PROMOTING BANK LIQUIDITY AND LENDING THROUGH DEPOSIT INSURANCE, HOPE FOR HOMEOWNERS, AND OTHER ENHANCEMENTS

HEARING

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PROMOTING BANK LIQUIDITY AND LENDING THROUGH DEPOSIT INSURANCE, HOPE FOR HOMEOWNERS, AND OTHER ENHANCEMENTS

Tuesday, February 3, 2009

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

The committee met, pursuant to notice, at 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Maloney, Watt, Sherman, Meeks, Moore of Kansas, Capuano, Clay, McCarthy of New York, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Ellison, Perlmutter, Donnelly, Foster, Carson, Minnick, Adler, Kilroy, Driehaus, Grayson, Himes, Peters; Bachus, Castle, Royce, Manzullo, Biggert, Capito, Hensarling, Neugebauer, Marchant, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order. Let me just explain; procedurally, this is the first meeting of the committee as a committee because it is our first opportunity to meet since we were formally organized. I know there was some concern about what we were doing, but we did not get all the relevant decisions made by the leaderships until last Tuesday. We were a little bit handicapped by the fact that last week we had the Republican gathering, and this week we will have the Democratic gathering, so we are trying to begin the regular order of procedure and we will be following it from here on in now that we are so constituted.

Just again, procedurally, my understanding from the Democratic leadership is that the subject matters we are dealing with today, and which I hope we will mark-up tomorrow, will come to the Floor not as part of the stimulus and not as part of the omnibus, but as a free standing bill, probably joined at the Rules Committee with the bankruptcy bill over which we have no jurisdiction. We are dealing with several things in our discretion. Members will have an opportunity to offer amendments with regard to that. My own view is—and I have been a supporter of the bankruptcy—but over and above that, there are things we need to do.

Even the most ardent supporters of changing the bankruptcy law can't think that bankruptcy is fun for everybody and it is something that very much ought to be avoided. What we are talking about today are ways to avoid that. HOPE for Homeowners came out of this committee and we passed it last year. We didn't do it well. I acknowledge that and it has to be corrected. We were, at the time, being told that we were being too lax and there would be too much spending and the Senate even tightened it up further. We tightened it up to the point where it does not function very well.

Late last year, the HUD officials and the Bush Administration charged with administering it, Secretary Preston and FHA Commissioner Montgomery, made some criticisms of the program. This is largely in response to those criticisms which seem to us to have a great deal of validity, although they weren't fun to read. We have asked the oversight board that we set up in the HOPE for Homeowners to make it better in some other ways. They have done so to the extent that they can, but there are some statutory changes that have to be made.

Secondly, we have—even if that is available—the problem with the servicers. Over a year ago—I don't remember when—the gentleman from Delaware first raised this with us, but he called attention to the fact that even where you had servicers willing to make these adjustments, the threat of lawsuits could deter them. We can't totally wipe out vested rights. We can't wipe them out at all. But you can clarify them. We passed this once before, but it didn't pass the Senate. We have the language of the gentleman from Delaware—again, these are the same thing—making HOPE for Homeowners work better or work at all. Removing a disincentive from the servicers is very important. Those are two very important pieces. Whether or not you do bankruptcy, I think they ought to be done. It will be another committee's decision and the Floor ultimately about bankruptcy. But it does seem to me we should be doing the most that we can to give alternatives.

I do note and welcome the Federal Reserve's decision recently to mandate foreclosure reduction pursuant to the legislative authority in the first TARP bill, which said that where the Federal Government owned mortgages, they should try to avoid foreclosures. The Federal Reserve has just announced they are going to do this with regard to all the mortgages they own, some of which they got through Bear Stearns and elsewhere. We know the FDIC has been working on this under the leadership of Sheila Bair, the Chair of the Committee. I try to avoid saying "Chair Bair" whenever possible.

And the Secretary of the Treasury has informed me that pursuant to a number of members and the legislation we adopted, though it didn't become law, that he is preparing what I hope will be a uniform Federal Government-wide approach to foreclosures. This is part of what is needed. There is also in this—one of the things that I think was fairly overwhelmingly supported by the members last year in the TARP bill was the extension of the deposit insurance limits. And this makes them permanent. It does seem to me and I think to others of us a bad idea to sort of do those on a yo-yo basis. We have people who, if we don't change the law, bought a CD that was covered by deposit insurance when they bought it but which will be uncovered before it expired as deposit insurance goes back down. I don't think any of us want to see that happen.

The FDIC has also asked for increased borrowing authority, not, I want to stress, because of any imminent need. We don't want to add to any panic, but out of a kind of prudent decision to be ready for this. There is a further issue that may be coming up at some point. I want to warn members that there is nothing in the legislation now. One proposal that has been floating around is that there may be a requirement that if you want to make this work, you will have to pay the servicer something.

Servicers were not set up originally to do this. We believe there is authority in the first TARP to do this. Some of the lawyers in the Federal Government have told people that there isn't. That is being discussed. If there were to be a definitive decision that there wouldn't be, I think if there is no such authority, than I think we should get to it.

Now, I will recognize the gentleman from Texas for whatever time. How much? 4 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. Thank you for holding this hearing. And I certainly respect the chairman for admitting that there have been shortcomings in the HOPE for Homeowners Program and that frankly, it is not working as designed. Many of us have a fear, though, that HOPE for Homeowners may turn out to be hopelessness for taxpayers if we don't make other changes to the legislation. Many of us are concerned, and I look forward to hearing the testimony from the FDIC of, frankly, the FDIC has run one of the few government insurance funds that has actually remained in the black.

But another number of provisions in this legislation I am afraid could put increasing pressure on that deposit fund and I would not want to see that happen. Also undoubtedly, the legislation was designed to make HOPE for Homeowners more attractive to struggling homeowners, but as it does, I am afraid, again, it may ensure greater pain for struggling taxpayers, provisions to eliminate the mortgage debt to income ratio, raising the loan to value by doing away with the upfront 30 percent premium, are all provisions that again may bring more struggling homeowners to the table but may turn taxpayers into struggling taxpayers as it happens.

I think it is important also to note that as we look at the effectiveness of the program, the Congressional Budget Office, which is headed by a Democrat, said at least 40 percent of the homeowners who refinance under such programs will still default. OCC has said that 50 percent of the mortgages that have been modified, at least the last data I have through the first quarter of 2008, they defaulted yet again. The Congressional Budget Office has opined—and I don't necessarily agree with them on every opinion that they render, but this is an office that has a recently appointed Democrat as its head and has said even with the changes, the program would help about 25,000 homeowners at a cost of millions, $675 million according to the Congressional Budget Office.

President Obama, in his inaugural address, promised to "eliminate government programs that were not performing." I might suggest to the President that he has a good case example here that he may want to a take a hard look at. Again, I feel that unfortunately the legislation may rest on a shaky foundation, one of which is an assumption that homeowners don't have an opportunity to refinance.

We know already through the HOPE NOW Program you have had about 2½ million voluntary workouts. And again, we know it is quite costly to the lender to have to go through the foreclosure process. Most wish to avoid it wherever possible. If they view that a borrower has a financial pulse, they want to be able to do something to help keep them in that home. And like the chairman, I would like to add my voice to recognizing the gentleman from Delaware for his leadership in helping elucidate to the committee the principle that there was legislation necessary to help servicers get over legal hurdles to make sure that we didn't have legal impediments to refinancings.

There are other options. We believe in foreclosure mitigation, but the best foreclosure mitigation is preservation of a job, creation of more jobs, increasing take-home pay, and more investment throughout the economy. With that, Mr. Chairman, I yield back the balance of my time.

The CHAIRMAN. The gentleman from Massachusetts is recognized for 3 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman. Mr. Chairman, I think that the legislation before us is very good. I have some concerns about a few aspects of it. And I would like to actually—I am looking forward to hearing from the FDIC as to why they think they might need unlimited access to capital. I understand the desire and I support the desire to increase the limit to $100 billion. It makes sense. Maybe some other number makes sense. But unlimited—I think I need a little bit more than just a request and say, well, just in case.

I think we need a little bit more than that. I would also like to hear at some point what the FDIC thinks about its own liquidity. Right now everything seems fine. But honestly, with some of the problems we have read about with some of the major banks, particularly Citi, I for one am getting a little concerned that you may be called on and you may not be in the black in a matter of moments if something bad happens there. As far as whether this bill is the be-all and end-all, I don't think anybody is putting it forward that way.

I think this is one of the many bills we are trying to do to get the Federal Government into the business of helping individual homeowners. And we all recognize that this is not the silver bullet, but this is one more step in the right direction. And I find it hard to believe that anybody could criticize something that is saving even admittedly 60 percent of the homes it is trying to save. If I was one of those 60 percent, I would certainly be happy. And if I was one of those 60 percent that were being walked away on with no other proposal being put forward, I would certainly be unhappy.

I think that the Federal Government has an obligation to society, not to individual homeowners, but to society to take some action to stem the tide of mortgage foreclosures. Because when our neighbors lose their homes—if it is one or two, it is one thing. But when it is tens of thousands and millions of people, it is bad for society, now matter how you look at it. There is probably not a silver bullet; I don't think what is before us is one, but it is a step in the right direction. I think that some action is better than no action. I look forward to being able to pass these bills and hopefully get them enacted. And I am looking forward to the new Administration actually getting it in place, some of the promises we have heard for real action as opposed to what we saw over the last 4 months which thus far has been virtually nothing. With that, I yield back the remainder of my time.

The CHAIRMAN. The gentleman from California, Mr. Royce, for 3 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. Just looking at the authorization, $300 billion for the HOPE for Homeowners Program, a government-designed plan here that just has not worked out all that well. I think we have had an underwhelming 25 borrowers so far. We had hoped for 400,000. But I guess what bothers me most about combining this with a bill that passed out of the Judiciary Committee is this: There is increasing speculation that a big part of the problem is the flight of capital out of the banking industry.

So it is somewhat ironic that we are discussing promotion of bank liquidity today, trying to get the idea that has to be addressed. While we are restricting the flow of capital, we are discouraging lenders in our beleaguered housing sector and we are doing that by the very measure that is going to be combined with this bill on the House Floor. I am just going to voice my objections to that bankruptcy cramdown provision that is moving through Congress because if the ultimate objective of this committee and this Chamber is to see a recovery in the housing industry, we have to do what we can do to encourage capital back into the system, not force it out of the system. The consequences of enacting a bill like this would fall hardest on those frankly who hope to buy a home in the future. Because if markets logically respond by setting mortgage interest rates closer to those, for example, that would be auto loans or credit cards which with this change would probably happen in the market according to the economists, you would have a bankruptcy judges changing the way they approach this.

You know, bankruptcy judges now are free to reduce amounts owed on many types of consumer debt. But for mortgages, there is this ironclad requirement to pay off the loan and it is precisely as Justice John Paul Stevens said, because of the importance of this principle. And in *Nobleman* v. *American Savings Bank,* he explained that favorable treatment of residential mortgages was intended to encourage the flow of capital into the home lending market. And that is what we are about to reverse by our interference in that process this week as we combine these 2 bills. Those that may see the recent reversal of Citigroup's position on this provision is a sign that these arguments are no longer relevant, I think, should, as I said last week, remember that the significant steps over there taken by regulators, reaching into the day-to-day operation of Citigroup obviously are having an effect on setting policy over at Citigroup. It is exactly what happens when you have government intrusion into the economic system. You end up, frankly, with getting players in the economic system not making decisions on the basis of markets but on the basis of political pull and that is a problem for our system and it is going to be a problem for our recovery if we don't recognize it. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Green, for 2 minutes.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, I would like to compliment you on these pieces of legislation. I think they are exceedingly important. Obviously, we need to look at the deposit insurance, since H.R. 786 does so in terms of making what is now temporary a permanent circumstance and H.R. 787 deals with the HOPE for Homeowners Program. I would like to associate myself with the comments that you made with reference to this piece of legislation. But I would like to focus, if I may, on H.R. 788, which deals with the safe harbor provision for mortgage servicers who engage in loan modifications. I think that this piece of legislation has a lot of potential, I am interested in the way it has been fashioned because I can see that someone has put a lot of thought into it. It seems to deal with those loans wherein there is a default or wherein default is reasonably foreseeable. That makes a lot of sense.

