part of arrearage, decreasing interest rate and/or extending the loan term. Despite the work we have done to modify these loans, we have not seen an appreciable decline in new foreclosure starts over this same period. In fact, delinquency rates as well as foreclosure rates are up not just in our portfolio but nationally as well.

Historically, Litton's average modification involved a payment reduction of $200 per month, which resulted in an average housing debt-to-income ratio of 39%.

In response to the current environment, we recently implemented a modification debt-to-income standard of 31%, which is consistent with FHA guidelines for new loans. Our expectation is that after a period of making payments on the loan modification many of our customers will be able to refinance into a fixed rate FHA loan. Our belief is that using this standard will allow us to do more loan modifications with greater payment relief to the homeowner, thus providing a more sustainable solution. Our investors will still benefit, as we are confident we can demonstrate a significant savings over the foreclosure outcome.

Investor and Homeowner Outreach.

Investor education is an important part of our efforts. As I mentioned, we are confident in our ability to demonstrate to our investors that loan modifications generally produce a significantly lower total loss than foreclosures. Before we complete a modification, we project the loss that would be realized should we foreclose and compare that value to the value of cash flow generated via a modified loan. When we can demonstrate that the loss would be lower in the modification example, we proceed with the modification.

Homeowner education and outreach is another essential component to achieving more loan modifications. We have found that working with local housing and consumer agencies has been an important part of our ability to reach homeowners who are otherwise unwilling or afraid to respond to our outreach efforts.

We have a relationship with a particular housing counseling agency that we think illustrates an effective model for the servicer-counseling agency relationship. The East Side Organizing Project of Cleveland, Ohio, known as ESOP, has assisted us in reaching homeowners throughout Ohio, and thus far, to complete modifications for more than half of the customers they have referred to us; a very high success rate. Further, many other customers referred to us by ESOP have received other types of workouts that were more appropriate for their situation. We believe ESOP's success stems from its commitment to providing homeowners with quality and realistic counseling and by encouraging them to actively participate in the modification process.

Recommendations.

It is clear that the negative trends related to new mortgage defaults, re-defaults on modified loans, customers accepting modifications, vacant properties, foreclosure starts, and declining home prices all present significant challenges. We urge the servicing industry and policy makers to work together to continue to develop partnerships between the public, private, and non-profit sectors to inform homeowners of their options and the often little understood consequences of walking away from their homes. It is certainly in everyone's interests to keep homeowners in their homes whenever possible.

Finally, as and industry, servicers should look to do all they can to create responsible, affordable loan modifications that are possible within the guidelines of their contractual obligations to investors and use all available resources to connect with homeowners during this important time. Servicers need to use more reasonable debt-to-income standards when creating modifications to provide more payment relief for homeowners. Although modifications to existing mortgage terms certainly are not a panacea that will cure all that ails the current housing market, we believe that thoughtful restructuring of existing arrangements to provide homeowners with payment relief is a positive step toward combating its decline.

Thank you again for allowing me to share Litton's views, and I would be happy to answer any questions you may have.

Mr. KUCINICH. I thank the gentleman.
Mr. Kudenholdt.

STATEMENT OF STEPHEN S. KUDENHOLDT

Mr. KUDENHOLDT. Chairman Kucinich, thank you for the opportunity to speak with you today. My name is Steve Kudenholdt. I am the head of the Structured Finance Practice Group at the law firm of Thacher Proffitt based in New York.

Mr. KUCINICH. Could you please pull that mic a little bit closer?

Mr. KUDENHOLDT. Certainly, sir.

Since the credit crisis began last year, our firm has worked closely with the American Securitization Forum and other industry participants to improve awareness about the flexibility in existing securitization structures to perform loan modifications. In today's environment, residential mortgage loan servicers need to be able to use all possible tools to minimize losses and foreclosures.

My comments will focus on how TARP or other programs could be used to increase loan modifications and reduce foreclosures in the context of residential loans included in private label securitizations, non-GSE securitizations.

Most private label securitization governing documents give broad authority to the servicer to service loans in accordance with customary standards and in a manner that is in the best interests of investors. Many securitization governing documents specifically authorize loan modifications where the loan is in default or where default is reasonably foreseeable.

EESA Section 109(a) provides that the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures. If a guarantee program were created that covered specific loans that had been modified, this could result in more modifications.

Under a typical loan modification program, the servicer takes the following steps: First, a specific proposed loan modification is designed based on the borrower's current ability to pay. Second, the anticipated payment stream from that loan as modified is compared with the anticipated recovery from foreclosure on a net present value basis. Third, the servicer chooses the alternative with the greater NPV.

Now, in comparing a loan modification with a foreclosure, the servicer applies an assumed redefault rate, and this factor reduces the NPV of the modification alternative. But if credit support were added that eliminated that redefault risk, then the servicer would be more likely to be able to choose the modification over foreclosure, as long as the cost of the guarantee was less than the reduction in NPV that would have resulted from the redefault risk.

In order to encourage modifications and protect the taxpayers' interests, such a guarantee program should be limited to servicers who have demonstrated that they have a robust and systematic modification program with sufficient staffing and resources to handle a high volume of modification. The program should include procedures to verify current income and should include a reliable model for calculating NPV. We think a program of this type could actually change servicer behavior without creating a mandate or changing the operative documents.

Another possibility would be to develop a program under TARP whereby defaulted mortgage loans could be purchased directly from securitization trusts at a discounted price. Such a program would be very helpful because there are borrowers who will default who would like to stay in the home but would not be able to qualify for a loan modification because they could not document current sufficient income and they may not be eligible for the Help for Homeowners program either. Defaulted loans purchased under this program would be subject to a wider range of workout options, such as potentially renting the property back to the borrower.

Although typical servicing authority provisions have been broadly interpreted to allow loan modifications, these provisions to date have not been interpreted to allow such sales for a number of reasons, primarily because FAS 140 does not permit sales of loans out of securitization trusts. However, most securitization documents are actually silent on whether defaulted loans can be sold for a discounted price. Where they are silent, we think there is a strong argument that such sales could be made if the loan was in default and if the cash price resulting from the sale was greater than the NPV of a recovery under foreclosure, and the servicer safe harbor provisions that were added under section 119 of these would support this interpretation.

However, an essential element of this type of program would be an authoritative change or clarification of FAS 140 to permit sales without adverse accounting consequences. These two programs would potentially offer additional tools to a servicer to mitigate losses and prevent foreclosures that they do not have today.

[The prepared statement of Mr. Kudenholdt follows:]

Testimony
Of
Mr. Stephen S. Kudenholdt
Chairman
Structured Finance Practice Group, Thacher, Proffitt & Wood LLP

Domestic Policy Subcommittee
Oversight and Government Reform Committee
Friday, November 14, 2008
2154 Rayburn HOB
10:00 a.m.

"Is Treasury Using Bailout Funds to Increase Foreclosure Prevention as Congress Intended?"

Summary of Testimony:

Chairman Kucinich, Ranking Member Issa, and distinguished Members of the Subcommittee:

My name is Stephen Kudenholdt and I am the head of the Structured Finance Practice Group at the law firm of Thacher Proffitt & Wood, based in New York. Our firm has been a leader in residential mortgage loan securitization since the early 1980s. Since the credit crisis began last year, we have worked closely with industry groups such as the American Securitization Forum to improve awareness of the flexibility in existing securitization structures to perform loan modifications and other forms of loss mitigation.

In today's environment, residential mortgage loan servicers need to be able to use all possible avenues to minimize losses on defaulted loans, and to minimize foreclosures. We believe that there are significant opportunities under the Troubled Asset Relief Program to advance those goals.

My comments will focus on how TARP can be used to increase loan modifications and reduce foreclosures on residential mortgage loans that are included in "private label" securitizations, that is that are not in Ginnie Mae, Fannie Mae or Freddie Mac pools.

Existing provisions

Most private label (non GSE) securitization governing documents give broad authority to the servicer to service loans in accordance with customary standards, and in a manner that is in the best interests of investors. Many securitization governing documents specifically authorize loan modifications where the loan is in default, or where default is reasonably foreseeable. Generally, modification of loans that are not in default (or where default is not reasonably foreseeable) could violate REMIC restrictions and therefore are not permitted under the securitization documents.

Guaranty program on loans in securitizations

The final sentence of EESA Section 109(a) provides that "[T]he Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." If the Secretary were to make available credit enhancement under a guaranty program that covered specific loans that had been modified, this could alter the equation of the servicer's net present value determination. Under a typical loan modification program, the servicer takes the following steps: 1) a specific proposed loan modification is designed based on the borrower's current ability to pay, 2) the anticipated payment stream under the loan as modified is compared with the anticipated recovery from foreclosure and liquidation on a net present value (NPV) basis, and 3) the servicer chooses the alternative with the greater NPV. In comparing a loan modification with a foreclosure and liquidation, the servicer normally would assume some likelihood that the loan as modified would re-default, and this factor reduces the net present value of the modification alternative. But if credit support were added that eliminated the re-default risk, then for any given proposed loan modification the servicer would be more likely to choose the modification over foreclosure, as long as the guaranty premium was less than the NPV reduction that would have resulted from the assumed re-default risk. In this regard, it should be noted that observed re-default rates for loan modifications are generally in the 25 - 40% range.

In order to encourage modifications and protect the taxpayer's interests, the guaranty program should be limited to servicers who have demonstrated that they have a robust, systematic modification program, with sufficient staffing and resources to handle a high volume of modifications. The modification program should include procedures to verify current income and a reliable model for evaluating NPV of modifications as well as foreclosure.

This guaranty program would be a very effective way to encourage modifications. The program would have the effect of potentially changing servicer behavior to use modifications in more cases, without creating a mandate or changing the operative documents. And, the program would encourage servicers to work harder to develop systematic loan modification programs, so as to qualify for participation in this program.

Purchasing defaulted loans out of securitizations under TARP

We believe that it would be possible to develop a program under TARP whereby defaulted mortgage loans could be purchased from securitization trusts at a discounted price. An important issue in implementing such a program would be resolving any FAS 140 barrier.

Such a program would be helpful because there are borrowers who cannot meet their mortgage payments but would like to stay in the home, and who would not be able to qualify for a loan modification that satisfies the NPV test (as compared to foreclosure) because they could document sufficient income. Borrowers with these characteristics also might not be able to qualify for a short refinancing under the Hope for Homeowners program or other available lending programs.

Defaulted loans purchased under the TARP program could be subject to a wide range of workout options. The borrower could be given a low interest rate loan with a reduced principal amount based on what the borrower could afford. Alternatively, title to the property could be taken by an entity established as part of the TARP program, or by a non-profit organization, and the property could be rented back to the prior borrower with a purchase option. These options would not be available for loans retained within a securitization.

Although typical servicing authority provisions have been broadly interpreted to allow loan modifications and other loss mitigation alternatives, these provisions have not been interpreted to allow such sales for a number of reasons, primarily because FAS 140 does not appear to permit sales of loans out of securitization trusts, and therefore securitization documents have been interpreted as implicitly prohibiting such sales.

That being said, most RMBS operative documents are in fact silent on the issue of whether defaulted loans can be sold for a discounted price, although a small minority do contain an express prohibition on such sales. Where the documents are silent, there is a strong argument that sales could be made pursuant to the general authority to service in accordance with the general servicing standard and if in the best interests of investors, under the following circumstances:

* The loan is in default

* The loan is sold to the Secretary under TARP for a cash purchase price

* The cash price is greater than the NPV of the anticipated recovery under a foreclosure, or under other potential alternatives (if available)

The servicer safe harbor under Section 119 of EESA would provide some legal protection for a servicer that interprets securitization operative documents as permitting a sale of defaulted loans to TARP at a discounted cash price as described above. Such a sale under should be considered to be "reasonable loss mitigation actions" that would be deemed to be in the best interests of all investors in that securitized pool.

However, an essential element of a program under TARP to purchase defaulted loans from securitizations at a discounted price would be an authoritative clarification of FAS 140 to permit such sales without adverse accounting treatment. Otherwise, a servicer could interpret the operative documents as not having been intended to allow such sales of defaulted loans.

<u>Use of TARP to apply market pressure</u>

Under TARP, the Secretary does have a very meaningful opportunity to bring market pressure to bear on servicers to adopt specific approaches to loan modifications and workouts, not only for whole loan pools purchased under TARP but also for residential mortgage-backed securities. One way to achieve this would be to restrict RMBS purchases to those securities where the servicer maintains a systematic modification program that is acceptable to the Secretary. RMBS that are serviced by servicers with an acceptable program might have a greater market value as a result.

These incentives may in some cases be sufficient to cause investors to seek to have servicing transferred on existing RMBS away from servicers who do not have an accepted modification program to ones that do. Such servicing transfers can be negotiated between the parties to the transfer, and would typically involve a payment to the transferring servicer. Securitization operative documents typically permit transfers of servicing without the investors' consent, provided that the new servicer meets specified criteria.

Supplemental Written Statement:

A. Background

1. Loss mitigation powers within securitizations

Most private label (non GSE) securitization governing documents give broad authority to the servicer to service loans in accordance with customary standards, and in a manner that is in the best interests of investors. Many securitization governing documents specifically authorize loan modifications where the loan is in default, or where default is reasonably foreseeable. Generally, modification of loans that are not in default (or where default is not reasonably foreseeable) could violate REMIC restrictions and therefore are not permitted under the securitization documents.

Servicing of loans that are held in a residential mortgage loan securitization is governed by the operative documents for the securitization, typically either a pooling and servicing agreement or servicing agreement. These agreements employ a general servicing practice standard. Typical provisions require the related servicer to follow accepted servicing practices and procedures as it would employ "in its good faith business judgment" and which are "normal and usual in its general mortgage servicing activities," and/or procedures that such servicer would employ for loans held for its own account. Some transactions also require that the servicer adhere to specific loss mitigation plans.

Most transactions address forbearance or modifying loans in default scenarios, and in some cases non-default scenarios. The provisions may require an opinion as to the continued REMIC status of the related securitization trust in order to modify a non-defaulted loan, which would be difficult to obtain. The "real estate mortgage investment conduit" sections of the Internal Revenue Code of 1986 (the "REMIC Provisions") impose tax impediments to modifying loans, unless the loan is in default or default is reasonably foreseeable. In general, the operative document provisions that permit the modification of defaulted loans are much broader and also provide for the ability to modify a loan so long as default is imminent or reasonably foreseeable.

The imminent default standard reflects a long-standing industry practice. The REMIC Provisions introduced the concept of "reasonably foreseeable" default. In order to permit a modification that would not impair the REMIC status of a securitization trust, the REMIC Provisions generally provide that a loan either (i) be in default or reasonably foreseeable default or (ii) not result in a "significant modification". Most market participants interpret the two standards of future default – imminent and reasonably foreseeable – to be substantially the same.

The modification provisions that govern loans that are in default or reasonably foreseeable default also require that the modifications be in the best interests of the securityholders or not materially adverse to the interests of the securityholders, and that the modifications not result in a violation of the REMIC status of the securitization trust.

In addition to the authority to modify the loan terms, such as changing the interest rate on a prospective basis, forgiving principal, and extending the maturity date, many securitization documents permit loss mitigation techniques, including forbearance, capitalizing arrearages, repayment plans for arrearages and other deferments which do not reduce the total amount owing but extend the time for payment. In addition, these agreements may permit loss mitigation through non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs. Even where these alternatives are not expressly laid out, the operative documents can reasonably be interpreted to allow these alternatives under the general servicing standard.

Certain transactions limit the total number of permitted occurrences of modifications for any individual loan. Certain provisions permit loans to be modified only once during any 12-month period and no more than three times during the life of the loan, or to modify a loan such that amounts owed are added to the principal balance of a loan only once during the life of that loan. Other transactions may limit the amount of modifications to a certain percentage of the initial size of the mortgage pool, or a certain percentage of individual loan groups within the total mortgage pool in some circumstances.

2. FAS 140 constraints

Statement of Financial Accounting Standards No. 140 ("FAS 140") may prohibit a qualifying special purpose entity ("QSPE") from having discretion to sell defaulted or delinquent loans. Most residential mortgage loan securitizations are structured as QSPEs. As a result, for securitizations structured as sales under FAS 140, it may not have been intended that the operative documents authorize the servicer to sell defaulted loans for cash at a discount, as a loss mitigation alternative. Most residential securitization operative documents do not contain an express prohibition on taking this action, although a small minority of them do. Nevertheless, if the practical effect of taking this action (or interpreting the documents as permitting such action) would be to retroactively disqualify the securitization as a FAS 140 sale, then a servicer may reasonably interpret the documents to not authorize this action. However, if FAS140 is amended or authoritatively interpreted to provide that the sale of delinquent or defaulted mortgage loans, where this action provides the best recovery on a net present value basis, would not prevent the related trust from qualifying as a QSPE, we believe that most securitization operative documents could be interpreted (or potentially amended without investor consent) to permit such sales consistent with the servicer's obligations to act in the best interests of such investors.

3. Provisions under the Emergency Economic Stabilization Act of 2008 (EESA)

Section 109(a) of EESA gives the Secretary of the Treasury, with respect to its purchase of certain assets under the Troubled Asset Relief Program (TARP), the following authority:

"To the extent that the Secretary acquires mortgages, mortgage-backed securities, and other assets secured by residential real estate, including multifamily housing, the Secretary shall implement a plan that seeks to maximize assistance for homeowners and use the authority of the Secretary to encourage the servicers of the underlying mortgages, considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program under section 257 of the National Housing Act or other available programs to minimize foreclosures. In addition, the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures."[1]

We interpret this reference to "other available programs" to include programs for modifying loans within existing securitizations, in addition to programs such as Hope for Homeowners, which would involve a short refinancing of a loan in a securitization (thereby removing the refinanced loan from the securitization).

4. Servicer safe harbors under HERA and EESA

Section 1403 of the Housing and Economic Recovery Act of 2008 created a safe harbor for servicers of residential mortgage securitizations, under which, "except as may be established" in the securitization governing documents, a servicer owes any duty to maximize recoveries to all investors in the pool rather than any specific investors, and a servicer is deemed to act in the best interests of all investors if it agrees to a modification or workout plan, where (A) default has occurred or is reasonably foreseeable, (B) the property is owner occupied, and (C) the anticipated recovery under the modification or workout "exceeds, on a net present value basis, the anticipated recovery... through foreclosure."[2] Section 119(b)(2) of EESA contains a similar provision as follows:

"Except as established in any contract, a servicer of pooled residential mortgages owes any duty to determine whether the net present value of the payments on the loan, as modified, is likely to be greater than the anticipated net recovery that would result from foreclosure to all investors and holders of beneficial interests in such investment, but not to any individual or groups of investors or beneficial interest holders, and shall be deemed to act in the best interests of all such investors or holders of beneficial interests if the servicer agrees to or implements a modification or workout plan when the servicer takes reasonable loss mitigation actions, including partial payments."[3]

This provision does not appear to directly supersede Section 1403 described above, but it does broaden the protection to servicers in two important ways. First, the standard "maximize the net present value" is broadened to determining whether the net present value of the loan as modified is "likely to be greater" than the foreclosure recovery, which is an easier standard to meet. Secondly, a modification or workout is deemed to be in the best interests of investors when the servicer merely "takes reasonable loss mitigation actions", which is again an easier standard to meet. This provision effectively opens up the safe harbor to situations where the loan is not in

[1] Emergency Economic Stabilization Act of 2008 at § 109(a).
[2] Housing and Economic Recovery Act of 2008 at § 1403; *see also* 15 U.S.C. 1601(129)(a).
[3] Emergency Economic Stabilization Act of 2008 at § 119(b)(2).

default, and also to non-owner occupied properties. Moreover, additional types of loss mitigation actions could be covered by this provision, such as selling a defaulted loan out of a pool to a distressed loan investor, for a discounted cash price that results in a better net present value recovery than a foreclosure.

One interpretive issue is whether Section 119(b)(2) was intended as a safe harbor applicable to all servicers in securitizations, or if the protections of this section were intended only to apply to transactions that are related to TARP. On its face the language appears to be broadly applicable, but the language may have been added to EESA primarily to facilitate the purchase of defaulted loans from securitizations under TARP.

5. Emerging trends in loan modification programs

Prior to the start of the credit crisis, loan modifications were used by servicers in limited circumstances. Since most first lien loans had enough equity to result in minimal losses on foreclosure, and since in many cases a borrower with payment difficulty could refinance into a new loan with lower payments, loan modifications were rarely used to address long term problems. Most loan modifications were actually forbearances, under which a borrower who had a short term difficulty in making payments would have a relatively short period of time to come current and repay arrearages.

Because modifications were not needed in large volumes and were made on a case by case basis, servicers did not need to follow a systematic program.

In today's environment, with high default rates and falling property values, loan modifications will be the best option for loss mitigation in a relatively high percentage of cases. This requires that the servicer follow a systematic approach in order to effectively design, evaluate and implement modifications. A servicer needs to have sufficient staff, as well as systems, procedures and models. In addition, there must be a detailed set of guidelines for designing and evaluating loan modifications.

Following are some key elements of a systematic loan modification program:

> Default or imminent default: the program should be limited to borrowers who are currently in default, or for whom default is reasonably foreseeable based on the original loan terms. Steps should be taken to confirm that the borrower did not deliberately default in order to be eligible for a modification.
>
> Income verification: there should be procedures for gathering specific information about the borrower's current income and expenses. Some programs omit income verification where the borrower is not likely to be able to afford projected increased monthly payments, for example on a hybrid ARM at its reset date.

Occupancy verification: there should be procedures for verifying that the property is being used by the borrower as its primary residence. Most loan modification programs are limited to owner occupied primary residences.

Defining affordability: there should be guidelines that define what payment level is considered affordable. For example, some programs use a 38% debt to income ratio to set a payment amount for a proposed loan modification.

Systematic modifications: the program should use a tiered approach in designing a proposed loan modification based on the borrower's income. For example, the following features could be applied, until an affordable payment level is reached: term or amortization period extension; interest rate reduction to a specified floor over a set period of time; and then principal reduction through partial forgiveness or forbearance. Most modification programs would set a reduced interest rate over a 5 year period, followed by a fixed rate over the remaining term of the loan which is a market rate as determined at the time of the modification.

NPV test: the net present value of the anticipated payment stream from the proposed modification should be compared with the net present value of the anticipated recovery that would be obtained from a foreclosure and liquidation of the property. The modification NPV should take into account a reasonable assumed re-default rate. The foreclosure NPV should take into account the estimated current property value, home price depreciation during the time required for liquidation, and other factors. Some streamlined programs use a current loan-to-value ratio floor instead of an NPV analysis.

Principal reductions: the modification program should contemplate a partial principal reduction as a way to reach affordability. Principal reductions should not be made solely because the property value has declined to below the mortgage balance, but rather should only be made for borrowers who have defaulted or who cannot afford the loan's original terms.

Forgiveness v forbearance: in making a partial reduction of the loan amount as part of a modification, either forgiveness or forbearance should be used. Forgiveness is a permanent reduction of the principal amount. The advantages of this approach are that the borrower perceives himself to be no longer underwater, and a "renter's mentality" under which the borrower might be disinclined to maintain the property is reduced. Forbearance would involve maintaining some or all of the amount that would have been forgiven as a lien on the property, in effect as a non-interest bearing balloon payment which is made only when the property is sold or refinanced. This approach has the advantage of allowing the lender or investor to share in the potential upside if the property value increases in the future. In addition, if there was a second lien on the property prior to the modification, forbearance prevents putting the second lienholder in a position where it can recover its loan at the expense of the first lienholder.

B. Ways to increase loan modifications and foreclosure prevention going forward

1. Guaranty program on loans in securitizations

The final sentence of EESA Section 109(a) provides that "[T]he Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." If the Secretary were to make available credit enhancement under a guaranty program that covered specific loans that had been modified, this could alter the equation of the servicer's net present value determination. As described in A 5 above, under a typical loan modification program, the servicer takes the following steps: 1) a specific proposed loan modification is designed based on the borrower's current ability to pay, 2) the anticipated payment stream under the loan as modified is compared with the anticipated recovery from foreclosure and liquidation on a net present value (NPV) basis, and 3) the servicer chooses the alternative with the greater NPV. In comparing a loan modification with a foreclosure and liquidation, the servicer normally would assume some likelihood that the loan as modified would re-default, and this factor reduces the net present value of the modification alternative. But if credit support were added that eliminated the re-default risk, then for any given proposed loan modification the servicer would be more likely to choose the modification over foreclosure, as long as the guaranty premium was less than the NPV reduction that would have resulted from the assumed re-default risk. In this regard, it should be noted that observed re-default rates for loan modifications are generally in the 25 - 40% range.