We not only will help those who are already in a crisis circumstance, but those who may be moving towards a crisis. And then, of course, the property has to be owner occupied for H.R. 788 to apply. But the thing that I am exceedingly interested in is the notion that the modification, the anticipated recovery on that modification, when it exceeds the anticipated recovery on a foreclosure, then the modification becomes an acceptable remedy. I think that there are many loans and many circumstances wherein the modification will exceed—the value of the modification, the net present value, will exceed the value that we will acquire by way of foreclosure.

And I do recall from our hearings that we have had servicers who have given us indications that they have some consternation about making these modifications. When they may not—based on the liability. I thank you and I yield back, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Illinois, for 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. And thank you for holding this hearing. I have been back in the district and had the opportunity to meet with a lot of different groups from builders to mortgage originators to home builders and actually citizens, and community bankers, and I am hearing a lot of frustration by all of these groups. If we look at what the Economic Stabilization Act of 2008 was to create—to allow the Secretary of the Treasury to use—be used to restore liquidity and stability to the financial system, I think we are finding that—is there really stability and is there really liquidity. I have heard frustration from the community bankers saying that they sense a dual policy on the one hand, regulators are encouraging banks to lend, but during examinations, the bank examiners are cracking down, forcing writedowns on performing loans and discouraging increased lending from smaller institutions. Even though they have plenty of capital and liquidity, they aren't going to lend for fear of aggressive examinations.

From home builders we are hearing that they are able—they have homes and condos to sell, people arrive and the severe restrictions that have been put on the loan make it so that the buyers walk away, saying maybe they can find something better. It is too restrictive and the question of whether there is a secondary loan or whatever. And the home builders can't even build more houses. They have to have just a few there. The other thing I hear from mortgage professionals is that living in an area that really is above the loan limits in FHA, that there is not the loans there for people that have—need too high of a loan. So I hope we look at these issues in this hearing.

The CHAIRMAN. The gentleman from Georgia, Mr. Scott, for 1 minute.

Mr. SCOTT. Thank you, Mr. Chairman. Thank you for this hearing. I think that bank liquidity and lending are certainly the major issue we are definitely faced with and I am certainly interested in the regulatory changes. I know they are necessary, but I am also interested to hear the opinions of the expansion of the FDIC program, as well as the progress that the HOPE NOW Alliance has made in helping American homeowners modify their payments and help with foreclosure. And while we have to address the loss of the investors, we have still have to be vigilant as to not forget the little guy in this and do what we can to help him, the little guy who is tied up in the housing crisis. So I am hoping to hear more detail about the risk of a prolonged housing slump, what the FDIC and HOPE for Homeowners Program will have in the foreclosure mitigation. And I yield back. Thank you, sir.

The CHAIRMAN. The gentleman from Delaware for 2 minutes.

Mr. CASTLE. Thank you, Mr. Chairman. Like everybody else here, I am very concerned about the mortgage foreclosure process that is going on in this country. And I, for one, feel that it is going to worsen as we see what has happened at Macy's, Caterpillar, Pfizer, you name it, in recent weeks. I think we are moving into more of a middle-class America situation, away from just the subprime circumstances. For that reason, we have to be concerned about this. And I am also concerned that the programs haven't worked very well and statistically that people who have been close to the foreclosure process, regardless of how they are bailed out of it, are most likely the ones to fall back into it at some later point too. There are a lot of concerns.

I am very pleased and I appreciate Chairman Frank and Mr. Hensarling mentioning the provision in last year's Housing and Economic Recovery Act to extend liability provisions for loan servicers to modify loans, which I sponsored. This was part of a bill introduced by Mr. Kanjorski and me, intended as a tool to assist borrowers facing foreclosure. Unfortunately, with this provision in the statute, I am not convinced the troubled loans have been modified at the rates we expected. For this reason, I am pleased to join Chairman Frank and Mr. Kanjorski to expand on the original proposal by offering this safe harbor liability protection to anyone who engages in loan modification regardless of the original service agreement as long as they act in a manner consistent with the homeowner emergency relief act. This expansion also requires servicers who engage in modification to report these activities to Treasury.

It is my hope this expansion will encourage servicers to revisit the conditions of a problematic mortgage and encourage them to restructure the loans so more Americans may avoid foreclosure. And with that, I yield back my time, Mr. Chairman.

The CHAIRMAN. I thank the members. We will now begin with our witnesses. We have two witnesses, and I appreciate the two agencies providing them for us. We have represented here the FHA and the FDIC and we will begin with Mr. Bovenzi on behalf of the FDIC.

STATEMENT OF JOHN F. BOVENZI, DEPUTY TO THE CHAIRMAN AND CHIEF OPERATING OFFICER, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. BOVENZI. Chairman Frank, Ranking Member Bachus, and members of the committee, I appreciate the opportunity to testify today on behalf of the FDIC. As you know, asset quality deterioration, especially amongst residential mortgages, played a large role in triggering the current crisis. Declining asset values have reduced bank capital levels, which, in turn, has reduced their ability to lend. However, it is also true that a lack of liquidity among banks has also impacted their ability to lend. Liquidity is a key component in returning the economy to a condition where it can support normal economic activity and future economic growth. And deposits, significantly FDIC-insured deposits, are a key source of bank liquidity.

As you know, the FDIC has implemented the Temporary Liquidity Guarantee Program to help stabilize the funding structure of financial institutions and expand their funding base to support the extension of new credit. The program has had a positive impact. There has been a high level of participation and we are seeing significantly reduced credit spreads for participants. The FDIC's action to establish this program was authorized under the systemic risk exception of the FDIC Improvement Act of 1991. Participating institutions pay fees to offset the FDIC's risk exposure. If losses should occur, the FDIC would cover those losses through a special systemic risk assessment.

However, under current law, the FDIC's authority to assess premiums extends only to insured depository institutions. Recent actions taken under the systemic risk authority have directly and indirectly benefited entities beyond insured depository institutions, such as large holding companies, nonbank affiliates, as well as shareholders and subordinated creditors of these organizations.

We support amending current law to allow us to impose systemic risk special assessments on the range of entities that benefit from a systemic action, rather than just insure depository institutions. It seems only fair that those who receive the benefit should pay the cost.

Another important way the FDIC can help foster greater liquidity is to ensure a strong and flexible deposit insurance system. Since the creation of the FDIC during the Great Depression, deposit insurance has played a crucial role in maintaining the stability of the banking system. By protecting deposits, the FDIC insures the security of the most important source of funding available to insured depository institutions, funds that can be lent to businesses and consumers to support and promote economic activity. As part of our contingency planning, the FDIC recommends that Congress provide additional support for our deposit insurance guarantee by increasing our existing $30 billion statutory line of credit to $100 billion. Assets in the banking industry have tripled since 1991, the last time our borrowing authority was adjusted. We believe it would be appropriate to adjust the line of credit proportionately to ensure that the public has no confusion or doubt about the government's continued commitment to protect their insured deposits. The FDIC is committed to maintaining liquidity and stability in the financial system in times of economic uncertainty. The deposit insurance guarantee plays a vital role in maintaining consumer confidence. The adjustments to the FDIC assessment in borrowing authority that I have described would ensure that the FDIC is fully prepared to meet any contingency.

In closing, the FDIC will continue to work with Congress to ensure the banking system is able to support economic activity in these difficult times. Thank you.

[The prepared statement of Mr. Bovenzi can be found on page 76 of the appendix.]

The CHAIRMAN. Thank you, Mr. Bovenzi.

Next we will hear from Meg Burns, who is the Director of the Office of Single Family Program Development at HUD. Ms. Burns.

STATEMENT OF MEG BURNS, DIRECTOR, OFFICE OF SINGLE FAMILY PROGRAM DEVELOPMENT, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Ms. BURNS. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to speak today about your proposal to modify the HOPE for Homeowners Program. My name is Meg Burns, and I am the Director of Single Family Program Development for the Federal Housing Administration. I am here representing the Secretary of HUD, Shaun Donovan. This past August, I was appointed to serve as the Executive Director of the HOPE for Homeowners board. As you know, the board is composed of designees from HUD, Treasury, the FDIC, and the Federal Reserve.

All of us at HUD welcome and applaud your decision to make modifications to the HOPE for Homeowners Program. As you are well aware, the initial program data clearly indicate that changes are not only appropriate but necessary. Furthermore, changes are needed as quickly as possible. To date, FHA has insured no loans under the program. Lenders have taken 451 applications and 25 loans have closed.

To put these figures in perspective, according to the Congressional Budget Office's original projection, FHA should have insured approximately 40,000 loans by this point in time. That said, FHA supports program modifications such as those proposed in H.R. 787. Your proposals cut to the heart of the problems with the program, overly restrictive eligibility standards and extremely high costs to consumers. We believe that elimination of a number of the eligibility criteria could result in significant program uptake. The program restrictions have proven to be more and more challenging as economic conditions have worsened. The March affordability test, in particular, prevents families who have suffered recent financial hardship from participating in the program.

The proposals to reduce consumer costs are equally worthy. In particular, HUD agrees that the shared appreciation feature has been very problematic. The way the existing law is written, borrowers are being asked to pay the Federal Government for the benefit of program participation in an amount that is likely to exceed the principal write down they received. Today there is no dollar cap or time limitation and the borrower can only pay off the shared appreciation mortgage by selling the home.

FHA also appreciates and welcomes the proposed language requiring the HOPE for Homeowners Program to be run in accordance with existing FHA practices. Every minor deviation from FHA's existing standards requires large lenders to train staff, modify systems, and establish new quality control measures. Any disparities within the loan operations of a large institution require a great deal of time and resources, both of which hinder program uptake and certainly slow lender implementation timeframes.

While HUD generally supports all of the proposed legislative changes, there are a few that could benefit from some additional consideration, such as the proposal to eliminate the upfront mortgage insurance premium altogether. As an insurance company with a $300 billion insurance authorization to run this program, an upfront premium reduces the subsidy costs from potential foreclosures and claims. The upfront premium helps to defray the subsidy expenses in a way that stretches the insurance authority further, enabling FHA to help more families in need. HUD agrees that the upfront and annual fees are too high, but some amount of upfront premium income should be considered.

Another area worthy of additional discussion is the effect of the mandatory principal write down on subordinate lienholders. While FHA supports the overarching congressional objective to reduce the borrower's debt load to create sustainability, it may be possible to accomplish this objective with a stronger incentive for subordinate lienholders.

Finally, the lending community has expressed tremendous concern that the shared appreciation and shared equity mortgages, which serve as contracts between HOPE for Homeowners, borrowers, and HUD may violate State laws. While elimination of the shared appreciation mortgage would certainly fix one part of the problem, other changes such as the provision that creates Federal preemption of State laws for the shared equity mortgages could be a simple way to address the problem.

Again, I would like to thank you for the opportunity to participate in today's hearing on the proposed legislation, H.R. 787, and commend the committee for your proposed changes. I would be happy to answer any questions you may have.

[The prepared statement of Ms. Burns can be found on page 93 of the appendix.]

The CHAIRMAN. Thank you.

First, Mr. Bovenzi, let me, I think, reassure your people, we are talking here about increasing the borrowing authority. Is there any imminent crisis?

Mr. BOVENZI. No. We do not expect to use the money, but at the same time, we believe it is just prudent contingency planning. Nobody knows the future in its entirety and it has been many, many years since that borrowing authority has been increased. So just to keep pace—

The CHAIRMAN. I appreciate that. Maybe a certain amount is inevitable. You run into this dilemma that if you anticipate trouble that is not on the horizon, you may be making people think you see something bad coming. If you don't, you are in trouble. So let us be very clear. We are going to increase the borrowing authority solely as a matter of general prudence. It is not that anybody has any bad news coming or that there is any expectation that it is going to be needed right away. And I hope that will diminish the alarmism that our journalistic friends will convey. I have no hope that it will entirely extinguish it.

Ms. Burns, you talked about greater incentives for the second lienholders. Would you elaborate on that?

Ms. BURNS. Sure. Today under the program, the subordinate lienholders are entitled to an immediate payment of 3 to 4 cents on the dollar to release their liens so that a borrower can participate in the program. Clearly, we have heard from some in the lending industry that perhaps 3 to 4 cents is not enough for them to make that decision. And frankly, the mechanism that we would use to make that payment is rather clumsy today. There is no direct way for FHA to pay off those—

The CHAIRMAN. Is that something that can be corrected? Is it that you have some oversight board discretion and others have legislative? Take the second part, the clumsiness. Does that have to be corrected legislatively or could that be done through action?

Ms. BURNS. The amount of the payment?

The CHAIRMAN. Well, you said the second is the—

Ms. BURNS. The clumsiness. No, unfortunately that would require a legislative fix.

The CHAIRMAN. Part of it is, I do believe, some of the funding here could legitimately come from the TARP. There was always that intention, that the TARP would be used that way. When the Federal Reserve, in fact, announced its plans to reduce foreclosures, they cited authority that was given to them, in fact, the directive that was given to them and other Federal agencies in the original TARP. If we were able to carry out the new plan, what is the response that the high redefault rate is such that it doesn't even pay to try?

Ms. BURNS. Well, it is funny. I was listening to Mr. Hensarling cite some statistics on the redefault rates. And to be perfectly honest, while we did have to use some assumptions of claim rates and redefault rates with this particular program, we in FHA have never experienced such high redefault rates with our own loss mitigation program. Our redefault rate is about 30 percent, but our claim rate, our ultimate claim rate is substantially lower; about 90 percent of borrowers who do go through our loss mitigation program do ultimately sustain homeownership.

The CHAIRMAN. Is that partly because you think the FHA has greater experience with borrowers? I mean, that is what you do. The others—

Ms. BURNS. I think it is twofold. One is that we do have very aggressive loss mitigation practices. But on the other hand, it is also the difference between a modification program and a refinance program. I mean, these are refinances that will require full underwriting.

The CHAIRMAN. A very important point; I am glad you made that. And, look, redefaults are going to happen. But to the extent that you are actually modifying the terms of the loan, you are less likely to get the redefault than if you are simply rearranging the finances in that way.

I think that is very important, that we don't neglect the possibility of redefault. We also have tried working with you to think of ways to reduce the redefault obviously to the extent that you are doing principal reduction and people may get greater equity, but that is also a factor.

And let me just ask the last question, because we were concerned and some people have raised the issue that we don't want the people who were getting subprime loans who shouldn't have been granted elsewhere now will wind up at the FHA. Are you confident—is the FHA sufficiently staffed at this point? Do you have the technology to do the screening that is required? We want to be on the record that this is no automatic mandate to the FHA if this is still an independent decision by the FHA as to whether to give the guarantee to any individual or not. Can you handle it?

Ms. BURNS. Absolutely. And the beauty of the HOPE for Homeowners Program is we actually have authority to hire. We actually have been hiring additional staff to support this particular program and we had the authority to use some of the HOPE bonds for technology changes, so we have spent money making technology upgrades.

The CHAIRMAN. The last point I would just make is this, and we are worried about extra people being handled. To the extent that the program doesn't attract a lot of borrowers, you wouldn't hire a lot of people. I think the hiring would be demand driven. We have been joined by the ranking member, and I now recognize the ranking member of the full committee for 5 minutes.

Mr. BACHUS. Thank you. Mr. Bovenzi, press reports are indicating that the Obama Administration is ready to announce the creation of a so-called bad bank or an aggregator bank to buy toxic or troubled assets. They also indicate the FDIC will be the operator of that facility or that entity. Are you aware of those discussions?

Mr. BOVENZI. I am aware certainly of general discussions about what kind of program ought to be put in place and certainly that there would be an option for the FDIC to be involved dependent upon which approach the Administration took.

Mr. BACHUS. Sure. Let me ask you this just from your knowledge and jury experience. One question that I have asked and I don't have an answer to, would these be mortgage-related assets or would they include credit swap derivatives or junk bonds, the FDIC, do you have any insight on that as to what type assets or whether there be restrictions or do you have any suggestions in that regard?

Mr. BOVENZI. Well, I can't speak to what type of program the Administration may come out with when it is ready to announce a plan. I do know from the FDIC's experience in handling failed banks that we have dealt certainly with residential mortgages and other types of assets as well.

Mr. BACHUS. Mainly mortgage banked securities and home mortgages and—how about with credit swap derivatives, do you have experience with those as an agency?

Mr. BOVENZI. In some bank failures we have dealt with, there have been some derivative contracts. When I was out at IndyMac Federal bank, there were certainly contracts that had to be unwound. And, certainly in our supervisory authority in looking at banks, we see banks engaging in derivative activity as well.

Mr. BACHUS. One major concern of mine is how do you price these assets? From the FDIC standpoint, if you give market value as opposed to holding maturity value or current distressed value, it doesn't help the banks, does it? So what—can you give us any insight into what actually the price would be that would be paid?

Mr. BOVENZI. Certainly the most difficult question to determine in setting up any kind of structure that would take assets off a bank's balance sheet is what is the appropriate price to pay. In determining what is fair value in a market where there is very little liquidity and few buyers, market price may have a big liquidity discount. To determine what is fair—what an asset would pay if held to maturity—is the greatest challenge of such an operation.

Mr. BACHUS. Have there been any serious discussions of what that price might be?

Mr. BOVENZI. Certainly there have been discussions about how to determine price and it is a big issue to deal with.

Mr. BACHUS. Did mark to market regulations come up during those discussions?

Mr. BOVENZI. Well, I can't speak to all the specifics of discussions, but in general, how one would determine an appropriate price would be an important consideration.

Mr. BACHUS. I will just close by saying that obviously the higher the price that is paid, the more exposure to the taxpayers, and the FDIC would have to balance helping the banks with protecting the shareholders. Do you agree that would be a pretty complex procedure?

Mr. BOVENZI. Yes.

Mr. BACHUS. All right. Ms. Burns, HOPE for Homeowners, despite I think all of us our hoping that it would work, has not worked very well at all, and it hasn't worked as it was intended. Do you have anything to offer on why that is the case and how it could be changed?

Ms. BURNS. Well, actually I think the bill does go a long way towards moving us in the right direction—the eligibility criteria that were set out in the original law clearly were intended to serve the right purpose, but have served as barriers to participation. We have heard that again and again both from counseling organizations and lending institutions and secondarily the cost to the consumer, the cost of the product today is very, very high between the shared appreciation mortgage, the shared equity mortgage, the upfront mortgage insurance premium and the very high annual insurance premium.

It is the kind of product that people need to think twice about before they just decide to take it on. So I think the bill addresses both of those concerns.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Mr. Bovenzi, let me zero in for a minute or 2 on the Temporary Liquidity Guarantee Program and who is taking advantage of that program, who you do not have the authority to make pay for that advantage. Can you tell us who that is?

Mr. BOVENZI. The Temporary Liquidity Guarantee Program was made available to banks, thrifts, bank holding companies, and thrift holding companies. Today, nearly 7,100 institutions have entered the part of the program that deals with guaranteeing senior unsecured debt issuance and probably close to 7,000 banks have entered the program that guarantees non-interest-bearing transaction accounts.

Mr. WATT. So everybody in the program who is not an FDIC insured institution is taking advantage of it for free?

Mr. BOVENZI. Well, no. We charge user fees for entrance into the program. So if you are a bank holding company or thrift holding company or bank or thrift, you pay a fee to get that guarantee. What the systemic risk authority does for us is if we end up with greater defaults than we have collected in revenue, under the law, we would have a systemic risk assessment to get the extra revenue from the industry to cover our cost. But right now we could only assess the banks and the thrifts. We could not assess the bank holding companies and the thrift holding companies.

Mr. WATT. So how do you have the authority to set up a program without the companion authority to make that kind of assessment?

Mr. BOVENZI. Because under the systemic risk authority, it requires ⅔ of the FDIC Board, ⅔ of the Federal Reserve Board, and the Secretary of the Treasury to agree.

Mr. WATT. And that authority comes from where?

Mr. BOVENZI. It comes from Congress.

Mr. WATT. Why would that not—that authority not imply the authority to do whatever is necessary to—

Mr. BOVENZI. The authority, as it stands right now, for making a systemic risk determination, is one part of legislation we have from Congress, but to assess additional premiums is a different part of legislation that focuses only on banks and thrifts, rather than the holding companies, and we think it would be fair and prudent to be able to assess the same group that is receiving the benefits from that.

Mr. WATT. That is a contingent assessment. You say they paid for it as long as it works. But if it fails and you had to assess, you wouldn't have the authority to assess more?

Mr. BOVENZI. That is right. However, we are charging.

Mr. WATT. So it is working as long as it works? How is it working?

Mr. BOVENZI. Well, it is working very well at the moment. We don't use the deposit insurance fund. We don't use taxpayer funds. We charge those who benefit from the guarantee of issuing that debt or getting the noninterest bearing transaction accounts insured. We charge those fees now and we will guarantee debt 3 years out into the future. So if by chance defaults in the future exceeded the revenue that we have generated from those user fees, we need a mechanism to charge additional money to those who benefited from that guarantee.

Mr. WATT. So is there sufficient value, in your opinion, for this authority to be made permanent as opposed to just 3 years out, or you haven't made that kind of assessment yet?

Mr. BOVENZI. This particular program is a temporary program.

Mr. WATT. I understand that. I am trying to find out whether it is valuable enough—

Mr. BOVENZI. It is a permanent authority. So having a permanent change that would match up the assessments with the authority would be appropriate, I think.

Mr. WATT. And you think it would be a worthwhile program to extend beyond these emergency circumstances?

Mr. BOVENZI. The systemic risk authority is only used in emergency situations, not used in a normal healthy economy or a stable situation. So any discussion about extending the program would depend upon an evaluation of whether we were still in a difficult financial period.

Mr. WATT. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. Ms. Burns, on page 3 of your testimony, you indicate that HUD agrees that the shared appreciation feature has been very problematic, though notes that any reduction to shared appreciation will increase the cost to the government. Has HUD estimated what those increased costs will be?

Ms. BURNS. No.

Mr. HENSARLING. In the previous paragraph in your testimony, you say that, "HOPE for Homeowners is a product that is intended to help as many families as possible." I suppose that only subject to the $300 billion ceiling theoretically you could help every family in America that was having trouble paying their mortgage. But in this balance between how much more taxpayers will have to bear versus struggling homeowners who may receive taxpayer assistance, what is the balance that HUD is seeking?

Ms. BURNS. Well, I mean, I guess I would answer the question by saying the beauty of the program is that those who would be eligible to participate are those who have sufficient income to repay on the HOPE for Homeowners mortgage. There are appropriate underwriting standards to make a determination about those who are appropriate to receive the benefit. So it certainly can't help every single person in trouble, but it is a program that is available to help those who have sufficient income and whose debt obligations are not so great that they can't qualify for this mortgage product.