There are a number of issues to consider in designing a program for guarantying modified loans held within securitizations. First, should the guaranty amount be the entire amount of the loan as modified, or a portion of the loan balance? It may be that guarantying only a portion of the balance is needed to achieve the desired effect of enabling the servicer to choose the modification. In calculating NPV of the loan as modified, if the guaranty was limited to an amount needed to cover any loss on liquidation if there was a re-default (based on an estimate of the property value after a re-default), that might be enough to mitigate the re-default risk. If as part of the loan modification there was a partial principal reduction, that would reduce the amount of coverage needed under the guaranty. The program could be structured to offer a range of options for a guaranty based on different assumptions as to the amount of any principal reduction included in the modification. The program could offer risk based premiums set on a loan by loan basis, and tied to factors including the current loan to value ratio of the loan immediately after the proposed modification. The guaranty would not cover any principal reduction included in the modification, whether the reduction is made by forgiveness or by forbearance.

The program could also include a feature under which, if and when a claim is made under the guaranty on a modified loan that re-defaults, the Secretary would have the option to purchase the loan from the securitization pool at its face amount (as modified at the time the guaranty was placed). The loan could then be liquidated, modified or otherwise worked out under a wide variety of options as described under B 2 below. This would enable the Secretary to avoid foreclosure and minimize loss to the taxpayers.

One question is whether the Secretary's loan guaranty authority under Section 109 is within the overall TARP program limit. Although that may have been intended, there is no clear link within EESA between this guaranty authority and the program limit.

Another major issue for the guaranty program would be, to whom would the program be available? In order to encourage modifications and protect the taxpayer's interests, the guaranty program should be limited to servicers who have demonstrated that they have a robust, systematic modification program, with sufficient staffing and resources to handle a high volume of modifications. The modification program should include the features described in A 5 above, including procedures to verify current income and a reliable model for evaluating NPV of modifications as well as foreclosure. There could be a procedure under which a servicer's loan modification program is reviewed, following which the servicer may be approved for purchasing loan guarantees under this program. In this regard, there should be flexibility to allow differing approaches to key program elements, such as the definition of affordability, the tiers for proposed loan modifications, the models used to estimate NPV and the key assumptions used in the model, as these matters may vary from servicer to servicer.

This guaranty program would be a very effective way to encourage modifications. It could be available both for loans that are within securitized pools, as well as loans held in portfolio. The program would have the effect of potentially changing servicer behavior to use modifications in more cases, without creating a mandate or changing the operative documents. And, the program would encourage servicers to work harder to develop systematic loan modification programs, so as to qualify for participation in this program.

Moreover, this additional credit enhancement should increase the market value of the related RMBS, because the re-default risk on loans in the securitization which had been modified would be mitigated by the guaranty.

2. Purchasing defaulted loans out of securitizations under TARP

We believe that it would be possible to develop a program under TARP whereby defaulted mortgage loans could be purchased from securitization trusts at a discounted price. The advantages of such a purchase program and its legal basis are discussed in this section. An important issue in implementing such a program would be resolving any FAS 140 barrier.

Under EESA, the Secretary may purchase troubled assets under TARP, including residential mortgage loans, from any "financial institution". While the definition of a financial institution does not explicitly include common law trusts (the typical form used for residential securitizations), legal title to the mortgage loans in residential securitizations is held by a trustee, which is clearly an eligible "financial institution" under EESA. If however the definition were not so interpreted, a defaulted loan purchase program could be structured so that loans would be bought from securitization trusts through financial institution intermediaries.

Such a program would be a very helpful development because it could provide relief to borrowers who could not be helped under the other forms of loss mitigation available, including loan modifications, short sales and short refinancings. There is currently no program available for sale of defaulted loans at a discounted value out of a securitization trust, and it is generally thought that servicers do not have the authority to do so.

This program would be helpful because there are borrowers who cannot meet their mortgage payments but would like to stay in the home, and who would not be able to qualify for a loan modification that satisfies the NPV test (as compared to foreclosure) because they could document sufficient income. Borrowers with these characteristics also might not be able to qualify for a short refinancing under the Hope for Homeowners program or other available lending programs.

For borrowers in default for whom foreclosure or short sale is the only option available to the servicer, it would be consistent with the investors' best interests to be able sell the loan out of the securitization trust at a discounted cash price, where the cash price is greater than the net present value of the anticipated recovery from foreclosure. If defaulted loans could be sold under these circumstances into a government or non-profit program the purpose of which was to maintain the borrower in the home pending an economic recovery, RMBS investors would be indirectly benefited because this would reduce foreclosure sales and the downward pressures on home values that they cause.

Defaulted loans purchased under the TARP program could be subject to a wide range of workout options. The borrower could be given a low interest rate loan with a principal amount set at e.g. 85% or 90% of the property's current market value. The rate could be set to an amount the borrower could afford, with an adjustment to a market rate in 5 years. This would encourage a sense of ownership and give the borrower a fresh start. Alternatively, title to the property could be taken by an entity established as part of the TARP program, or by a non-profit organization, and the property could be rented back to the prior borrower with a purchase option. These options would not be available for loans retained within a securitization, to the extent that the NPV of the recovery under these options was less than the NPV of a foreclosure.

The question then arises as to whether a servicer under typical securitization operative documents would have the authority to sell a defaulted loan at a discounted cash price under TARP. Although typical servicing authority provisions have been broadly interpreted to allow loan modifications and other loss mitigation alternatives (see A 1 above), these provisions have not been interpreted to allow such sales for a number of reasons. First, such sales to date have not been a standard servicing practice. Second, typical provisions direct the servicer to itself foreclose on or otherwise liquidate or workout defaulted loans, and do not appear to contemplate selling the loan for cash to a third party such as a collection agency or a distressed asset investor. Third, some securitization documents contain an express provision allowing the servicer to purchase for its own account a defaulted loan, but these provisions typically specify a par price. Finally, as described under A 2 above, FAS 140 does not appear to permit sales of loans out of securitization trusts, and therefore securitization documents have been interpreted as implicitly prohibiting such sales.

That being said, most RMBS operative documents are in fact silent on the issue of whether defaulted loans can be sold for a discounted price, although a small minority do contain an express prohibition on such sales. Where the documents are silent, there is a strong argument that sales could be made pursuant to the general authority to service in accordance with the general servicing standard and if in the best interests of investors, under the following circumstances:

* The loan is in default

* The loan is sold to the Secretary under TARP for a cash purchase price

* The cash price is greater than the net present value of the anticipated recovery under a foreclosure

* The cash price is greater than the net present value of other potential alternatives (if available) including the servicer's modification program, a short sale or any available short refinancing.

The servicer safe harbor under Section 119 of EESA (see A 4 above) would provide some legal protection for a servicer that interprets securitization operative documents as permitting a sale of defaulted loans to TARP at a discounted cash price as described above. Such a sale under the conditions listed above should be considered to be "reasonable loss mitigation actions" that would be deemed to be in the best interests of all investors in that securitized pool.

However, a servicer could not rely on the safe harbor, and should not engage in the sale of defaulted loans at a discounted cash price, if the securitization operative documents expressly prohibit such actions.

Finally, before participating in a program for the sale to TARP of defaulted loans at a discounted cash price, the servicer should consider whether taking that action would cause the entity that sold the loans into the securitization to no longer be able to treat that transaction as a sale under FAS 140. For the reasons described above, a servicer could interpret the operative documents as not having been intended to allow such sales of defaulted loans if that adverse accounting treatment would result.

For these reasons, an essential element of a program under TARP to purchase defaulted loans from securitizations at a discounted price would be a clarification of FAS 140. We note that on July 18, 2007 the Office of the Chief Accountant (OCA) of the Securities and Exchange Commission issued a memorandum that gave broad support for the proposition that "entering into loan restructuring or modification activities (consistent with the nature of activities permitted when a default has occurred) when default is reasonably foreseeable does not preclude continued off-balance sheet treatment under FAS 140". In addition, the OCA issued a letter dated January 8, 2008 that provided similarly helpful guidance under FAS 140 as to the ASF's Streamlined Foreclosure and Loss Avoidance Framework.

We would hope that the OCA or the Financial Standards Accounting Board could issue favorable guidance on the FAS 140 issue under a TARP defaulted loan purchase program. Such guidance could be limited to sales under the TARP program, under the circumstances outlined above.

3. Use of TARP to apply market pressure

Under TARP, the Secretary does have a very meaningful opportunity to bring market pressure to bear on servicers to adopt specific approaches to loan modifications and workouts, not only for whole loan pools purchased under TARP but also for residential mortgage-backed securities. One way to achieve this would be to restrict RMBS purchases to those securities where the servicer maintains a systematic modification program that is acceptable to the Secretary (see A 5 above for a discussion of key features of a systematic loan modification program). For example, a review could be performed of existing modification/workout programs of the major residential loan servicers, and the Secretary could publish a list of those servicers that maintain a program acceptable to the Secretary. (This review process could be part of, or in addition to, the review process for the modified loan guaranty program discussed in B 1 above.) Financial institutions holding substantial blocks of RMBS that are serviced by servicers that do not have such an acceptable program, would then have an economic motivation to pressure those servicers to adopt enhanced modification/workout programs. Also, RMBS that are serviced by servicers with an acceptable program might have a greater market value as a result.

These incentives and economic considerations may in some cases be sufficient to cause investors to seek to have servicing transferred on existing RMBS away from servicers who do not have an accepted modification/workout program to ones that do. Such servicing transfers can be negotiated between the parties to the transfer, and would typically involve a payment to the transferring servicer. Securitization operative documents typically permit transfers of servicing without the investors' consent, provided that the new servicer meets specified criteria.

4. Potential changes to REMIC

As discussed in A 1 above, most residential mortgage backed securities are structured as REMICs for federal income tax purposes. The REMIC Provisions include a number of restrictions, including that loan modifications are effectively prohibited unless the loan is either in default or default is reasonably foreseeable. The question arises, whether any amendments to the REMIC Provisions would be necessary or helpful in enhancing the ability of servicers to engage in more loan modifications.

One change that could be made would be to permit loan modifications where the loan is not in default and where default is not reasonably foreseeable. However, this change would not necessarily result in more loan modifications. In deciding whether to modify a loan, the servicer must compare the modification to a foreclosure and liquidation scenario, which is not realistic unless default is at least reasonably foreseeable. Generally, securitization operative documents would not permit a loan modification if the borrower was able to pay the loan under its original terms.

5. Amending existing securitization documents

The ability to amend any securitization document to allow modifications and workouts (or to change express restrictions thereon) is very limited, other than for amendments that are made under limited provisions that allow changes without investor consent for matters such as curing errors or ambiguities in the documents. In most cases, an amendment would require a supermajority approval from each separate class outstanding. It should also be noted that some transactions do impose express restrictions on modifications, such as number of loans that may be modified, or a limit on rate reductions. Further, most transactions would restrict a maturity extension. These express restrictions are not superseded by either of the servicer safe harbors described in A 3 above, and would not be overridden by any provision of EESA.

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November 18, 2008

Committee on Oversight and Government Reform
U.S. House of Representatives
Subcommittee on Domestic Policy
B-349B Rayburn House Office Building
Washington, D.C. 20515
Attn: Mr. Jaron R. Bourke

Re: Domestic Policy Subcommittee of the Oversight and Government Reform Committee hearing, "Is Treasury Using Bailout Funds for Foreclosure Prevention, as Congress Intended?"

Dear Jaron,

Thank you for the opportunity to appear on November 14, 2008 at the above-referenced hearing. As we discussed this letter is to confirm that the views I expressed at the hearing were my own and that I was not speaking on behalf of Thacher Proffitt and Wood LLP or any of the firm's clients.

I would be happy to help further with the review and discussion of issues covered in the hearing.

Best regards,

Steve Kudenholdt

SSK/rh

Mr. KUCINICH. I thank the gentleman.

Mr. Deutsch, you may proceed.

STATEMENT OF THOMAS DEUTSCH

Mr. DEUTSCH. Chairman Kucinich, my name is Tom Deutsch, and I am the deputy executive director of the American Securitization Forum. I very much appreciate the opportunity to testify before this committee on behalf of the more than 330 member institutions of the American Securitization Forum, including mortgage lenders, servicers and institutional investors, regarding how the securitization industry and the Federal Government can work together to prevent avoidable foreclosures under the new Emergency Economic Stabilization Act.

I testify here today with one simple overarching message: Industry participants have been and will continue to deploy aggressive and streamlined efforts to prevent as many avoidable foreclosures as possible. But let me also repeat the statement that you quoted earlier today, that macroeconomic forces bearing down on an already troubled housing market are simply too strong for private sector loan modification initiatives alone to counteract the systematic risks imposed by a nationwide increase in mortgage defaults and foreclosures.

In my testimony here today, I look to outline a number of ways that the industry and the government can work together under TARP to target relief to troubled homeowners while simultaneously helping to restore credit to mortgage borrowers.

The economic and housing market conditions have clearly deteriorated over the last 18 months, and that deterioration has intensified recently. Job losses, declining home values and borrowers' extraordinary non-mortgage consumer debt have combined to put severe strain on homeowners and drive rising delinquencies, defaults and foreclosures. Given these unprecedented challenges, servicers have responded with unprecedented efforts, as no securitization market constituency, lenders, servicers or investors, benefits from loan defaults or foreclosures.

As a result, the number of loan modifications, for example, has increased by over six times the rate at which they were being provided to borrowers at this time last year. One driving force behind this exponential increase was the streamlined framework the American Securitization Forum developed last year that all major servicers have implemented to provide efficient loan modification decisions to subprime-ARM borrowers facing interest rate resets.

In an effort to expand this framework, we are actively reviewing criteria from other streamlined loan modification approaches that have recently been announced, such as the plan implemented by the FDIC at IndyMac and the Federal Housing Finance Agency protocol announced on Wednesday.

Ultimately though, we must all recognize the seismic economic challenges in the United States, the epicenter of which is in the housing market, are too great for purely private sector loan modification solutions. As such, evolving private sector loan modification activities, though playing an important part of the solution, have limits in their effectiveness in addressing the extraordinary challenges in the housing market and should not be seen as a panacea for all housing market ills. As such, we believe expanded voluntary government programs under TARP would be very effective in bridging the gap to address the potential foreclosures that commercial and contractual obligations cannot prevent.

The newly enacted TARP contains significant opportunity for the Federal Government to use guarantees to incentivise additional loan modifications for distressed borrowers. In particular, the act specifically authorizes that the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.

We believe there have been some positive general approaches put forth; for example, by the chairman of the FDIC, that would have the Federal Government through TARP provide credit guarantees for redefaults on modified loans that would substantially increase the number of loan modifications granted and ultimately foreclosures avoided. But the details of the program, such as that which was announced this morning, are very important. Issues like DTI and LTV requirements are thoroughly under review by our members as we speak to evaluate the program and to see about the next steps the ASF may be able to take.

Since the TARP program announced, there continues to be a great deal of discussion, much of which has occurred today, regarding what assets the program would purchase and how that ownership would give the Federal Government control over the servicing of those assets. If whole loans were purchased by TARP directly from the banks, for example, the government would have complete discretion to apply its own loss mitigation and loan modification protocols to those loans. But if the TARP program were to buy mortgage-backed securities in whole, their ability to exercise control over servicing policy to effectuate their own loan modifications would be limited unless the program purchased a supermajority of each outstanding class of each note in the trust.

Given that there is currently $7.5 trillion of securitized mortgage debt outstanding in the United States, which is slightly more than half of the $14.8 trillion of mortgage debt outstanding, a third opportunity for TARP should be explored. That is, in this time of extraordinary housing market dislocation, it may be appropriate for the industry, accounting standard setters and tax officials to reevaluate the ability of servicers to be able to sell individual distressed loans out of mortgage-backed securities pools to TARP, which could give the Treasury Department unlimited discretion to modify those loans under whatever protocol they think appropriate. Currently, mortgage loan servicers generally do not have the legal ability to sell distressed loans out of mortgage securities.

I would note that it is critical that these programs remain voluntary. As we have noted and as we have heard today, one of the primary objectives of TARP is to restore credit availability to mortgage and consumer assets throughout the country. Anything other than voluntary could greatly put that at risk and further entrench the credit crisis.

I thank you very much for the opportunity to testify here today, and look forward to answering any questions that you may have.

[The prepared statement of Mr. Deutsch follows:]

Statement of

Tom Deutsch
Deputy Executive Director
American Securitization Forum

Testimony before the

Committee on Government Oversight and Reform
Subcommittee on Domestic Policy
United States House of Representatives

Hearing on

"Is Treasury Using Bailout Funds to Increase Foreclosure Prevention, as Congress Intended?"

November 14, 2008

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Chairman Kucinich, Ranking Member Issa and distinguished Members of the Subcommittee,

My name is Tom Deutsch and I am the Deputy Executive Director of the American Securitization Forum (ASF).[1] I very much appreciate the opportunity to testify before this Committee again on behalf of the 330 member institutions of the ASF, including mortgage lenders, servicers and investors, regarding loan modifications and how the mortgage-backed securities (MBS) industry and government can work together to prevent avoidable foreclosures.

I testify here today with one simple overarching message—industry participants have been and will continue to deploy aggressive and streamlined efforts to prevent as many avoidable foreclosures as possible. But macro economic forces bearing down on an already troubled housing market are simply too strong for private sector loan modification initiatives alone to counteract the nationwide increase in mortgage defaults and foreclosures. In my testimony today, I will outline a number of ways that the industry and the government can work together to target relief to troubled homeowners, while simultaneously helping to restore capital flows into the U.S. housing markets.

Overview of Testimony

The testimony that follows addresses four principal topics:

1) Current economic and housing market conditions, and the challenges those conditions impose on efforts to prevent foreclosures via loan modifications;
2) The goals, progress and limitations of industry loan modification initiatives targeting securitized residential mortgage loans to date;
3) Additional efforts underway within the securitization industry to further facilitate and streamline the loan modification process; and
4) Perspectives on additional steps that we believe the federal government should consider to expand opportunities to modify and refinance troubled mortgage loans through the Troubled Asset Relief Program (TARP), to avoid foreclosures and to help stabilize the broader housing market.

Current Economic and Housing Market Conditions; Challenges for Loan Modification Initiatives

Economic and housing market conditions have significantly deteriorated over the last eighteen months, and that deterioration has intensified recently. The primary factors our members have

[1]ASF is a broad-based professional forum of over 330 member organizations that are active participants in the U.S. securitization market. Among other roles, ASF members include institutional investors, servicers, issuers, financial intermediaries, and professional advisers working on securitization transactions backed by all types of mortgage and consumer credit assets. ASF's mission includes building consensus, pursuing advocacy and delivering education on behalf of the securitization markets and its participants. Additional information about the ASF, its members and activities may be found at ASF's internet website: www.americansecuritization.com. ASF is an independent affiliate of the Securities Industry and Financial Markets Association (SIFMA).

identified that have combined to put severe strain on homeowners and drive rising delinquencies, defaults and foreclosures include:

1) unavailability of mortgage credit for refinancing opportunities;
2) declining home values;
3) high levels of non-mortgage credit outstanding (e.g., credit card, auto loan, other debt);
4) prevalence of 2^{nd} liens; and
5) rising unemployment levels and reductions in income, making mortgage payments unaffordable.

While critically important and increasingly employed, industry-led loss mitigation initiatives, including loan modifications, are not a panacea for declining home prices, mortgage defaults and foreclosures. Loan modifications are a viable foreclosure avoidance option for only a subset of mortgage borrowers now at risk of default. In general, loan modifications are appropriate and can be effective only for borrowers who: a) cannot afford their current or future mortgage payment; b) wish to remain in the home and are capable of managing the broader responsibilities of home ownership; and c) can afford a reasonable mortgage payment as modified. Loan modifications cannot overcome situations in which a borrower does not evidence a desire to stay in the home, or cannot afford payments on the loan as modified, even with significant reductions in interest or principal payments. Unfortunately, an increasing number of borrowers share one or both of these characteristics. A brief examination of recent mortgage market dynamics helps to explain why this is the case.

As prices have declined over the last two years, approximately 1 out of every 4 mortgage borrowers now owes more on their homes than what those homes are worth (underwater mortgages). Although these value declines are clearly unwelcome, they ultimately do not increase the monthly payment obligations for borrowers and therefore do not affect the affordability of their mortgage obligations. As such, most of these borrowers continue to pay on time. Unfortunately, some borrowers choose to ignore their obligations and 'walk away' from their homes, resulting in a foreclosure. Similarly, as financial obligation ratios have reached an all-time high,[2] servicers are finding an increasing number of borrowers whose mortgage and consumer debts (such as credit cards and auto loans), even after significant mortgage modifications, simply are too high, given their incomes, to sustain their mortgage payments. These borrowers face challenges in meeting debt obligations that extend well beyond their mortgage. This may help to explain why some 30-50% of mortgage payment defaults proceed to foreclosure with no borrower response to servicer outreach via phone calls and mailings—even where some of those borrowers might otherwise qualify for a modification.

Many borrowers having difficulties meeting their payments on their primary mortgage also have a 'silent' second lien (in the form of a home equity loan or line of credit). Second liens are serviced separately and often times by a different servicer than that of the first lien. A recent study estimates that approximately half of 2006 borrowers with a securitized subprime first lien mortgage have a second lien exposed or hidden behind that first lien.[3] In addition to contributing to an increased debt load and low or negative home equity for borrowers, the existence of these

[2] Loan Performance Data
[3] Loan Performance Data

second liens creates significant difficulties for servicers who might be considering modifying the first lien, especially in situations like a Hope for Homeowners (H4H) refinancing where the owner of the second lien is required to extinguish to allow the first lien to refinance. Also, servicers of first liens seeking to apply loss mitigation techniques, including interest and/or principal reductions, have to take into account the second lien. They cannot compel the second lien controlled by a different servicer to employ equal or greater loss mitigation strategies on the second lien as the first lien. Proper and efficient coordination of second liens has and is expected to continue to be a significant obstacle in expediting help for troubled borrowers.

We support changes such as one made in the Emergency Economic Stabilization Act (EESA) to the H4H program that allows the Department of Housing and Urban Development (HUD) to make payments "to any holder of an existing subordinate mortgage, in lieu of any future appreciation payments..."[4] Given the existing operational, legal and economic difficulties of extinguishing these second liens, the ability to provide direct payments rather than equity upside incentives will help expedite the process of appropriately clearing away second liens.

Even in situations where servicers successfully identify, grant and communicate a loan modification that meets a distressed homeowner ability to pay, up to 44% of borrowers have redefaulted after the lender has granted a modification concession.[5] As such, a redefault by a modified loan can expose the holder of that loan to even greater losses in a declining home price market.

Potentially the most troubling macro economic factor impacting the housing market today is the rapidly increasing levels of unemployment in America, which will continue to increase the rate of mortgage defaults and foreclosures. For example, Freddie Mac found that in June of 2008 45.5% of all delinquencies were due to unemployment or loss of income. Given recent announcements of additional job reductions across a wide range of industries and geographic regions, servicers are preparing for an even larger uptick in delinquencies due to rapidly rising unemployment levels. Especially in protracted economic downturns like our current one, a borrower who is laid off is not likely to find new employment that ultimately supports the same lifestyle and mortgage payment as his or her previous employment. In these situations, retention of the borrower's current home may not be sustainable even with an aggressive loan modification.

Ultimately, it must be recognized that the seismic economic challenges in the United States, the epicenter of which is the housing market, are too great for purely private sector loan modification solutions. As such, evolving servicer loss mitigation activities, though playing an important part of the solution, will not be sufficient to address the steep challenges the American housing market faces today. In addition to expanded industry efforts, federal government initiatives, such as H4H and the Troubled Asset Relief Program (TARP), will have to be even more aggressive in their efforts to stabilize homeownership, neighborhoods and communities around the country.

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[4] Emergency Economic Stabilization Act, Section 124 (2008).

[5] Credit Suisse Fixed Income Research, Subprime Loan Modifications Update, October 1, 2008.

Current and Future Industry Loan Modification Initiatives

Notwithstanding the formidable challenges outlined above, securitization industry participants have worked to avoid foreclosures and mitigate losses on defaulted loans wherever possible. From July 2007 through September 2008, some 2.5 million troubled borrowers were assisted by industry loan modification and loss mitigation initiatives. Those efforts continue, for example, in September 2008 alone, servicers helped some 212,000 borrowers avoid foreclosure, 30,000 more than the previous record established in August 2008.[6] Through these efforts, the number of loan modifications and workouts has increased by over six times the rate at which they were being provided to borrowers at this time last year.

Securitization industry participants have strong incentives to pursue loan modifications because, as a general matter, no securitization market constituency—including lenders, servicers and investors—benefits from loan defaults and foreclosures. Because foreclosure is usually the most costly means of resolving a loan default, it is typically the least-preferred alternative for addressing a defaulted loan, whether or not the loan is held in a securitization trust. Although there is variation among individual transactions, most securitizations provide servicers with significant flexibility to engage in loan modifications and other loss mitigation techniques, subject to contractual obligations that the particular loss mitigation alternative selected maximizes the net present value, or ultimate recovery, on the related mortgage loan.