Mr. HENSARLING. But under the new amended legislation, aren't you, by definition, decreasing the underwriting standards to hopefully have an uptick in participation rate, and one could argue that is what led us into the problem that we have in the first place? Are we not still trying to sustain people in homes that unfortunately they cannot afford?

Ms. BURNS. I would say no. I would say that the eligibility criteria that are proposed for elimination in 787 are not underwriting criteria. They are factors that will restrict people from being eligible to even attempt to qualify for the program. So the qualifying standards would not change under the program. It simply opens the door to make sure that more people are eligible. So for example, the affordability measure that exists in the law today says as of March 1, 2008, a borrower must have a mortgage payment to income ratio of 31 percent.

There are people who have sustained some type of loss to their income since March 1, 2008. As of March 1st, they were able to make their mortgage payments; since March 1st, they can't. Those people aren't eligible to participate in HOPE for Homeowners. I don't think that was the original intent of Congress. So those are the kind of eligibility restrictions that to me appear to be the subject of the proposed changes. And I think that is appropriate.

Mr. HENSARLING. It appears this legislation will be tied to other legislation coming out of the Judiciary Committee dealing with what is popularly known as "cramdown," which gives bankruptcy judges the unilateral ability to, among other things, write down principal. What impact might that have on the FHA insurance fund and the ability to attract lenders to participate in the program?

Ms. BURNS. Well, I am actually in the program development side of our business in FHA. That is really a servicing issue. And I understand that the Obama Administration is looking at that issue and they will be formulating a position on that issue. But I am not an expert on that subject.

Mr. HENSARLING. Mr. Bovenzi, when the FDIC became the conservator for IndyMac and started a new streamlined loan modification program that some see as a template for other legislation, can you share with me how the universe of potential homeowners, struggling homeowners were chosen, why the particular universe, and what the redefault rate has been?

Mr. BOVENZI. Sure. The program was set up to be of benefit to both the borrower and for IndyMac. As a condition, it has to be shown that modifying the mortgage would maximize the return for IndyMac compared to the cost of foreclosure, so we started by looking at loans that were 60 or more days past due. There would be a certain percentage of those that would go into foreclosure and a certain percentage that would ultimately be able to pay. So we would look at a formula to determine whether this person's mortgage can be reduced enough to make it affordable and sustainable for them and still provide a greater present value than would be obtained through foreclosure.

It is a fairly detailed model to run through. Not everybody is going to qualify. If you don't have a job, and your income has dropped very low, then it is not going to be sustainable or affordable, and you won't get the modification. The program is designed to do two things: maximize net present value for the institution; and be affordable and sustainable for the borrower. In terms of redefault rate, it is a little early, so we don't have sufficient experience at this point. They are very low.

Mr. WATT. [presiding] Mr. Meeks is recognized for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman. Mr. Bovenzi, I just want to follow up briefly so that I make sure I understand about the TLPG program, that it works in emergency situations. It seems as though it is working currently, is what you are saying. Does that extend because one of the huge problems that we are having all across America right now with credit tightening up as it is, small businesses who employ a large number of Americans throughout and I know just recently in my district, in talking to some small business people because they don't have liquidity, they are beginning to lay off individuals, one or two, and it is having a real effect. I was wondering whether or not the use of the TLPG program is at all something that can help with liquidity for the small business man and woman in America?

Mr. BOVENZI. Yes. And this is the primary purpose of the program. Banks in the current market, where the marketplace is very unsure of the value of their assets are unable to borrow money that they in turn could lend to businesses and consumers. So this program is to provide liquidity for banks to help them lend. And we think it has been working very well. Their borrowing spreads have come down significantly because of the FDIC guarantee. They are paying the fees for that guarantee. It is structured where they can continue to issue senior unsecured debt up through mid-year 2009 for maturities of up to 3 years beyond that, so that they can borrow longer term funds to keep lending going for a longer period of time. So we think it has been a very helpful program and that is the purpose, to help businesses and consumers obtain loans.

Mr. MEEKS. Now, I think Mr. Watt asked the question about making it permanent, but you said that it would be up to someone else. I thought that I did read somewhere that the 3-year temporary period would be extended, or was thought about being extended, to 10 years. Could you tell me something about that?

Mr. BOVENZI. The authority to extend the program would have to be taken up by the FDIC Board of Directors directly. Yes, discussions have taken place about whether it should be extended for a longer period of time. And so we would see if indeed that will happen. It is being evaluated.

Mr. MEEKS. Would you recommend it?

Mr. BOVENZI. It depends on continued market conditions as to how long you have such a program in place. Ultimately we want to get back to the point where we don't need these kind of government guarantees in place. So when the market is stabilizing, then we really do need to exit from this kind of business.

Mr. MEEKS. Thank you.

Ms. Burns, let me ask you this question in regards to HUD and dealing with some of these FHA loans. I understand that currently mortgage brokers can receive what we call yield spread premiums, which seems to be directing individuals or borrowers into higher interest rates than they may ordinarily qualify for. Do you believe that at least for FHA loans that we should eliminate these yield spread premiums so that we can drive the costs further down?

Ms. BURNS. To me, that is an issue that is much broader than FHA. We don't regulate the interest rates on our loans. But the question about yield spread premiums has certainly been discussed in a broader context, certainly in the context of RESPA reform. So in the context of FHA, I would say FHA shouldn't be treated differently from any other type of loan-type product, and if somebody wanted to address that question in a broader context, that would not be a question for us.

Mr. MEEKS. But you would be part of this conversation, wouldn't you, surely? Because when we are talking about FHA, as to Federal housing, you want to make sure people get the lowest loan or interest rate that they qualify for, they are not steered in another direction simply because someone else is making money. But definitely shouldn't FHA be a part of that dialogue?

Ms. BURNS. Oh, FHA could be part of that dialogue. And there are other regulatory bodies within the Department of Housing and Urban Development who would certainly be a part of that conversation.

Mr. MEEKS. What about originators? Oftentimes I have found that you have had originators who—maybe you have an FHA loan that doesn't, and they don't comply with FHA requirements. In that regards, if someone or an originator has—

Mr. WATT. [presiding] The gentleman's time has expired. I am sorry, the chairman is following a pretty busy schedule, and there are a lot of people.

Mr. MEEKS. Thank you. I understand, in order to be fair to everyone else.

Mr. WATT. Mr. Castle for 5 minutes.

Mr. CASTLE. Thank you, Mr. Chairman.

Let me ask you a question, Mr. Bovenzi. H.R. 786 gives the FDIC the authority to take out loans from the Treasury of up to $100 billion at any one time, and to go beyond that limit with the Treasury Secretary's approval. What limits are there on the FDIC's ability to use these funds, and could you fund the bad bank facility with this money?

Mr. BOVENZI. The FDIC's intent in asking for this greater authority is not to use it for a bad bank. The request came in before such discussion. The purpose is to cover losses. If the FDIC fund were to become insolvent for a temporary period, until it could assess the industry to replenish the fund, it would be a source of borrowing for the agency to cover that shortfall until such time as the industry paid the money to repay the U.S. Treasury and the taxpayer.

Mr. CASTLE. Thank you.

Ms. Burns, you are a very bright lady and appear to be a very nice lady. You are in charge of one of the most failed programs we have had in a long time, and I can't quite figure out why. I am not blaming you when I say this, obviously. Maybe we should blame us as the ones who drafted it, I don't know. But I am concerned about that and concerned about what the future is.

If we make some of the changes with legislation, and you have already gone through some meetings and made some changes yourselves, and yet I think the total loans are 25 that have been revamped as a result of this program. I am concerned we are wasting money at this point. In other words, we would be better focusing on a different direction altogether.

I saw some statistic here that even with these changes, CBO, the Congressional Budget Office, now predicts the program will help a mere 25,000 borrowers. Originally it was 400,000 borrowers. So this is clearly not doing what we hoped it would do.

My question is, first of all, do you feel we can amp those numbers up somewhat? And perhaps, first or secondly, I would be interested to hear you restate—you stated in both answers to questions and in your original testimony exactly what the real blocks are as far as you are concerned. I heard some of the cost issues or whatever. But if you could sort of give us a 1, 2, 3, 4, 5, I would appreciate that, as best you can.

Ms. BURNS. Sure. There were a lot of questions embedded in your single question, so let me actually start with, do I think the program could be revamped and improved and made to work? Absolutely. And I also think it is critically important that we have a refinance product available; modifications are fine and good and certainly help some subset of the borrowers who are in trouble, but a refinance product has a different place in the toolkit. And today we have no refinance product available to borrowers who are delinquent on their existing mortgages.

So I do think it is critically important that we either fix the HOPE for Homeowners program or provide the Federal Housing Administration with some other type of legislative authority to offer a product to borrowers who are in trouble.

That said, as I mentioned previously, some of the eligibility criteria that are associated with the program today are very problematic. The affordability measure that I mentioned earlier, the March 1, 2008, affordability measure, has proven to be very problematic.

Mr. CASTLE. You are doing this in the order of how you see the importance?

Ms. BURNS. Well, no, I was not doing it in quite that order, to tell you the truth. But there are other eligibility criteria that are barriers to participation. It is obvious when you actually read the original piece of legislation. There was a requirement that the borrower certify that they did not intentionally default on the previous mortgage. That is really problematic only in the sense that technically everybody intentionally defaults. You are making a very hard decision as a consumer when you are in trouble, do I pay my gas bill and keep the heat on so that my kids are warm, or do I make my mortgage payment? And there are a lot of people who feel very uncomfortable certifying that they did not intentionally default on their previous mortgage.

There was a provision that said that borrowers must not have provided false or misleading information to qualify for the previous mortgage. There are certainly a number of people who have stated income loans who either knowingly or perhaps unintentionally provided false income information to qualify for that previous mortgage. These people aren't eligible to participate.

There is a provision in the law that says the borrower cannot default on the first payment on the HOPE for Homeowners loan. We believe the intent of Congress was good: You were all trying to protect FHA from lenders dumping nonperforming loans on the FHA insurance fund. Great intent, but it really scares away lenders. They say, gosh, if there is any chance that a consumer might miss that first payment, it is not somebody I want to serve.

So there are all of these eligibility criteria listed in the law that are very specific and very narrow that have proven to be problematic; and perhaps an easier way to write a piece of legislation is more broadly, more generally to give authority to the Federal Housing Administration to design the program and then to—

The CHAIRMAN. Time has expired.

The gentleman from Massachusetts.

Mr. CAPUANO. Thank you.

I realize all the difficulties we have, and we are trying to fix those, and I appreciate your efforts, but when I see a title that says, “Office of Single Family Program Development,” I always have to ask one question: the definition of single family. I live in, own, and occupy a two-family home. Am I covered?

Ms. BURNS. Yes, you are. And we recognize that the original policy reflected a very narrow interpretation of the original legislation, and that has been fixed. I am sure that that is what you are referring to.

Mr. CAPUANO. It is. I knew the answer, but I wanted to hear it anyway.

Ms. BURNS. Very good.

Mr. CAPUANO. Mr. Bovenzi, I wanted to talk a little bit more about the FDIC. As I said earlier, I generally support this proposal. I would like to ask two questions. Number one, why is it that you think there is any need for you to have unlimited access to capital? I understand the $100 billion and am not worried about a specific number, but why would you suggest that we should simply say that it should be unlimited?

Number two, I would like to have a little discussion on potential concerns I have for the FDIC in the near future.

Mr. BOVENZI. Going from the $30 billion to $100 billion; the $30 billion came about in 1991.

Mr. CAPUANO. I understand that and accept the $100 billion.

Mr. BOVENZI. And to go beyond that would require agreement by the Secretary of the Treasury and could only be done in consultation with this committee.

Mr. CAPUANO. I understand, but why would you think that, after having been through what we have been through, that I or anyone in their right mind would want to say, you don’t ever have to come back to us again; go ahead, all you people in the Administration, just go in a closet and make a determination of how much money you want to print?

Mr. BOVENZI. I would just say two things. One, the full faith and credit of the United States Government does stand behind the FDIC, and the public is dependent upon that full faith and credit. Any borrowing that the FDIC did from the U.S. Treasury would be paid back from assessments from the banking industry.

Mr. CAPUANO. I understand all that, but that does not give me an argument as to why you need it. That simply tells me what happens. I understand the full faith and credits behind the FDIC. I like the FDIC, I think you do a good job, but I, for one, will never vote to give anybody another blank check. It won’t happen, ever. So I appreciate it, but you did not answer the question.

The next thing I want to talk about, because I only have a few minutes, I am getting more and more concerned particularly when it comes to some of the large banks. We have one in particular—there are several, but one in particular stands out in all the news accounts—a year ago was worth $225 billion, and today it is worth $19 billion. That is after taking into account $45 billion of taxpayer money that is there. It is effectively underwater by $26 billion. If it was any other bank, you would have taken it by now.

What is going on? Should I be concerned? Should America be concerned? I know it is not going to happen tomorrow, but I have to tell you, that is a little disconcerting to me as a person who might have to vote to increase your borrowing way more than $100 billion if this bank were to go under.

Mr. BOVENZI. Well, certainly I understand your concern. And without talking about any particular banks—

Mr. CAPUANO. I think it would not be very difficult to know who I am talking about.

Mr. BOVENZI. Clearly the financial system has had extreme difficulty for some time now, and the U.S. Government has been taking every measure to address that situation and help improve that situation. And a number of very positive steps have been taken to help the situation, but we are not fully in the clear yet.

Mr. CAPUANO. Wouldn't my taxpayers be better served—it is their $45 billion that is sitting in this bank, their $26 billion of money that has already been lost on paper. Wouldn't we be better served by having somebody who might understand that maybe they shouldn't be buying jets, or paying out huge bonuses, or maybe they shouldn't be paying $400 million to name a stadium; that maybe somebody who understood those things should be running those banks, this bank in particular, as opposed to the people who have gotten us into the problem?

Mr. BOVENZI. I agree, it is important for banks that receive taxpayer assistance, even if that assistance is earning interest and being paid back, to understand that money is being brought forward to help stabilize the financial system, improve lending, and improve the economy.

Mr. CAPUANO. Mr. Bovenzi, I voted for the TARP. I am happy I did. I am not happy with everything that has happened with it, but I think it was the right thing to do. I voted for the stimulus. I fear that I may be voting for additional assistance or additional bailouts for banks as a necessary item for the economy, not for an individual bank, but it is necessary.

I am deeply concerned that my taxpayers may be asked to put good money after bad because the FDIC might be afraid to take action in a dramatic fashion, and I would ask you to ask your superiors to make sure they consider that.

My time is up.

The CHAIRMAN. The gentleman from Florida, Mr. Posey.

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

Mr. Bovenzi, I am trying to connect the dots, and my question is not as sophisticated as some of the others that have been asked of you, but it will help me get a little bit better handle and enable me to better explain some of the things that have happened to some of my folks back home.

I would just like your take on a situation, and it is a realistic situation. It would be indiscreet to name names, I guess, you know, Countrywide. People having a house that has a $400,000 mortgage. I like the term somebody used: It has become a devalued asset, and the value of the house is probably about $200,000. And in the rough times, the rough storms at the beginning of this tough economy, one of the breadwinners was out of work for a while, and they got behind a couple of payments on their house. They got another job, and were ready to make the payment, and the mortgage company said, no, we are not going to accept your payment unless you get caught up and pay us up in full.

Now, help me understand when you are upside down, 50 percent in a piece of property and you are supposed to be trying to mitigate your loss, how in the world that can happen?

Mr. BOVENZI. Well, I certainly don't understand why something like that would happen. If you have a property that is worth $200,000 with a $400,000 mortgage going into foreclosure, you are not even going to get $200,000 after you go through all your expenses, so accepting some reduction from a borrower in such a circumstance certainly makes sense to me. It is the kind of program that the FDIC has supported—to have more affordable mortgages in situations where it works to the institution's and the borrower's benefit.

I think maybe, as some of these events were developing, there were situations that weren't handled by some institutions the way they should be. And I think all of us are trying to be very public about appropriate types of loan modifications that can help everyone in this situation, stabilize housing prices, help improve the economy, and help such borrowers.

Mr. POSEY. And this is not—may I, Mr. Chairman?

This is not an historic perspective I am telling you about, this is current. It almost seems like a malfeasance on the part of the lender here. I mean, what would you as a highest-ranking expert recommend, or how would you recommend we approach things like this? What do I tell the people? Is there a cause of action they can have? How about the people who are holding this paper, that they are obviously, clearly, willfully and knowingly jeopardizing for who knows what reason—I mean, we are not talking about mortgage modification, we are talking about common sense, accepting more money to pay down a mortgage that is in default which far exceeds the value of the property.

Mr. BOVENZI. I would suggest that if there is a particular institution, that the individual or people speak to someone at a high enough level in the organization and bring it to their attention. Then if the facts are such that the modification is better than foreclosure, most institutions are saying that it is their policy today to do loan modifications where that improves value compared to foreclosures. So it could probably be addressed by bringing it to the attention of that organization.

Mr. POSEY. I would suggest they go higher up the ladder. I respect and I admire these kids. They have shown me clearly how it would make sense to let their home go back and buy one next door in a short sale, because that is the kind of neighborhood that it is in right now. But the company just seems to play this crazy hardball. I don't see any upside to it, and I was hoping you could give me insight, but you are just as frustrated by it as I am.

The CHAIRMAN. Would the gentleman yield? How recently is that? Is that current?

Mr. POSEY. Mr. Chairman, within the past year. Currently, that situation exists.

The CHAIRMAN. It does exist currently?

Mr. POSEY. As we speak.

The CHAIRMAN. Thank you.

Mr. POSEY. I yield back.

The CHAIRMAN. The gentleman from Missouri, Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman.

Ms. Burns, in your statement you mentioned that to date, HUD has insured no loans under the HOPE for Homeowners program, and that FHA-approved lenders have taken 451 applications, and 25 loans have closed. You further stated that the CBO had originally projected that the program would assist 400,000 families over 3 years, and that FHA should have already and should approximately 40,000 for these figures to be achieved.

You have concluded that programmatic restrictions and high costs have contributed to low participation rates. Can you be more detailed and specific in explaining this and other remedies to the low participation rates that you think will work?

Ms. BURNS. Well, sure, since I already listed out the eligibility restrictions that are very problematic, I will turn to the other side and talk about some of the costs to the consumer.

The shared-appreciation mortgage in particular is of tremendous concern. As I mentioned in my testimony, it is very costly to a consumer. Moreover, the shared-appreciation mortgage and shared-equity mortgage are two financial instruments that the lending community is not familiar with. That complicates the program, and they both represent new costs to a consumer that are not familiar. So those two costs in addition to the annual premium in particular on this product we have heard are problematic.

The annual premium is 1½ percent. That is 3 times the standard FHA premium. The way you can understand how significant that cost is, is to envision it added onto the interest rate of the mortgage. And because this is a product that has a likely higher default and claim rate, the interest rate will be slightly higher.

So let us say this is a product that has a 6½ percent interest rate. When you add the 1½ percent to it, that is an 8 percent interest rate. When you try to qualify a borrower for this product, and you have an 8 percent interest rate, and you are trying to get them under some debt ratios, you are trying to get them into a mortgage-payment-to-income ratio of, say, 31 percent and an overall household-debt-to-income ratio of 43 percent, the higher the interest rate, the harder it is to get the consumer into the product.

Mr. CLAY. Let me ask you, on that point, then, do all of these potential borrowers belong in that category; is it based on a credit rating? Or why are they being pushed into these high loans?

Ms. BURNS. Why is the interest rate slightly higher on a product like this? It really has to do with what the secondary market's appetite is for the type of mortgage product. These are mortgages that do go into special Ginnie Mae pools, and they are a product that is intended for a borrower who already has a riskier credit profile. So they are subject to analytics by people on Wall Street, and people would say, you know, we expect to see these loans go bad at a higher rate.

Mr. CLAY. Which was part of the problem of the whole housing crisis and the meltdown of mortgages, correct? I mean, steering people who probably qualified for conventional or prime rates into subprime mortgages so that others could make money. Wasn't this part of the problem?

Ms. BURNS. Well, we in FHA would certainly—

Mr. CLAY. And we are continuing it?

Ms. BURNS. Well, no, I would disagree with that. We in FHA would agree that there were a number of consumers who took out subprime loans who certainly could have benefited from an FHA loan where they would have gotten prime rate financing or close to prime. But this particular product, the pricing is slightly higher than the market rate, but it is not like your subprime products of the past 5 years.

Mr. CLAY. Okay. What are some of the obstacles that will continue to make it difficult for servicers or securitized loans to participate in the HOPE for Homeowners program? What can be done to make the program more effective?

Ms. BURNS. Well, in my opinion, elimination of a number of the restrictive eligibility criteria and some consideration of some of the costs to the consumer. Really, to me, if we want the lending community to do the right thing, if we want people to take a loss to put borrowers into the HOPE for Homeowners program or some other type of refinance vehicle, we actually need to make it as easy as possible for them to do that and not set up barriers to entry. That is what we have with this product; that in trying to protect the American taxpayer and create a program that is fair, we actually created a number of barriers to participation.

Mr. CLAY. Sure. I thank you for your response. I appreciate the insight.

I yield back.

The CHAIRMAN. The gentleman from Minnesota.

Mr. PAULSEN. Thank you, Mr. Chairman.

Mr. Bovenzi, one of the concerns last fall when the FDIC limits were being discussed was the ability of the Deposit Insurance Fund to withstand the strain of potentially any bank failures that came up. I certainly believe we must make sure that Americans have trust in the deposits that are going into the FDIC-insured accounts.

Do you have any concerns at all with extending the restoration plan or the reserve period for when the reserve ratio would drop from 5 years to 8 years as proposed in the legislation?

Mr. BOVENZI. I think if Congress were to go forward and make permanent the deposit insurance level at $250,000, it does add exposure to the FDIC funds, so we would need to be able to charge premiums to the industry to help restore a balance to the level of the Deposit Insurance Fund. And it would seem appropriate to have that kind of flexibility, in going from 5 to 8 years, to be able to balance how quickly to bring the revenue in with the demands being placed on the banking industry at that time.

So that flexibility, to me, seems to go together with the $250,000; if one were to be put in, it would be appropriate to have the other.

Mr. PAULSEN. And obviously if the assessments were going to go up or potentially double, as I think has been discussed at the FDIC, is there some concern about the liquidity, having the ability for liquidity in the market as well?

Mr. BOVENZI. Yes. And those are very careful deliberations on what is the appropriate premium level to charge the banking industry and how quickly to replenish the Deposit Insurance Fund back to its normal level, given those competing objectives that we have at this time.

Mr. PAULSEN. And, Ms. Burns, I know you mentioned you really believe that removing these barriers and making it much easier to participate in the HOPE for Homeowners program is going to make it successful. I guess my question is, do you have any sense of what the timeline might be to actually see some real numbers come in? Because when you see the forecast of 400,000 homes that are potentially users to actually use the program, and only 25 actually do—what sort of timeline do you think as Members we will actually be able to say it was successful and actually worked if we remove the barriers?