Given the multiple variables and detailed analysis involved, this can be a complex and difficult judgment for servicers to make. Where a loan modification is pursued, the servicer must be able to demonstrate a reasonable basis for concluding that the particular modification selected is likely to produce a greater recovery than other loss mitigation alternatives available, including but not limited to foreclosure. ASF therefore recognizes and strongly supports the benefit of providing additional, industry consensus guidance on ways that servicers can fulfill more efficiently their obligations to mitigate losses and maximize recoveries on distressed mortgage loans, in a manner that is also consistent with their duties to investors. As outlined below, we have taken steps to provide this guidance in the past, and are actively engaged in additional efforts to provide additional guidance to servicers in light of the increasing challenges they face.

Over the past two years, the ASF has worked to develop several market standards and practices initiatives aimed at promoting the utilization of loss mitigation and loan modification strategies to prevent avoidable foreclosures. For example, in December, 2007, ASF announced the release of the first systematic protocol, the ASF Streamlined Foreclosure and Loss Avoidance Framework for Securitized Adjustable Rate Mortgages ("ASF Framework"), which outlines systematic criteria that servicers can use to streamline the evaluation of their subprime hybrid ARM portfolios and offer appropriate solutions to borrowers facing significant interest rate resets.

As a result of servicers' efforts under the ASF Framework, approximately 111,000 subprime ARMs have been modified with over 73 percent of these modifications having a duration of 5 years or longer.[7] As outlined in two scenarios in Appendix A of this testimony, servicers

[6] Hope Now Alliance October Data Release.
[7] Hope Now Alliance October Data Release.

generally seek to employ interest rate modifications to achieve affordability for the borrower prior to contemplating any principal reductions. A recent study on the use of loan modifications notes that, "Because of ASF's streamlined loan mods plan beginning in January 2008, this type of mod [rate reset] currently makes up the largest group of subprime loan mods."[8] The fact that very few borrowers are experiencing delinquencies caused by a resetting interest rate on a subprime ARM ultimately demonstrates the ASF Framework has been effective in achieving the targeted aim.

Notwithstanding the above initiatives, in light of the recent deterioration in the broader economy and housing market, ASF is working aggressively to develop an expanded framework that servicers can use to modify loans in a manner that is consistent with appropriate loan modification goals, and with the contractual rights and commercial expectations of institutional investors. A group of ASF members, including investors, is reviewing criteria from other loan modification approaches that have recently been announced, such as the plan implemented by the FDIC with respect to loans it acquired via the receivership of IndyMac Bank or the plan the Federal Housing Finance Agency (FHFA) announced on Tuesday. We believe that the development and application of an investor-developed framework with input from all stakeholders can help to establish broader consensus on ways that loan modifications can be effectuated in a manner that appropriately targets them efficiently and effectively. We are optimistic that this new approach will promote an even greater number of appropriate loan modifications delivered throughout the industry via more streamlined processes.

Some of the key challenges that we are actively working to address include:

1. Developing a mechanism to distinguish between troubled borrowers needing assistance and borrowers who otherwise have an ability to pay and don't need assistance;
2. Addressing the motivations that might exist for non-troubled borrowers to default or to attempt to disguise their true ability to pay;
3. Streamlining methods of verifying troubled borrowers true income and occupancy status to avoid 'no doc loan mods' that assist housing speculators;
4. Addressing the complex challenges presented by pay option ARMs in a depreciating housing market;
5. Developing operationally-efficient, market-accepted methods to compensate and extinguish second liens to allow a first lien to refinance into a more sustainable loan;
6. Creating appropriate loss mitigations on second liens that are proportionate and appropriate in relation to the loss mitigation being applied to first lien positions;
7. Designing better evaluative tools for all of a borrowers' debts, including both mortgage and consumer debts, to make more effective and sustainable loss mitigation solutions;
8. Accounting for a borrower's relative income bracket, size of loan and geographical location in any calculation that compares their mortgage debt with their income;
9. Addressing operational challenges of detecting borrower, broker or other fraud in origination that would trigger alternative approaches; and
10. Providing greater market practice clarity to servicers to apply appropriate streamlined loss mitigation techniques in compliance with their pooling and servicing agreements.

[8] Credit Suisse Fixed Income Research, Subprime Loan Modifications Update, October 1, 2008.

Government Opportunities under TARP to Expand Loan Modification Alternatives

Although industry-driven loan modification and loss mitigation actions have been and will continue to be key components to preventing avoidable foreclosures, there are limits to their effectiveness in addressing the extraordinary challenges in the housing market. As such, we believe expanded government programs may be effective in bridging this gap, and helping to address the potential foreclosures that commercial and contractual arrangements cannot prevent. The nationwide home price correction and persistent uptick in foreclosures present systemic risks to the national economic infrastructure. Moreover, foreclosures are bad for everyone—borrowers, communities and investors. Vacant homes drive down home prices and invite crime. Given these extraordinary systemic risks and public policy concerns, we believe the federal government could helpfully supplement industry initiatives to modify and expand voluntary programs to aggressively seek to prevent additional foreclosures in three primary areas under TARP: 1) Guaranty loan modification redefault risk; 2) Purchase individual loans out of securitization trusts; and 3) Provide lender or guaranty facilities for servicer advances.

- **Federal Guaranty of Loan Modification Redefault Risk**

The federal government could use authorization under EESA to provide guarantees to incentivize additional loan modifications for distressed borrowers, as the Act specifically authorizes that "the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures."[9] We believe there have been some positive proposals put forth by, for example, the Chairman of the FDIC that would have the federal government, through TARP, provide credit guarantees for redefaults on modified loans. Although there are a number of details that would need to be worked out on both the modification protocols as well as the guarantee arrangements, ASF believes there is significant opportunity for such an approach to work. A well-tailored program could result in a significant increase in loan modification activity to help homeowners stay in their homes and provide significant support for a declining housing market. In sum, there appears to be a substantial opportunity to marry a much larger industry-wide loan modification protocol with a guarantee program under TARP.

One particular benefit of a guarantee program under TARP is that the same outlay of funds through a guarantee program could provide support for a significantly higher number of outstanding loans than can be assisted via other means. Direct purchase of loans, although a desirable option to consider, requires direct and immediate use of the limited capital available under TARP. A guarantee program may in some cases then be a more efficient use of limited TARP funds.

- **Direct Purchase of Loans Out Of Securitization Trusts**

Since the TARP program was announced, there continues to be a great deal of discussion regarding what assets the program would purchase and how that ownership would give the federal government control over the servicing of those assets. If whole loans are purchased by TARP, for example, the government would clearly be able to apply its own loss mitigation protocols to those loans. If the TARP program were to buy mortgage-backed securities (MBS)

[9] Emergency Economic Stabilization Act, Section 109 (2008).

though, their ability to exercise control over the servicing policy of any particular trust would be limited unless a supermajority of each outstanding class of notes of that trust were to vote to amend the underlying pooling and servicing agreements.

One potential opportunity is that TARP could purchase individual distressed loans out of MBS trusts, which could give the Treasury Department unlimited discretion to modify those loans. Historically, whole loans have not been sold out of securitization trusts by servicers for a variety of legal, tax, and accounting constraints. The ASF supports, where feasible, facilitating such purchases as part of a broader range of loss mitigation alternatives, and has recently undertaken a review of the various opportunities and obstacles for servicers to sell below par individual distressed loans out of MBS to the TARP. Today, we report out in this testimony some of the initial findings and conclusions of that review.

The ability of a servicer to sell a securitized mortgage loan in default (Defaulted Mortgage Loan) or one where default is imminent or reasonably foreseeable (Imminently Defaulting Mortgage Loan) is dependent on the tax and accounting consequences of any such sale and the specific contract provisions of the governing servicing agreement (Securitization Servicing Agreement).

1. Accounting

Most residential mortgage securitization trusts are structured to be treated as "qualifying special purpose entities" (QSPEs) for purposes of FAS 140. The mortgage loans held by a securitization trust that satisfy the QSPE requirements are treated as being sold under FAS 140 and are not consolidated under FIN 46(R) on the books of any party. Servicers will not take any action under a Securitization Servicing Agreement that would alter the accounting treatment of the securitization trust as a QSPE. The QSPE requirements under FAS 140 prohibit a servicer from selling a Defaulted Mortgage Loan or Imminently Defaulting Mortgage Loan from a QSPE securitization trust even where the servicer determines that such sale would represent the loss mitigation technique that results in the maximum net proceeds (on a net present value basis) to the securitization trust.

In order to be considered a QSPE, a securitization trust must comply with the requirements set forth under FAS 140, including among others, certain limits on its ability to sell assets from the securitization trust. FAS 140 specifically identifies activities not permitted by QSPEs. One of the prohibited activities consists of giving the entity power "to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure." Providing the servicer of a QSPE securitization trust with the option of selling a Defaulted Mortgage Loan or Imminently Defaulting Mortgage Loan in lieu of foreclosing or pursuing other non-foreclosure loss mitigation options fits squarely within the above-referenced QSPE prohibited activity. As such, a servicer of a QSPE securitization trust will not be permitted to consider such sales as a loss mitigation option, absent explicit authorization from the SEC or FASB that they would not object to sales of Defaulted Mortgage Loans or Imminently Defaulting Mortgage Loans from QSPE securitization trusts and will not alter the continuing QSPE treatment of securitization trusts.

2. Tax/REMIC

Most residential mortgage securitization trusts elect to be treated as Real Estate Mortgage Investment Conduits (REMICs) under the Internal Revenue Code. Under the REMIC rules, a mortgage loan included in a REMIC securitization trust can only be sold from such trust if (i) the REMIC is being completely liquidated or (ii) if the loan is in default or default is imminent or reasonably foreseeable. The servicer should be able to determine with little difficulty whether a mortgage loan is in default or not. However, determining whether a default is "imminent" or "reasonably foreseeable" requires the servicer to exercise more judgment. As such, the servicer may feel less confident coming to the conclusion that default is imminent or reasonably foreseeable, especially if the REMIC status of the securitization trust may be jeopardized as a result of incorrectly so concluding.

In order to maximize the number of Imminently Defaulting Mortgage Loans that may be sold from securitization trusts, an IRS Revenue Procedure would need to be issued to provide appropriate certainty to servicers with respect to the imminent default/reasonably foreseeable default determination. The Revenue Procedure should provide guidance confirming that a REMIC would not be subject to tax as a result of a prohibited transaction if a servicer sold a mortgage loan from a REMIC if the servicer reasonably believes that there is a significant risk of foreclosure of the mortgage loan. This reasonable belief may be based on guidelines developed as part of a foreclosure prevention program or any other credible systematic determination. The IRS articulated similar standards in Revenue Procedure 2008-47 on December 6, 2007 relating to the ASF Framework and Revenue Procedure 2008-28, relating to foreclosure prevention programs.

3. Contract Provisions

It is not typical for Securitization Servicing Agreements to contain provisions that expressly permit a servicer to sell mortgage loans from the securitization trust. However, an agreement's silence on this point does not end the analysis. All Securitization Servicing Agreements impose on the servicer a general standard (Servicing Standard) that must be complied with in connection with servicing of mortgage loans. The ASF believes that in the circumstances described below, and where appropriate relief from the accounting and tax consequences is obtained as described above, a mortgage-backed securities market practice could evolve to a point where the Servicing Standard in Securitization Servicing Agreements may be interpreted to permit a servicer of a Defaulted Mortgage Loan or Imminently Defaulting Mortgage Loan in a securitization trust to elect to sell such mortgage loan to the TARP.

Securitization Servicing Agreements vary from issuer to issuer and, in many cases, from transaction to transaction for each issuer. As a result, determining whether a Defaulted Mortgage Loan or Imminently Defaulting Mortgage Loan can be sold from numerous securitization transactions will necessarily require a review of each related Securitization Servicing Agreement. While the Servicing Standard applicable under each Securitization Servicing Agreement varies, there are some general practices common to most Servicing Standard definitions. These general practices include, among others, giving due consideration to customary and usual standards of practice of servicers administering similar mortgage loans, using practices that the servicer would employ for mortgage loans held for its own account, and/or using practices employed by prudent mortgage lending institutions that service similar mortgage loans. The inclusion of these general practices in the Servicing Standard results in a Servicing Standard that evolves over time to incorporate the latest servicing practices employed in the market place.