Ms. BURNS. Well, it is a very interesting question. One of the questions back would be how quickly could the piece of legislation be passed, and how similar would the program look to an existing FHA product? The closer it is to an existing FHA program, the easier it is to implement for everyone; for FHA, obviously, but also for the lending community.

One of things that makes the program so difficult today is that it has so many distinct requirements and these new financial instruments that require the lending community to set up new protocols and procedures. If we had a product that was similar to the existing FHA programs, the lending community could adopt it fairly quickly, easily modify systems in a minor sort of way, and we could get it up and running within, I would say, a matter of weeks. So I would certainly advise that we think along those lines, making the new product as similar to existing FHA programs as possible.

Mr. PAULSEN. I yield back, Mr. Chairman.

The CHAIRMAN. Let me just ask you, how close would the program be to an existing FHA project if we passed the bill as proposed?

Ms. BURNS. It would certainly be closer, but there are still some components that are different. For example, the shared-equity mortgage is certainly still different.

The CHAIRMAN. Would we get rid of it here?

Ms. BURNS. You would get rid of the shared-appreciation mortgage.

The CHAIRMAN. If there are further proposals that could help us, please feel free to let us know what they are. There will be a markup tomorrow, but there will be a bill going to the Floor, a separate bill.

The gentlewoman from New York, Mrs. McCarthy.

Mrs. MCCARTHY OF NEW YORK. I just want to follow up on something my colleagues have already brought up. When you read the paper about all those losing their jobs, and obviously they go on to unemployment, and a lot of these areas are in distressed areas already, what do you see out there as far as helping someone, or is there not going to be any help for those who have lost their job, unemployment, and now they are not going to be able to make their mortgage payments? I mean, we are going to probably see a lot more of these foreclosures coming in.

The curiosity they also have is being that you have certainly the larger financial institutions, you have the larger banks, but you also have these small community banks. Are there any estimates on who is out there on really making the lending to some of these customers? Is it the smaller community banks or the larger institutions? Do you have any statistics on that?

Mr. BOVENZI. Well, first, to respond to the first part of your question, there are going to be some situations where loan modifications aren't going to work, and if somebody has lost their job and has no income, then it is not going to be possible to have the appropriate type of loan modification. So there you need some different kind of package to help stimulate job creation in the economy. So I think loan modifications are very positive, but they are one piece of a package that needs some form of economic stimulus as well to help in this kind of economy.

In terms of institutions doing the lending, we have put out guidance to the banks stating that we expect them to track how they are using government money toward lending, and our examiners will be checking that when they do their examinations. And we encouraged institutions to put it in public reports, so we will be gathering that information. But at this point in time, institution-specific information, in terms of who is doing more lending than others, we don't have that at this point.

Mrs. MCCARTHY OF NEW YORK. The problem is—and one of my colleagues—in my opinion, it is pretty radical, but maybe, you know, we are talking about the possibility of having thousands and thousands of families homeless. One of our colleagues suggested they break the law and stay in their home. But what is the solution going to be? We don't have enough shelters for homeless families now. What are we going to do?

Hopefully, the stimulus package will work. Let us face it, that will take time also. I think everybody needs to rethink what we are going to be doing with an awful lot of families on how we are going to make sure—you know, they are all paying their mortgage up to a certain point. So the banks are going to lose out on that, because no one is going to buy their home, most likely; keep the families in there; the economy comes back hopefully within the next year or so; renegotiate and pay a little bit extra for the year that you are out there. Or is that too much common sense?

Mr. BOVENZI. I would just say you are right. People need to be thinking as broadly as possible in this situation as to what are the appropriate solutions, and it is going to take more than one type of action. I don't have a specific answer for you, but the government needs to be addressing this in a variety of ways to help get the economy back on track.

Mrs. MCCARTHY OF NEW YORK. Ms. Burns, one of the things you and I had talked about just a while ago, we are still seeing these advertisements on TV on predatory lending. Are we taking any steps on those who are trying to get into the FHA program, that they are not predatory lenders and taking advantage again of the consumer?

Ms. BURNS. Well, FHA does have approval standards for all lenders who want to come into our business. We certainly reject lenders who can't meet those standards. We don't have a standard that specifically says if you have been engaged in some type of predatory practice per se, but if an organization has been convicted of some type of activities, they certainly wouldn't be eligible to participate in the FHA program.

Regarding marketing, one of the concerns we always had is misrepresentation by an organization that they are part of the government, that they are FHA, and we certainly do take action in any cases where we see that type of activity.

Mrs. McCARTHY OF NEW YORK. When you say a predatory lender was convicted, if it is in one State, and they go to another State and start their business all over again, are you tracking that? Do you have the computer that will say, okay, they were convicted in New York, but now they are going to New Jersey?

Ms. BURNS. This is not my area of expertise.

The CHAIRMAN. Time has expired.

At the last hearing which we had on the FHA, the FHA representative did raise a question of what seemed to us to be unduly limited debarment powers. And I don't remember who, but I know there were some Members here working with the staff on legislation to enhance the debarment powers of the FHA. So that is something that we did get out at the last hearing, and it is our intention to move a bill to that extent, and that one I do remember very clearly. So I expect that we will have—I think the gentlewoman from California, Ms. Speier, is the one who had raised the issue, and she is working on it, and we have a bill that I think will probably be broadly accepted to enhance the debarment proceedings of the powers of the FHA.

The gentleman from Texas.

Mr. NEUGEBAUER. I thank the chairman.

Ms. Burns, during the hearing this committee held right after the 1st of January, I asked the Department about the impact on FHA should the law be changed to allow bankruptcy judges to modify the terms of mortgages. HUD responded to my question in writing. I ask unanimous consent that we enter this letter from the FHA Commissioner for the record.

The CHAIRMAN. Without objection, it is so ordered.

Mr. NEUGEBAUER. They expressed numerous concerns about this provision of cramming down mortgages. And quite honestly, after I looked at those concerns they have, I believe if this ill-advised legislation is brought forward, I would think we should exempt FHA from the cramdown bills.

One of the problems with that is that peels off a guaranteed instrument and provides some of that then remains a secured instrument, and part of it remains an unsecured instrument. And so the question of how much insurance—are you detaching the insurance from the secured portion or the unsecured portion?

And I think I asked this question, and I am still waiting for this portion of the answer, but has anybody taken a look into the portfolio? You have had a substantial amount of losses in 2008, and the fund has been going in the wrong direction. It has been shrinking its percentage of assets. Has anybody taken a look at that and said, hey, if judges start cramming down these mortgages, our loss ratio will increase? Do you have some numbers for us on that?

Ms. BURNS. No, I do not have numbers on that, but I would like to state for the record that while FHA has taken some funds from the reserve account to cover future potential losses, those do not represent losses to the FHA today. So while there has been some mischaracterization in the press of the recent action by FHA to take, frankly, prudent action and move some funds from one account to another to cover future potential losses, that isn't a loss to the fund.

Mr. NEUGEBAUER. Well, now, correct me if I am wrong, but actuarially, I think a third party actuarially looks at that number, and they have raised the amount of potential loss that they think you are going to incur. And it has, in fact, reduced your number pretty close to the statutory level; is that correct?

Ms. BURNS. Let me just clarify the way that works. At the beginning of a fiscal year, we calculate, we actually do a projection at the beginning of the fiscal year to determine what we think the composition for the book of business for that year will look like and what do we think the volume of business will look like. And we set some assumptions what do we think the economic conditions will look like, what will the home values be, what will the interest rates be. And we set the premiums so that we can generate adequate premium income to cover losses.

We then, again, partway through the fiscal year, do another assessment of the composition and volume of the business coming in and the economic conditions. And what everybody saw just recently was that when we did that reassessment, some of the assumptions we set at the beginning of the year were different from what we were experiencing. So in other words, the book of business was much larger than we had originally projected, and the economic conditions were worse.

So what we did was we said we may sustain greater losses than we projected at the beginning of the year, so we are going to take some funds from the reserve account and set them aside to cover those future potential losses. It really is a prudent management practice as opposed to any loss to the Federal Government. And we do that constantly; every single year we do that same kind of assessment again and again.

Mr. NEUGEBAUER. I am going to stop you.

Did you increase the premium to try to offset some of those assessments?

Ms. BURNS. We had increased the premiums at the beginning of this past fiscal year, correct.

Mr. NEUGEBAUER. And when do you think you are going to have to—and I think this is an important question, because we are all interested in how to get the right balance here. But are you going to have to increase premiums again, and would this cramdown provision change that risk model where you may even have to increase those premiums more?

Ms. BURNS. I am not in our budget office, so I cannot say for sure whether we will or will not increase premiums, but I can say that if we were to do a projection and an estimate that demonstrated that we needed to increase premiums, yes, we absolutely would. And the policy assumptions that are used to make that determination include legislative changes that might affect the FHA fund.

Mr. NEUGEBAUER. So doesn't that then begin to affect the affordability issue and the competitiveness of the FHA program then?

Ms. BURNS. Well, the beauty of the FHA program is that the borrower still gets market-rate financing. So while the premium may increase slightly, it is relatively small in the scheme of things, and they still get market-rate financing.

Mr. NEUGEBAUER. So could you furnish this committee the information? When will you do your next assessment? When will the model be?

Ms. BURNS. I actually think we are in the process of doing that right now.

The CHAIRMAN. The gentleman from Massachusetts is recognized for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank the witnesses as well for their testimony today.

Mr. Bovenzi, I want to go back to the earlier discussion that you had with the ranking member about the bad bank model that is under consideration right now. I am concerned, as a lot of my colleagues are, about the bad bank model and purchasing these assets. And it does hinge on the valuation problem about how much do we pay, does the so-called bad bank pay, for these assets.

I think it is fair to assume that the banks will give us the worst of the worst, the most complex derivatives, exotic derivatives, nonperforming assets. That is why it is called the bad bank. But I get this sickening feeling that the taxpayer is going to be asked to overpay for this. Otherwise, you know, the banks will have to acknowledge the real losses that they have incurred, and they will either become illiquid or insolvent.

So what I am asking you is that since it has been floated that the FDIC would be riding herd on this bad bank, do you feel right now that the FDIC would be capable of taking on that responsibility? I know you mentioned before in response to the ranking member's question that you have sort of run into this situation with IndyMac, and that you have been confronted with some of the complex derivatives, but what the bad bank plan, if you want to call it that, envisions is that the FDIC will have a steady diet of this. You will be engaged in substantial price discovery or valuation of these assets. Do you think you have the personnel, expertise necessary to embrace something like this?

Mr. BOVENZI. Well, first let me say with regard to the bad bank proposal, I am not in any position to speak to what ultimately may be the proposal from the Administration.

Mr. LYNCH. I understand, and I am going to ask you about some other possibilities as well, but you go ahead.

Mr. BOVENZI. In terms of the FDIC's expertise, part of our responsibilities are handling troubled assets. Typically, we receive them from failed banks. That is where a great deal of the experience of the FDIC is—how to manage and sell such assets as appropriate from failed institutions. So without speaking to what kind of role the FDIC may or may not have, there would be some level of expertise to help in some way, in some process, if that were the kind of plan that were to go forward.

Mr. LYNCH. You don't think—and I know we are going down, because this is speculation—but do you think you are currently staffed and you have the people and the resources necessary to do this?

Mr. BOVENZI. We are in the process of hiring more staff now. As the current situation was developing, the FDIC started building up its staff to handle the level of workload. We are still in the process of doing that.

The model that was used by the FDIC in the previous financial crisis during the 1980's and early 1990's.

Mr. LYNCH. The RTC model?