With respect to Defaulted Mortgage Loans and mortgage loans the servicer determines to be Imminently Defaulting Mortgage Loans, the Servicing Standard requires the servicer to deploy loss mitigation strategies that maximize proceeds (on a net present value basis) on such mortgage loans. When faced with a Defaulted Mortgage Loan or Imminently Defaulting Mortgage Loan in a securitization trust, a servicer must typically decide between commencing foreclosure (for Defaulted Mortgage Loans only) and, if not expressly prohibited by the terms of the Securitization Servicing Agreement, other loss mitigation techniques, such as modification of the mortgage loan, forbearance, repayment plans for arrearages, short sales and short payoffs. The servicer's decision of which approach to pursue must be based on its determination of the approach that will result in the maximum net proceeds (on a present value basis) to the securitization trust. Where a Securitization Servicing Agreement is silent on permitting the use of any of the non-foreclosure loss mitigation techniques, the Servicing Standard could potentially be interpreted to permit the servicer to utilize such non-foreclosure techniques because it is a customary and usual standard of practice and prudent for mortgage lenders and loan servicers administering similar Defaulted Mortgage Loans and Imminently Defaulting Mortgage Loans to employ such non-foreclosure techniques.

While the sale of Defaulted Mortgage Loans and Imminently Defaulting Mortgage Loans to third parties has not typically been a loss mitigation option that servicers have considered, this approach may be able to be viewed as one more loss mitigation technique that a servicer could utilize. As such, unless the Securitization Servicing Agreement expressly prohibits the sale of Defaulted Mortgage Loans and Imminently Defaulting Mortgage Loans and so long as appropriate relief from the accounting and tax consequences is obtained as described above, the ASF, through servicer and investor member consensus, could consider reinforcing a market practice that the Servicing Standard be interpreted, under appropriate Securitization Servicing Agreements, to permit the servicer to add the sale option among the other non-foreclosure loss mitigation techniques it may consider when deciding what course of action to take with respect to such mortgage loans. Adding the sale option, of course, does not change the servicer's responsibility to analyze what loss mitigation strategy is optimal to pursue. Ultimately, the servicer's decision must still be based on its analysis of which approach would result in the maximum net proceeds (on a net present value basis) to the securitization trust.

- **Provide Lending or Guarantee Facilities for Servicer Advances**

The third area where the federal government, potentially through TARP or other mechanisms, could provide critical liquidity in the housing market is in the area of servicer advances on MBS. As part of their Securitization Servicing Agreements, servicers often advance their own funds to cover unpaid principal, interest, taxes and insurance as well as for other property protection and related advances. The servicer ultimately receives a first priority reimbursement for these advances when troubled loans payoff or are liquidated. Due to the recent significant increase in delinquencies and slow down in prepayments, the amount of advances that servicers must make to remain in compliance with their servicing obligations under these servicing agreements has risen exponentially. Simultaneously, the number of commercial banks that help servicers finance these advances has shrunk dramatically, thereby radically increasing these funding costs.

Some servicers unaffiliated with depository banks may be unable to continue to operate economically, forcing a transfer of servicing responsibilities to another servicer. Servicing transfers causes significant disruptions to borrowers making payments or working out loans during the transfer process. As such, federal government provision, at little or no risk to the taxpayer given the first priority reimbursements, of a lending or guarantee facility for liquidity constrained servicers could quickly provide significant assistance to troubled borrowers.

Mortgage and Consumer Credit Availability in the U.S.

There is currently $7.55 trillion dollars of securitized mortgage debt outstanding, which is slightly more than half of the $14.8 trillion dollars of mortgage debt outstanding in the United States.[10] Yet, only $500 million of securitization bonds were issued in October of 2008, which is less than 1% of the $50.7 billion issued in credit-constrained October of 2007.[11] As these figures indicate, private investment capital flows into the U.S. securitization market have all but disappeared, threatening the availability of credit to all current and future mortgage borrowers.

Significant action is being taken by the industry, such as through ASF's Project RESTART, designed to rebuild investor confidence in both the assets and process of securitization. The finance ministers of the largest economies of the world went so far as to articulate as one of their top five global priorities to, "take action, where appropriate, to restart the secondary markets for mortgages and other securitized assets."[12] Voluntary programs that incentivize private actors in securitization, such as servicers and institutional investors, to reduce foreclosures are the only constructive options to help address housing dislocations in a credit-starved environment. To the extent that governmental initiatives can offer loan modification opportunities beyond those that are commercially feasible in the private market, those programs may provide an effective bridge to a wider range of troubled borrowers and help to stabilize housing prices and markets.

Conclusion

Chairman Kucinich and distinguished Members of the Subcommittee, I thank you for the opportunity to participate in this hearing on some of the most pressing issues facing our country today and look forward to answering any questions you may have regarding my testimony.

Thank you.

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[10] Statistical Supplement to the Federal Reserve Bulletin, October 2008, Table 1.54 Mortgage Debt Outstanding
[11] Wall Street Journal, Bond Woes Choke Off Some Credit to Consumers, C1, November 6, 2008.
[12] G-7 Finance Ministers and Central Bank Governors Plan of Action, October 10, 2008

Appendix A

LOAN MODIFICATION EXAMPLES

Original Scenario

Borrower and co-borrower earn $35,000 and $32,000, respectively and pay as agreed based on an adjustable rate mortgage.

	Original Economics
Income	$67,000
Home Value	$400,000
Loan Size	$320,000
Mortgage Rate	7.0%
Monthly Payment	$2,129
DTI	38%

Scenario 1 - Job Loss

Co-borrower loses job with limited employment options locally. The monthly housing obligation for the family is now unaffordable.

Job Loss	**New Economics**	**Job Loss - Rate Reduction with Interest Only for 5 yrs**	**Job Loss - Principal Reduction**
Income	$35,000	$35,000	$35,000
Home Value	$400,000	$400,000	$400,000
Loan Size	$320,000	$320,000	**$165,000**
Mortgage Rate	7.0%	4.2%	7.0%
Monthly Payment	$2,129	$1,120	$1,098
DTI	**73%**	38%	38%
Impact		**No Immediate Loss**	**Results in immediate loss of $155,000 or 48%**

Scenario 2 - Rate Reset

The initial interest rate was fixed at 7% for 2 years, providing for an affordable monthly payment. Upon resetting to 95, the loan is now unaffordable based on a 46% housing ratio.

Rate Reset	**New Economics**	**Rate Reset - Rate Reduction w Interest Only Period**	**Rate Reset - Principal Reduction**
Income	$67,000	$67,000	$67,000
Home Value	$400,000	$400,000	$400,000
Loan Size	$320,000	$320,000	**$265,000**
Mortgage Rate	9.0%	8.0%	9%
Monthly Payment	$2,575	$2,133	$2,132
DTI	**46%**	38%	38%
Impact		**No Immediate Loss**	**Results in immediate loss of $55,000 or 17%**

Mr. KUCINICH. Thank you very much, Mr. Deutsch.

I just want to say to each and every member of the panel, thank you for your very thoughtful, analytical presentations. I have had the chance to read your testimony, and based on the urgency of this moment, I am going to ask staff to work together to provide Members of Congress with the testimony that was given today. We really need to do that. When Members come back next week, we need to get to them this testimony from these individuals, because what we are looking at here is a way forward.

Mr. Issa, I just mentioned that it is so important for Members of Congress to look at this perspective that has been offered, which is really a way out of where we are right now, and I have asked staff to work together to communicate this to the Members of Congress.

We are going to have the first round of questions, 10 minutes, and I am going to begin. I would like to just go down the line of witnesses with the same question.

Each of you had the opportunity to sit through the lengthy questioning of Mr. Kashkari, and I am sure that you also are very familiar with Mr. Paulson's announcement 2 days ago that the TARP would not buy troubled mortgage assets.

What was your reaction to Mr. Paulson's statement about how he views the use of the Troubled Asset Relief Program at this point?

Mr. BARR. Well, Mr. Chairman, I think it is quite troubling that the administration has decided not to use the authority that the Congress gave to the Treasury for the purpose of helping homeowners. I think it is a significant policy error and it has enormous negative consequences for our country. So I was quite disturbed by it. I am hopeful that Congress can work with the administration in its remaining weeks to reverse that decision, and I am hopeful that the new administration would take a different approach.

I think we need to have a systematic effort to restructure troubled mortgages. It sounds like many of the panelists agree that a program of guarantees, a program of purchase, changes in tax and accounting rules, are in order to unlock the trusts and help our country move forward.

Mr. KUCINICH. Professor Sanders.

Mr. SANDERS. Thank you, Congressman Kucinich.

I just wanted to go on record and say I was kind of startled by the decision to cancel the loan repurchase part of TARP for the simple reason as this, is that what is causing the problem with banks are failed loans, and the failed loans are costing the banks enormous amounts of money, which means they can no longer meet their capital. So what do we do? We give them checks for more capital in the form of preferred stock, however you want to do it. In other words, so we didn't get to the root cause of the problem; we simply treated what the outcome was, like a rash. I mean, it is very severe, and I don't mean to downplay that. Having banks fail was a horrible thing, but if they are not making loans to anybody, kind of, why are we doing this, is No. 1?

But, No. 2, in terms of the repurchases, I am trying to, we really have to do something, and I agree with everyone on this panel more or less who said we have to become much more aggressive or assertive in how we are going to modify some of these loans because we have another wave coming, and we are going to get swamped by business as usual. So I am just pleading with Congress and the incoming administration to take some bold steps, because we are going to be under water severely.

Mr. KUCINICH. That is a point that member of the committee have made, and we appreciate you making it.

Ms. Cohen, your assessment of the Treasury Secretary's announcement?

Ms. COHEN. Well, your question reminds me of that weekend back in September when we saw the first draft of the TARP legislation coming out of Treasury. The purposes of the act then were only to help banks and not to help homeowners, and folks had to fight very hard to get the rights of homeowners in.

And so in some ways it is not surprising that the vision of the Treasury Department and the administration is not different now from what it was then. In their view, it is all about liquidity; and on Main Street, it is really about homes and neighborhoods. So it is a huge disappointment, and I agree with the other panelists that it needs to be turned around.

Mr. KUCINICH. As we go to Mr. Litton, I just want to say that I appreciate the relationship that you have with the East Side Organizing Project in Cleveland, OH, where you have worked to complete modifications. And you know, from our understanding, it has been a model of success in these troubled times, you know, more success than we've seen in other areas. I just wanted to point that out and thank you and ask you for your assessment of Mr. Paulson's pronouncement relative to the work that you are doing right now and trying to do.

Mr. LITTON. So, as it relates to that announcement, as a servicer in the trenches every day, servicing loans that are in mortgage-backed securities, it doesn't impact me as directly on a day-to-day basis because we can't sell the assets anyway on a one-off basis, as these gentlemen had previously indicated.

What does become more clear to me—and Mr. Chairman, I think that you hit on a great point a moment ago with your acknowledgement of the work that we do with ESOP—is that the borrowers that I deal with every day cannot afford the mortgages that they are in, and we are re-underwriting them on loan modifications to standards that do not produce long-term affordable mortgages. To me that is the simple, fundamental realization as a guy that is trying to work with these consumers on a day-to-day basis, that we have to be more effective at coming out with a lower debt-to-income standard, and we have to be more reasonable as it relates to writing principal off and right-sizing these balances if we are going to put a stop to the downward spiral on what is going on with home prices.

So anything that we can do that helps me get that objective accomplished I think is a good thing. Anything that gets in the way of getting that objective accomplished is, I think, ultimately a bad thing.

Mr. KUCINICH. Thank you.

Mr. Kudenholdt.

Mr. KUDENHOLDT. Thank you, Mr. Chairman.

I think I could understand why large-scale purchases of residential mortgage-backed securities in and of themselves would not necessarily reduce foreclosures, would not necessarily enable the government to cause those pools to service the loans differently because it is very difficult to get control over a pool by purchasing classes. And as Mr. Deutsch mentioned, it is extremely difficult, considered impossible really, to amend a governing document to change the rules.

But as I talked about in my testimony, the existing rules of these securitization documents do permit a wide array of options for the servicer in mitigating losses. And the existing provisions do support the types of modification programs that the panel has talked about today.

Now, the two programs that I talked about which could be done through TARP or through the FDIC or another government program, namely a guarantee program and a purchasing individual defaulted loans out of pools program, these could actually change servicer behavior. They could change outcomes. They would result in a fewer number of loans going into foreclosure. I think incrementally they could certainly make improvements.

Mr. KUCINICH. Thank you.

And, finally, Mr. Deutsch, your comments on Mr. Paulson's announcement relative to the Troubled Asset Relief Program.