Mr. BOVENZI. Yes. Also it was a model where resources were added very quickly, and the expertise of the agency was used to help set up a process to deal with that kind of a situation.

Mr. LYNCH. Okay. Since my time has run out, I just want to ask you in your testimony on page 7, you mentioned that the FDIC had done an estimate of expected losses for the 2008 through 2013 period. It says here that $40 billion was your estimate that you considered the most likely outcome. However, since that time you got another quarter of financial data, and now you feel that it is going to be greater than that. Can you give me a ballpark? Is this a matter of—

Mr. BOVENZI. I don't have a number at this point in time to give you. We feel that estimate is low, and our losses over an extended period will be higher, but I don't have a number.

Mr. LYNCH. By a magnitude of—all right. Thank you.

I yield back.

The CHAIRMAN. I also want to say, and Members understand this, we have two, I think, very good career people here, but there are obviously limits on the extent to which they can speak for the Administration on policy questions. I appreciate what they are doing with what they have here.

The gentleman from Texas.

Mr. MARCHANT. Thank you, Mr. Chairman.

My questions have to do mainly with the legal ability of the people that—most of the people that mortgage holders deal with are not the lenders, they are the servicers. And the servicers are governed in their servicing agreement—by a servicing agreement, and that is governed by the bond covenants, which most of the mortgages that you are wanting to have refinanced are in bonds.

So in reading through the bill and looking at the attempts to change, structurally change, the mechanics of this program so that it would work, I still do not see anything in the bill that would enable the servicer to go back to the legal counsel for the bond holders who have drawn up the bond covenants to give them the ability to act. And in many instances, in Mr. Posey's case, the servicer is limited in its servicing agreement as to what it can do. In many instances, it cannot accept partial payment. That is the servicing agreement. They didn't make the loan, they are paid to service it, and they are paid by the legal counsel for the bond holders.

So do you have any discussions as far as structurally how any program that Congress brings forward can legislate to the servicers? In FHA's case, there are no lenders per se, because every FHA loan is originated by a broker but almost immediately sold, servicing released into a Ginnie Mae bond, and then you have a servicing agreement that is signed back.

Now, to me, this is the structural problem in making any kind of a mortgage program work. And although I do not favor a cramdown, and it is not the way I would go about it, other than a judge, how can we enable—any mortgage program that would come out of this Congress—the servicer to bypass the servicing agreement?

We are having the same thing happen with short sales. One of the most popular things in America that is really working out there is—in the real estate community is that Realtors are—the country is very innovative, and so a lot of sales that are going on are short sales. But in a short sale now, the biggest impediment to a short sale is getting the servicer to get the bond holder to agree to taking less than the amount of money that is owed on it.

And so now you have people buying houses, executing contracts, agreeing to short sales, and they are waiting 90, 120, 180 days to going through the system of it, getting that short sale agreed to. And it seems to me that this is the structural problem inside of this mortgage program and any mortgage program is that the servicers cannot get where they want to get. And FHA cannot mandate that a servicer take a short sale, because at that point the bond holders entered into the bond agreement feeling like they had a legal document that said, we are going to select a servicer based on the fact that they are going to follow these rules. So how does FHA suggest that this happens so that this program can work? To me, this is the number one impediment.

Ms. BURNS. You put your finger on it. That is a complication, and it is a complication for modifications and a complication for refinance transactions in the sense that if a short payoff is required, there have to be parties who agree to that short payoff.

Now, the beauty of a refinance transaction over modification is that the old loan disappears, and there will be times when an existing lien holder would say, you know what? I would prefer to just get this loan off my books. It is no longer my problem, it is not a modified loan. I am not likely to sustain the damages of redefaults and nonperformance in the future. It is a loan that is gone.

In particular, we have heard from lenders who are willing—

The CHAIRMAN. Time has expired. If you want to finish your sentence, go ahead.

Ms. BURNS. I was just going to say willing to buy pools of loans at a discount, and then they very much want to refinance them, get them off their books, put them into Ginnie Mae pools, which are in tremendous demand right now, which is, of course, exactly what we want, create the cash flow, create the liquidity.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. My questions are also about the valuation of assets and proposed bad banks. We certainly have heard some grim reports recently. Goldman Sachs economists just a couple of weeks ago estimated that there were still $2.1 trillion in overvalued assets, that the real diminution of the value of assets was $2.1 trillion. Only about a trillion of that had been written down to this point. Nouriel Roubini, Dr. Doom, not surprisingly is more pessimistic; he says it is more like $3.6 trillion. About half of that is in U.S. banks and brokerage houses. And if that is the case, he says the entire United States banking system is insolvent. We have an insolvent system, he calls it. The system's capitalization started at $1.4 trillion.

And then the New York Times, yesterday there was an article that made the obvious point that value in troubled assets was going to be thorny if we tried to buy them. It gave the example of a bond that was backed by 9,000 second mortgages, presumably second behind and 80 percent first, where the homeowners had very little equity in their home. Presumably these bonds—the mortgages were made 3 years ago. Property values have declined 25 percent since then, and a quarter of the loans are delinquent. The financial institution that held that bond was carrying it at 97 percent of its original value. They had written it down 3 percent. There had been an actual—somebody had actually bought one of those bonds recently and paid 38 cents on the dollar for it. Is that a typical valuation of a bond like that?

Let me explain. I know you know this, but those second mortgages are now completely unsecured debt. They have no collateral. Is a 97 percent valuation typical of what our financial system is doing?

Mr. BOVENZI. No, I don't think so. I think many of those securities on a bank's balance sheet are in a mark-to-market portfolio. Some are not, some are. But part of the problem is there is no clear market rate now, and to step back—

Mr. MILLER OF NORTH CAROLINA. Is there any possible valuation that that is not just outright fraud?

Mr. BOVENZI. I think the issue right now, what the hearing is about and what we have talked about, is providing liquidity for banks, and capital is needed for banks. We want to get to the point where the private sector is providing that liquidity.

Mr. MILLER OF NORTH CAROLINA. I have a question about that.

Mr. BOVENZI. I guess I would just say one of the reasons why that is not being provided to a sufficient degree by the private sector right now is because there is such uncertainty over the assets on the bank's balance sheet.

Mr. MILLER OF NORTH CAROLINA. Yes. In fact, there is $180 billion in new capital attraction the financial system in the first 6 months of last year, is down to a billion dollars in December. And you kind of have to wonder what kind of special circumstances there were with that billion dollars. If that is the kind of valuation placed on assets, a private investor would be better served by giving their money to Bernie Madoff to manage it than they would in investing in the United States financial system.

A bank whose solvency depends upon that kind of valuation is what was called a zombie in Japan in the 1990's; isn't that right? That is a yes or no question.

Mr. BOVENZI. I think you were—I would not characterize the issue quite the way you have. Private investors in some sense right now not wanting to put monies in banks, or they are not sure of what the value ultimately will be of a lot of these assets, depending upon the future performance of the economy, so the only price that they are willing to pay is at a very steep discount protecting against the case that the economy may not improve.

Mr. MILLER OF NORTH CAROLINA. This summer, the regulators for Fannie Mae and Freddie Mac went into Fannie and Freddie, and even though Fannie and Freddie's checks weren't bouncing, they were meeting current obligations, they said, your assets do not—your liabilities exceed your assets, you are insolvent, and we are taking you over.

Do we have the resources in our regulators to do that with a large number of our banks; do we have the capacity and expertise to go in and look hard at the assets, the valuations and determine which banks are really solvent and which ones aren't?

Mr. BOVENZI. That is what the bank examination process and supervisory process is designed to do. There are regular exams and supervisory reviews of institutions to determine their financial condition and determine what steps need to be taken to restore them to health if they are not there.

The CHAIRMAN. The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman.

You know, I keep getting more and more frustrated as we get through this home foreclosures situation. I just don't believe that we have our hands around the enormity of the problem. I mean, we are losing 6,300 homes to foreclosure every day. That is 46,000 every week. At the end of this year, it is estimated that we will lose 2.8 million homes to foreclosure. It is just staggering. And yet, there seems to be a double standard here. We will throw out a strong helping hand to the banks, to the automobiles, to industry, to others who have come before here, but to the poor, struggling homeowner, we give no kind of help. We didn't give any help in the first TARP.

We are doing all we can. There is a lot we say we are going to do here. Even in the economic recovery, it doesn't seem we are doing enough with that. It is sort of like you have the poor homeowner out there flailing away in the water, can't swim, he is out there drowning, just like the big banks and others, but the boat comes along and picks up the big banks, picks up the auto industry, but then he throws the poor, struggling homeowner out there a book that says, learn how to swim.

We really have to change, I think, and really get big on this. Of those 2.8 million that we said will lose their homes this year, over 1 million of those will be seniors who have lost their pensions because of this, their retirements and 401(k)s. What are they to do? When we look at the measure of 6,300 homes every day we are losing, that has almost been matched now by the number of jobs we are losing every day. That has gotten over 6,000 every day.

So the question comes down to the fundamental question—we can dance around this all we want to—what are we going to do to keep folks in their homes that don't have, by no fault of their own—this is not somebody here who overbent or is not fulfilling an obligation, they lost their job, they have lost their 401(k)s; what are we going to do and structure this recovery here to help people who don't have a way of paying their mortgages beyond this business of we have to just do it to 4 percent? Maybe they can't even handle that.

Now, President Obama has said, and I agree—and many of us have tried to push for this early on, the chairman said we couldn't do it at the very beginning—and that is, why not put forward a moratorium, a 90-day moratorium until we can get our hands around the size of the problem? Now, President Barack Obama says he favors that.

I would like to get your thoughts on that right quick as my first question.

Mr. BOVENZI. Okay. Well, when we were at IndyMac Bank after the FDIC took it over, the first thing that we did was to put a moratorium on foreclosures while we evaluated whether loans were eligible and we could modify them to keep people in their homes. So it seems like having institutions stop and look at what can be modified is an appropriate step. And I know the State of California did a similar thing based upon that IndyMac model so it could be looked at.

In some cases, at the end of the day, there will be a foreclosure, and so doing this across the board for extended periods may not be the answer. But certainly, if I were a servicer or owner of mortgages, I would want to stop and look and see which ones I could maintain value with by modifying rather than foreclosing.

Mr. SCOTT. And don't you believe that a good expenditure—we have just given, or we acquiesced to the President's request to give him the second tranche of this $350 billion, and with a mandate entered to spend up to $100 billion of that to help folks stay in their homes. How would you suggest would be the best way for them to spend that?

The CHAIRMAN. We are running out of time. Time has expired. I will just say this; we have two career professionals who represent agencies. They are not empowered to make resource decisions. We are, they are not. To some extent, frankly, we have been asking them questions we should ask ourselves.

Now, I did ask them to be here because we have some legislation we're going to mark up to talk about some of the technical aspects, but I do have to say that these are not people who could speak on behalf of the Obama Administration about these broader public policy questions. So the time has expired, but there are other witnesses in other contexts in which you could get to that.

Mr. SCOTT. Well, Mr. Chairman, the only thing I was saying is that they are going to be the depositor, the FDIC, of what I think Ms. Bair is on the right track of doing. I certainly was not asking for them to speak on behalf of the Obama Administration, just their—

The CHAIRMAN. Well, when you talk about what are you going to do about people who don't have a job, I mean, that's not within their competence. They are here to help us figure out how we are going to administer the existing things. But the broader questions, people who are unemployed, what you do about that, and even how much of the TARP money should be used for foreclosure—which you and I agree should be very substantial, but again, it's beyond the competence of—they would be stepping, I think, outside of their mandate if they were to start making policy decisions. They are here as representatives of their agencies in this specific sense.

Mr. SCOTT. Your point of view is well taken, Mr. Chairman, and I certainly will take your point of view.