Mr. DEUTSCH. I think one of the primary objectives of TARP at the beginning, and continues to be an objective, is to get credit available to consumers, whether that is mortgages, auto loans, credit cards, etc. It is one of the primary focuses, because as we all know, the securitization markets, the secondary and capital markets, are essentially a frozen tundra right now where capital is not available to the banks in that secondary market, which if banks don't have that credit available, they cannot lend it to consumers.

So I do think there was a very fine focus by Secretary Paulson to get the securitization markets resumed, to get them going again so banks will have capital to lend to consumers, so that they will have an ability to refinance, so that they will have an ability to buy a car, so that they'll have an ability to use their credit card at reasonable rates. By invigorating that market, by invigorating the securitization market, it will allow the economy to get back on its feet and resume as normal.

Mr. KUCINICH. Professor Barr, I want to ask you, do you think Treasury is justified in diverting its attention away from mortgages and toward other urgent needs, such as credit card defaults?

Mr. BARR. I think there are growing problems throughout the credit markets, including in the markets that Secretary Paulson identified. But I don't think that it is either appropriate or justified to move attention away from the origins of this crisis, as Professor Sanders suggested, in the mortgage markets. We do need to deal with troubled home mortgages. We need an aggressive, robust plan. They can do actions now under their existing authorities. They can take further steps by clarifying tax and accounting rules. I think that is absolutely essential if we are going to get out of the current crisis.

Mr. KUCINICH. Well, let's look at where we are right now, and I would like your response as to what Congress should do. And if anyone else wants to jump in here as I ask my final question of this round, you can feel free to.

After today, this administration has only 65 days remaining. If the President asked for the next installment of $350 billion for the Troubled Asset Relief Program, that's the TARP, should Congress give it to him or wait until a new administration has had the opportunity to reconsider Secretary Paulson's decision not to buy mortgage assets with the Troubled Asset Relief?

Mr. BARR. Mr. Chairman, I think if the Treasury insists on its current path and refuses to implement a program of the kind that has been described by this panel with respect to buying, not the mortgage-backed securities, but mortgages themselves that can be remodified; if Treasury continues to block the FDIC's plan for a guarantee program, my own judgment is it would be inappropriate to proceed with the additional funding.

Mr. KUCINICH. Anyone else want to jump in on that question before I go to Mr. Issa? Anyone else want to respond?

Mr. DEUTSCH. I would say that it is urgent that TARP use the funds that were authorized to get the market resuscitated as soon as possible. And I think it is imperative for government, both the administration and Congress, to find a way for that to be spent to reinvigorate the market.

Mr. KUCINICH. Anyone else?

Mr. Sanders.

Mr. SANDERS. Yeah, I just want to, again, go back to the root cause issue, that we have to get to the root cause issue as fast and as expediently as possible. Delays are going to kill us. Housing prices are not slowing down. I know people like to think that they are. They are not. They keep falling. Defaults are falling—are increasing dramatically.

What we can do at least in the short run during the current administration is go into a dramatic loan modification—we can even modify ZIP codes and States. We can prioritize them. We can go hit some of the cities in the northeast. We can go out to some of the places in California.

I have maps of all of the hot spots, where the foreclosures are the largest. And you ought to see it. It is very compelling.

Mr. KUCINICH. I have seen it. We know all about it. We also know what is going on with the ALT-A in California. We are concerned coast to coast here.

Mr. Kudenholdt, did you have something you wanted to add?

And thank you, professor.

Mr. KUDENHOLDT. Thank you, Mr. Chairman.

I was just going to agree with the panel that, provided that any systemic risks are addressed, that the most important priority in the recovery is to find a floor and stabilize home price values.

Mr. KUCINICH. Thank you.

We are now going to go for a 10-minute round of questions to Mr. Issa.

Mr. ISSA. Thank you, Mr. Chairman. And I am going to continue, as we have all day, along pretty much your line of questioning but maybe expand it a little bit.

A long time ago, somebody said a billion here, a billion there; pretty soon it is real money. I guess we are talking a trillion here and a trillion there; and pretty soon it will be real money.

Mr. Deutsch, I am a little concerned, $350 billion, in the old days used to be real money after you put that many billions together. If we allow this administration in the last 65 days to continue down the same course they are going, in other words, $350 billion more to buy investments in American Express, GMAC, other things that become banks, because they are all becoming banks, because that is the in thing, it is in fashion, do you believe that urgency of 65 days preempts the consideration by the new administration of alternative ways to spend that relatively small amount of money, $350 billion?

Mr. DEUTSCH. I think there is an urgent need to get TARP money into the market. I think there are different variations on how that can get into the market, and I don't think we are here today to provide an opinion on exactly how that should be put into the market. But we have identified, there are a number of ways that it can get into the market to not only restore pricing within securitization, and particularly mortgage backed, but also a way to meet the objectives of the foreclosure standards as well of the bill.

Mr. ISSA. And before I get into sort of the housing portion of this, I just want to ask one question, realizing you are all very well educated, but you are not Goldman Sachs folks like the last gentleman we had here, but I still want to ask this: If you are going to price preferred stock, a debt/equity instrument, and you buy it behind closed doors at a relatively low return rate, and it is not floated in the market, how would any of you know that you are paying a fair value? I mean, I would settle for no one would possibly know, but I will take an attempt at an answer.

Mr. SANDERS. Well, since everyone is pointing to me on this, I will be glad to try to answer that. And the answer is, I agree with you 100 percent. The markets are so ill-liquid right now; we have no clue what these things are worth. The CBO market, as you're aware, has completely failed. We don't know how to price those. So I think, we will call it a heroic effort if they think that they can go through and price these things appropriately.

The only thing I will say is, if they go in and try to buy the loans off the books or give preferred stock or debt, it will be mispriced. But knowing the way this whole thing works, they will overpay rather than underpay.

Mr. ISSA. When I couldn't get an answer as to whether—since the credit markets had improved—whether we'd gotten back to par, I think that said a lot today.

Let me go through a line of questioning because I think it may lead this committee and hopefully the rest of the Congress as they review this to some thoughts for, not just the $350 billion, but the clearly large amount of money that directly or indirectly is going to be invested in the next Congress in stabilizing home prices. I keep hearing that you can't actually get to these instruments and buy them out. I heard it here just a minute ago.

Mr. Litton, you're probably the best one to handle this. If the house burns down, don't you have to find out who you are going to give the money to?

Mr. LITTON. Yeah, so, let me give you a brief description of how we go about working out these loans——

Mr. ISSA. No, no, I don't want that. I really want, a house that is within your servicing burns down, and let's assume for a moment it was leased land. So you have 100 percent loss, and the insurance company says, we know there is a mortgage on it for $300,000, but there is $80,000 that we are going to pay on this liquidated asset because that is what it is insured for. You have an $80,000 check. You've got a $300,000 loan. Do you know where to send that? That check doesn't just sit in a deposit account? Doesn't it go——

Mr. LITTON. No, we actually file a claim with the insurance company. The check comes in, and then we would remit that check as a remittance through to the investor or mortgage-backed security that is the owner of that asset.

Mr. ISSA. So taking a piece of that asset and liquidating it, you don't have to go find the guy in Abu Dhabi or the sovereign wealth fund of China, you in fact can start at the home that is underwater, and you can liquidate it because it can happen if there is a fire, right?

Mr. LITTON. Right.

Mr. ISSA. Mr. Kucinich and I discovered 18 months go that there was a mass fire in Cleveland because we are watching boards go on top of homes. And they are going no where. The people are thrown out. The homes are boarded up, and they are sitting there, and of course the neighbor's house goes upside down in value.

Ms. Cohen, you have worked in the community for a long time. Let me ask you, again, a question that is a little off the main, but I think it is germane. A road is going through a house, and they tell people, I'm sorry but you have to go, and here is what your house is worth. The city tells you that. Your house and your neighbor's house is worth this amount. They take the house by eminent domain and give you X amount of dollars, right? And I assume, like a fire, Mr. Litton would know where to send the check to, even if the check was less than the loan?

Ms. COHEN. Is your question, who gets the check?

Mr. ISSA. No, Mr. Litton already took care of who gets the check. But the city comes in and just takes your house, and it turns out their value is less than you owe on it, so it all goes to Mr. Litton, and he sends it off to Abu Dhabi. That part we understand. We know where the check goes.

But cities do that regularly in blighted communities. They do it in a number of different regions for redevelopment, right?

Ms. COHEN. Well, it is required under the Constitution's Takings Clause.

Mr. ISSA. Right. So for us here on the dais, if we began anew looking at how to deal with blighted homes, upside-down situations, people who could pay the current fair market price of a home, either theirs or the one two doors down that is boarded up in the case of many of the homes in Cleveland, the fact is we could empower the cities with money to do this, to take those homes on an individual basis, to allow them to figure out where they are going to stabilize their prices the most. We could do that through existing sub-government bodies, and we could do it with funds that ultimately we'd get substantial amounts back, couldn't we? And isn't that somewhat what we have done from the Federal Government when we are trying to help communities stabilize prices?

Ms. COHEN. I think that is part of the goal of the Neighborhood Stabilization Program and other programs where essentially they are trying to make affordable housing out of foreclosed properties. But to the extent there are homeowners who are in homes that are their primary residences and they can make reasonable payments on the homes, we should give them a shot at that first before we move on to the other plan.

Mr. ISSA. Of course.

So when we look at this $350 billion, and I am somebody who lobbied my colleagues and was happy when I could get my colleagues, a majority of them, to vote against the TARP because I thought it was ill-conceived. Now Secretary Paulson agrees with us. He has decided that his ill-conceived, his fire-ready-aim plan, he is not doing that firing. But he is now doing other things.

I guess the question is, do any of you see that going to the end result, the community, as Professor Sanders says, the communities most blighted, Stockton, CA; Las Vegas, NV; Cleveland, OH; Detroit, MI—we can go city by city—that going to those cities and the individuals who could pay, will pay, and dealing with them first, does anyone see that wouldn't be an every bit as good a use of the $350 billion remaining, because that is what Mr. Kucinich and I are here to talk about today?

Mr. LITTON. Well, just to give you some feedback on that, the chairman referenced our relationship with the East Side Organizing Project, which is a classic example of a relationship that works, and it works very well. The members of that community feel comfortable working with that group. They act as the intermediary in many instances between the consumer and ourselves, and we do a lot of workouts through them.

So dollars that are spent to help expand the reach of those local groups where there is alignment between the community—and these are people who live in the community, they care about what happens in those communities—those have been very effective relationships that we have been able to lever into getting more deals done. So I can tell you that there are perfect models where that works, and it works very, very well.

Mr. ISSA. My final question, and it is an important one. During the bubble, we ran up the prices of homes beyond what would have been their normal credit value. Given a normalized credit, the bubble would not have given us home prices as high as it has. I understand the first panel, you know, told us that we need to shore up these markets, shore up these markets. Can any of you or have you begun to model what the fair value in a normalized credit market is of home values, and whether or not the Congress needs to look at that, because—and my question is simply, in some cases, do we have to go further down against normal credit and ultimately need to let that happen? And in other cases, we are already below the fair value, and many areas of Cleveland fit that examination—or is that they have gotten too low, is that a factor that we can analyze, and if so, who should help us do it?

Mr. KUDENHOLDT. I'd like to—I think what I would suggest on that is, you know, a normalized value for the housing market I think would be values that would prevail in an environment where we had normalized mortgage lending and where we had mortgage lending being made under conservative standards with full documentation of income, with loan products that do not include rate-shock features.

So, you know, if the mortgage markets were restored and were lending anew under conservative parameters, having learned the lessons of the last several years, and maintain those standards, I think that would over time bring the market values back to a normalized level.

Mr. BARR. I would just add that one of the key problems now is that foreclosures and defaults and the frozen credit markets are so dramatically pushing down home values nationally and then even further in some areas, that it is not a question of reaching bottom. In other words, we will keep going down. It is a self-reinforcing cycle of credit decline, credit freezing, foreclosures and defaults. You don't break that cycle unless you have a major initiative to stabilize the credit markets. And so I don't think that we are going to reach bottom in a natural state unless we take some rather bold action.

Ms. COHEN. Can I——

Mr. ISSA. Ladies first.

Ms. COHEN. I just want to highlight how your question fits in with a couple of other pieces. One is, a lot of borrowers got loans with inflated appraisals. So notwithstanding the decrease in housing values, and by the way, in east St. Louis and in other places, there was not a hugely inflated home market to begin with. We are talking about homes that are worth $10,000 or $20,000 or $50,000 or $60,000. But many of those folks all over the country, even in California where things were already expensive, got inflated appraisals. So that is another piece of figuring out how the loan piece fits with the value piece.

And then the other point I just want to make is that to the extent that loan modifications are premised on an analysis of net present value, your question about where we are in the market and how do we measure what the value of a home is, is a prescient question in that context. And we really have to figure out, what do we mean by net present value, and how do we figure that out? Is it based on a foreclosure sale? It used to be based on a percentage of the value of the home, but if we don't know how to value the home, we might need to look at another way to do that. And Treasury and everyone else engaged in net present value analyses need to be more transparent about how they are doing it.

Mr. ISSA. I am shocked that you would suggest that we should get transparency out of the Treasury. But I appreciate your asking for it, as this committee has been asking for it.

Thank you, Mr. Chairman.

Mr. KUCINICH. And I want to——

Mr. SANDERS. Can I add one clarifying comment?

Mr. ISSA. I'm sorry. Gentlemen second.

Mr. SANDERS. Mr. Issa, in terms of housing value, until we actually get lending back in the markets, I don't know where we are going to see the bottom of this, but, again, until Mr. Paulson and Mr. Kashkari can give us some degree of confidence when liquidity is returning, that would be great.

Also, and the other reason it is difficult to price this, as you pointed out yourself, we don't even know what the preferred stock values are. So it is kind of hard to find the bottom of the housing market because nothing is being priced correctly.

But one thing I do want to say about TARP, in a perfect, do you know who I would like to stick the cost of this to? The banks and the ABS holders. They went through and bought subprime mortgages. They went through and bought these knowing there was a probability this whole thing was going to melt down. And suddenly we find out, what we knew all along, from Mr. Kudenholdt, there were problems with getting ABS holders to accept modifications, even if it is in their best interests.

And then we are also saying, maybe we should make the banks do this. Well, it turns out we are giving the banks preferred stock; at the same time, we are not making them modify the loans that perhaps they should have done, knowing what the risks were when they went into this market in the first place. So it is this kind of—unwinding this is very difficult because there are so many competing problems and competing objectives and competing solutions. So, I think, unfortunately, we are to the point where we probably will have to use some taxpayer dollars, but I wish we could unbundle the ABS and get them to start—really telling them hey, look, you bought this. You should modify this. You help us save the economy. And the same to the banks. And that wouldn't cost taxpayers a cent. That is really what I would like to say. I don't know if we can achieve that any more.

Mr. ISSA. Thanks again, Mr. Chairman.

Mr. KUCINICH. Which raises some of the questions that you, Mr. Issa, have been looking at, and that is, as the professor points out, there is a point at which the government does have to intervene. There are those of us who, when we began this discussion about the Troubled Asset Relief Program, we thought, well, you know what, the government is interfering in the market here, picking winners and losers, and we are looking at a sea change that we are still finding out what it means. We just don't know yet what it means.

We do know, for example, in Cleveland, yes, National City Bank, they were in trouble because the CEO made a decision to go into subprime loans. National City was a blue chip bank at one point. It is a 160-year-old-plus bank, and yet it made some bad decisions. OK. Even with that, it could have been saved. Even with that. So a decision was made, and the point you made, imagine if they would have given that money, instead of giving it to PNC, given it to National City Bank. They could have saved the bank. I pointed out that they apparently weren't mindful of the fact that, you know, let's face it, on Wall Street, there is a battle going on for dominance in banking. Banks are eating banks. And now they are using the TARP to take over banks. There is consolidation going on. I mean, that seldom gets discussed about the competition that is still going on.

National City, short-selling attack, undervaluation of assets, of their stock, over assessment of their debt, credit agencies, which we saw how political they are weighing in, just as credit agencies are weighing in right now, knocking down the auto suppliers, weakening the auto industry a little bit. You know, there is another level of predatory conduct going on here which goes back to your point about, if the Treasury is picking these winners and losers, we are in trouble if you can't really establish a ground of meaning of what anything is worth, and I think that this question of value that was pointed out, that you have been hammering at, Mr. Issa, and that has been talked about by the panel here, I want to go back to Cleveland, OH.

Our homes weren't overvalued there to begin with. We didn't really see in the city any kind of a boom, a housing bubble, let's say. We didn't see that at all. But the bursting of the bubble has affected us, and the subprime wave has affected us. So you have homes in the city and in some of the suburbs where the property values have dropped 25 to 30 percent. This is a real loss, I mean, people, for most Americans, their only investment. So the market manipulation with the subprime, with the $600 trillion plus and these derivatives, it is coming home to roost in middle America, and we are seeing a massive transfer of wealth, just massive transfer of wealth. And the government now apparently is presiding over it and helping the banks do it. This is my concern.

Now, you know, Mr. Litton, Secretary Paulson apparently left foreclosure mitigation to private industry. Recently the industry put out a protocol that looks something like what you have been doing for years. Do you think, based on your experience, that such initiatives will be enough to stem the foreclosure crisis?

Mr. LITTON. So here is one of the challenges with our industry. With the company that I run, the vast majority of the pooling and servicing agreements gives me wide latitude on being able to operate within doing these loan modifications. There are other servicers who don't have quite that same latitude. So that is a problem.

I can tell you, as an asset manager, that if I didn't have that latitude, then the losses that I would be presiding over as it relates to trying to administer defaults on these loans would be a lot higher than they are today. So I think that is a significant obstacle and a significant problem that needs to be dealt with.

Mr. KUCINICH. What is the obstacle?

Mr. LITTON. The obstacle is that there are some pooling and servicing agreements that don't provide the wide latitude that servicers like a Litton or in others may have; because of the inconsistency of those pooling and servicing agreements, it creates obstacles from servicers being able to execute that. I think that is a problem.

Mr. KUCINICH. Would you comment on a target of the 38 percent debt-to-income that is the cornerstone of the streamlined modification program issued by HOPE NOW?

Mr. LITTON. Absolutely. From my perspective, when I look at our recent performance, I look at all of the loan modifications we did in the last year, 41,000. I look at the redefault rates, which are now north of 40 percent and going up, going up dramatically. When I look at that 38 percent debt-to-income standard which has been our average income-to-debt-rate standard, what that clearly tells me is, even though we are doing more loan modifications, the loan modifications are not as effective as they need to be. It also tells me that we need to lower the debt-to-income standard so we can provide a longer-term sustainable mortgage. I think doing that is consistent with my obligation under the terms of the pooling and servicing agreements in which I will create lower losses for investors at the end of the day. But a 38 percent standard, in my judgment, based off of performance that I have looked at in my book, will not be as effective as a 31 percent standard that produces a lower monthly payment for these borrowers.

Mr. KUCINICH. So what is the role of principal reduction and sustainability of a loan?

Mr. LITTON. From a principal reduction perspective, as we have analyzed this issue, we believe that more principal reductions need to occur. Here is the reason why: Servicers, when we service loans on a day-to-day basis, we make decisions every single day to write off principal. When we sell a piece of real estate that has been foreclosed on, that is a determination that I as a servicer have to make, taking into account property value and other things, to sell that piece of property and take a principal reduction.

When I do a short sale, it is the same type of an analysis. Our pooling and servicing agreements gives us wide latitude to waive principal when we need to, so we'll waive principal which resets the loan balance at a more reasonable level. We believe using a market-based note rate, waiving principal creates a longer term affordable mortgage because right now, leaving that balance out there and rolling it forward is going to make it much more difficult for that borrower to pay that loan off in the future.

If this was going to be a V-shaped recovery and property values were going to recover next year, we would want to forebear principal, but nothing in the cards seems to indicate that is the case. So waiving more principal more aggressively is, I think, the appropriate response given the conditions we are facing today.

Mr. KUCINICH. There is a question of whether the recovery is V or Z.

Mr. LITTON. Good point, sir.

Mr. KUCINICH. Mr. Litton, what assumptions do you have about the future of the housing market that—strike that. I'm going to go to Mr. Deutsch.

Mr. LITTON. Yes, sir.

Mr. KUCINICH. Mr. Deutsch, you have heard other witnesses say that loan modifications, emphasizing principal modifications, are needed to restore financial certainty and to keep borrowers in their homes. What I would like you to comment on is this: Do you think, left on its own, private industry will perform that kind of modification program? And if not, what might that say about the role the Federal Government should perform?

Mr. DEUTSCH. Well, let me start with the programs that are out there. Nearly every loan modification program, including IndyMac through the FDIC's program, the Countrywide program, the Chase program, the Citibank program, all, each and every one of those programs focuses on interest rate modifications and principal forbearance as the initial steps, as the first things to look at to be able to get to an ability to pay for each of those borrowers. That is, and is included in my testimony as Annex A, is that interest rate modifications can get most borrowers to a point where they have the ability to pay their mortgage. Some, whether it is a Jose Canseco in California or others, who choose to walk away from their homes, who choose to walk away from their obligations, some of those simply cannot be prevented. None of us want or require Jose Canseco to stay in those homes that are underwater.

Now it is very clear that in certain circumstances and appropriate circumstances that principal modifications can, will be, and as Mr. Litton said, have been made. But I think those will continue to be used in limited circumstances.

It does say, to the second part of your question, what is the role, if any, of the government? I think we have outlined two ways that can encourage principal reductions, first through purchasing loans out at sub par prices. That is servicers acting on behalf of investors could sell loans out of the pool potentially after a number of hurdles could be cleared to the TARP program. Those would not be sold at 100 percent of the value. They would be sold at something below 100 percent of the value, depending on the delinquency default probabilities.

So I think, ultimately, and as well as the program announced this morning by the FDIC chairman, it is looking to take advantage of providing incentives, to be able to have servicers modify these loans into programs, to refinance them into the programs like the Hope For Homeowners, but I do think those take modifications and a lot of analysis on to the detail.

Mr. KUCINICH. I want to thank you very much for that response. We are at the conclusion of the hearing. I would just say that your response and the other witnesses indicates that Secretary Paulson should be rethinking his decision about the use of TARP funds with respect to loan modification. Would you agree with that?

Mr. DEUTSCH. I think there is a lot of opportunity to help reduce foreclosures through the use of TARP funds.

Mr. KUCINICH. Mr. Kudenholdt.

Mr. KUDENHOLDT. I agree. I think that program should be initiated as we discussed to help reduce foreclosures.

Mr. KUCINICH. Mr. Litton.

Mr. LITTON. It is clear that we need to do more sustainable loan modifications. I think that is absolutely certain.

Mr. KUCINICH. Ms. Cohen.

Ms. COHEN. The government can do a lot for loan modifications, and they can also allow the private sector and courts to do more with bankruptcy reform.

Mr. KUCINICH. Thank you.

Professor Sanders.

Mr. SANDERS. And I agree with everything, but I also want to point out that we do mark-to-market for mortgaged-backed securities, AVFs, CDOs, but the one person or set of groups we don't do mark-to-market for is homeowners. If we marked their loans to market, we wouldn't be having a default wave.

Mr. KUCINICH. Thank you, professor.

Professor Barr.

Mr. BARR. Yes, I think we need to start quickly with the change to the tax and accounting rules to unlock the securitization trusts, and then we can proceed with a systematic modification program using the guarantee authority, and the Treasury purchase program as has been described, I think it would make an enormous difference.

Mr. KUCINICH. I want to thank each and every one of the witnesses. Our staff will continue to be in touch with you as this matter continues to be not just in discussion but vexing the Congress as far as what to do. Your testimony today shows a path, and it is very thoughtful testimony. Each and every one of you are very much appreciated for your presentation here today. We ask you to feel free to communicate with our subcommittee with respect to any other observations you have as we proceed.

We certainly have to find a way to keep people in their homes. As you pointed out, you are looking at loan modifications which include principal, interest, arrearages, and a rescheduling of the debt. So, thank you, because you give hope to millions of Americans who are looking for a new direction.

This is the Domestic Policy Subcommittee. I am Congressman Dennis Kucinich from Cleveland, the chairman of the subcommittee. Today's discussion has been on this question: Is Treasury using bailout funds to increase foreclosure prevention as Congress intended?

We have witnesses who included Mr. Neel Kashkari, the interim assistant secretary of the Treasury for financial stability and assistant secretary of the Treasury for international economics and development, and we very much appreciate his participation today; as well as the second panel, Professor Michael Barr, Professor Anthony Sanders, Ms. Alys Cohen, Mr. Stephen Kudenholdt, Mr. Larry Litton, and Mr. Thomas Deutsch.

Thank you for being here, and I thank the staff for the excellent work they have done in preparing Members for this, and I thank my partner, Mr. Issa, for his tremendous participation.

This committee stands adjourned.

[Whereupon, at 1:43 p.m., the subcommittee was adjourned.]

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