The CHAIRMAN. And we will have further hearings on the point in question.

The gentleman from Alabama has asked unanimous consent to make a statement for 1 minute.

Mr. BACHUS. Mr. Chairman, the gentleman from Massachusetts a few minutes ago mentioned a $45 billion capital injection into one of our larger institutions, and I think that it ought to be clear to all Members on both sides of the aisle, as well as the audience, anybody reporting these procedures, that it was not a gift. That particular institution, on a $45 billion capital injection, is paying $3.5 billion a year in dividends, which is a pretty good return in today's market.

There seems to be a confusion that this money was just given to our banks; in fact, it was not in any way a gift. And in that regard, one of the things that I don't think we appreciate is what it has allowed them to do. And taking that institution as an example, we are talking about troubled homeowners and loan modifications, they have modified 440,000 loans, and a great majority of those have not fallen back into default. So it is a very good thing.

And finally, Mr. Chairman, I can tell you that all of us read an awful lot and we talk to regulators, and our banking system is solvent. The vast majority of our financial institutions are well capitalized, and are in no case in danger of insolvency.

The CHAIRMAN. The gentleman's time has expired, the additional time. We have another panel here, and in fairness to them, I want to be able to get to them.

The gentleman from Texas.

Mr. GREEN. Mr. Bovenzi, I would like for you to, if you would, help to provide some ocularity with reference to why we have some institutions that are not lending to the extent that it is perceived that they should be.

Let's start, if you will, with the TARP funds—approximately $300 billion—that went into something that we now call a CPP, that is, a Capital Purchase Program. And let us define the funds that went into the Capital Purchase Program that banks will receive and have received—we have 9 banks that received $125 billion of this money, and others have applied for an additional $125 billion. But those monies will go into banks, and when these monies go into banks, they will go into the cash reserve. Is this true, generally speaking, Mr. Bovenzi?

Mr. BOVENZI. These funds go in as capital into the bank, which would strengthen the bank's—

Mr. GREEN. Capital reserve.

Mr. BOVENZI. Yes.

Mr. GREEN. Hopefully to cause a bank to be considered well capitalized, true?

Mr. BOVENZI. Yes.

Mr. GREEN. Hopefully. These monies are not monies that are lent to the borrowing public, true?

Mr. BOVENZI. Generally speaking.

Mr. GREEN. Because they use deposits to lend, they use CPP monies to capitalize, true?

Mr. BOVENZI. It is used to capitalize, which helps build a base that, yes, ultimately supports lending.

Mr. GREEN. Right. And the banks can lend from accounts that they have or they can lend from monies that they can borrow. They like to borrow cheap and then they lend high. And I don't mean to—well, let me put it this way; they like to borrow at a lower rate and then they lend at a higher rate. I don't mean to demean any of the banks, I just want to be factual. And in so doing, we have had a circumstance where the deposits were not sufficient so that they could make some loans, and there were banks that were afraid to lend to each other, so they couldn't borrow money to make loans. We have opened a discount window, hopefully that will be used to borrow money to make loans.

So my question, sir, is this; what percentage, if you can tell me, generally speaking, of the banks are not making loans because they don't have the deposits such as they can make them? Notwithstanding being capitalized, they don't have the deposits from which to make the loans? Is that a pervasive problem?

Mr. BOVENZI. I wouldn't characterize that as a pervasive problem. With deposit insurance, it gives stability to the customer so that they know that whatever institution they put their money in, it is safe. Certainly it is a competitive environment in trying to attract those deposits. So I think your point is right, that it is difficult to—

Mr. GREEN. But let me just share this with you, sir, another thought. The capital cash reserve is something that is required to act as a cushion in the event there is something called a "run." So they are not allowed, generally speaking, to lend that money; they have to lend the deposits and they have to lend money that they can borrow.

So, again, how pervasive is this lack of liquidity in deposits such that loans can be made? I am really trying to get to the root of why loans aren't being made. I have no desire to demean the banking industry. I want empirical evidence as to what is going on.

Mr. BOVENZI. You are certainly on the right track. If an institution can't get adequate deposits, it can't lend. I think overall, in the banks themselves, they probably have the same rough amount of lending that they had on those deposits as before. One of the big problems is that the banks used to take these loans and might securitize them and sell them into the market. And where the securitization market is not what it used to be, there is not the same outlet. So it affects their capacity.

Mr. GREEN. Quickly, before my time is up, let me ask you about the second part of this now, which has to do with the lack of a source to borrow.

Have we pretty much taken care of that, the lack of a source from which to borrow money to lend?

Mr. BOVENZI. I would say that certainly to the extent that deposits are insured, it provides a source of liquidity. The Temporary Liquidity Guarantee Program has, to some extent, helped provide additional liquidity as well.

The CHAIRMAN. The gentleman doesn't have time to ask another question. Do you want to finish that last answer quickly?

Mr. BOVENZI. That's it.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Mr. Chairman, I am very anxious to listen to and question the next panel, and so I will forego my questions at this time in anticipation of 30 minutes when we go to the next panel.

The CHAIRMAN. Mr. Minnick.

Mr. MINNICK. Back to the issue of authorities of servicing agents in these collateralized loan situations where the indentured does not give the servicing agent the authority to modify loans. If we were to create that authority statutorily so that servicing agents could have that authority, would you agree that would lead to some subset of these loans being modified and more people staying in their homes and a higher percentage of return to the owners of these obligations as a general proposition, Mr. Bovenzi?

Mr. BOVENZI. I think certainly if you gave protections to servicers and incentives to them, that would encourage them to do more loan modifications.

Mr. MINNICK. Well, that was the second part of my question. If it would be beneficial, should we also create incentives to do that, including protections from—as long as the authorities were executed in good faith, standard fiduciary standards, should we give them statutory protection?

Mr. BOVENZI. Certainly, protection is an incentive that would give them greater ability to modify mortgages and however that is structured, you just need to be sure of what other consequences you are putting in place. But certainly, financial incentives to servicers would be helpful in the loan modification process.

Mr. MINNICK. Do you think there is a superior way, based on your professional experience, to unlock these loans than going down that course?

Mr. BOVENZI. There may be complementary procedures. I know in the model we had with IndyMac, we have encouraged paying expenses for parties who help in the process. Also, there are complementary measures that can be done as well.

The CHAIRMAN. Mr. Sherman.

Mr. SHERMAN. As the Deputy to the Chairman of the FDIC, we are talking about increasing the limit to $250,000 permanently. My concern is about CDARS, broker deposits, where someone could, in an efficient way, get $25 million worth of FDIC insurance by participating with 100 different banks. Do you see a way of crafting the legislation so that someone would not be able to have interest-bearing accounts of over $5 million in various banks that were subject to insurance?

Mr. BOVENZI. That is a difficult question. The broker market exists now where somebody could have accounts separated and spread in different banks, and legislative fixes often are difficult.

One of the things from a regulatory viewpoint we are looking at and have put out a proposal for comment is whether different types of liability structures should require higher premium charges for the Deposit Insurance Fund. We have put out such a proposal related to broker deposits for comment. And sometimes there may be ways to approach things more flexibly in a regulatory framework. But I don't have an answer for you in terms of what specific you should—

Mr. SHERMAN. Well, I hope you get us your ideas, because anything you can do we can also do. And if you have ideas along these lines, it would depend on the judgment of the committee, but increasing to $250,000 just means that somebody willing to deal with 100 banks is able to get 2.5 times as much insurance, and our objectives are multi-faceted on this.

But one of them is to provide assurance to middle-class families and even upper-middle-class families when somebody starts getting Federal insurance in excess of millions of dollars, then we may be exceeding our purpose. Of course, even leaving things at $100,000 simply means that they have to deal with 3 or 4 times as many banks—or 2.5 times as many banks, doing the math correctly.

I would like to ask Ms. Burns about a question that came up at more than one of my town halls. They asked, why should I pay my mortgage? And one of the answers is that if you can afford to pay your mortgage, that is your legal and moral obligation; but also, I would like to be able to tell them, well, because you don't want to give up the appreciation—everybody in my district thinks they are eventually going to sell their house at a profit.

Could you comment on the shared appreciation being a way not only to get some money from the Federal Government, but to convince the people in my district who never benefit from any of these programs that they are not suckers, and that, in fact, those who are getting HOPE for Homeowners are also giving up something?

Ms. BURNS. Well, I don't know if I can talk about it specifically in the context of a shared appreciation mortgage, but certainly the HOPE for Homeowners program was intended for just that purpose, that these are borrows who are, in many cases, underwater, their existing loan balance or balances are greater than the value of their property.

Mr. SHERMAN. If I can interrupt, we have $4 trillion of underwater mortgages. And we are not going to provide help for all those folks, we are only going to provide help to those who most need it. I have a lot of people who are underwater, but they are making the same mortgage payment they were making 5 years ago, and they can make that payment for the next 5 years and hopefully they will be above water.

How do we convince the person who has a fixed rate mortgage and can continue to make payments on what, in many cases, is an underwater mortgage that they are not a sucker for not walking away from the mortgage, or more to the point for this hearing, for not getting government help to stay in their home?

Ms. BURNS. Right. I mean, that is the kicker of the whole situation, that there are people who have played by the rules, have paid their mortgage, have done everything right, and who aren't getting a government benefit.

Mr. SHERMAN. With time being limited, I think the word "kicker" is right, we need an equity kicker for the Federal Government, because then I can go back to my constituents and say, you get the profit when you sell your home, and the guy who got the government benefit didn't. I believe my time has expired.

The CHAIRMAN. The gentlewoman from West Virginia.

Mrs. CAPITO. Thank you, Mr. Chairman. I just have a comment. I know we want to get to the second panel. I appreciate both the folks who testified before us today.

The HOPE for Homeowners program, a $300 billion program, helped 25 so far. The cost per person has to be extraneously huge. I guess what is coming through my commonsense mind here is, rather than patching, fixing, plugging the holes, can we just say "uncle" and start over here and get a better program that actually meets where our homeowners are, the ones who are in foreclosure, the ones who are in arrears, and start over like that? I mean, is that something that you would consider a wise way to go when you are considering the cost to the taxpayer?

Ms. BURNS. Well, I speak for myself when I say this: Absolutely. Obviously, as Chairman Frank has pointed out, I am not part of the political team, I am not part of the Obama Administration, but I would envision that they would feel that way as well, that we want a program that works. And if it requires that we start from scratch and perhaps give FHA some new legislative authority for a different refinance product and that can happen more quickly, I would envision that they would embrace that approach.

Mrs. CAPITO. Thank you. I think that was a really candid answer, I really appreciate it. And I think it is refreshing to know that you are willing to stand up and say if something is not working, then we ought to just scrap it and start over.

The CHAIRMAN. If the gentlewoman would yield?

Mrs. CAPITO. Yes, I will.

The CHAIRMAN. I will apologize; we have misplaced her alternative proposal. So if she has such a proposal, we would be glad to entertain it. Somebody forgot to show it to me.

Mrs. CAPITO. Well, I am just trying to say if it is not fixable, why go in and keep trying to fix something that we have issues with? It is $300 billion for 25 homeowners. I don't think anybody could—I don't have ownership in trying to find the solution, that is why I am here learning.

The CHAIRMAN. Well, we all do, as Members, I think, have that. Secondly, the $300 billion is, of course, entirely bogus; that would only be if there were, in fact, guarantees issued. But finally, the gentlewoman didn't just say it wasn't working, she said why don't we start over? And the answer is, I think we are perfectly willing if someone has something.

Mrs. CAPITO. Thank you.

The CHAIRMAN. The gentlewoman from Illinois.

Ms. BEAN. My questions are for Ms. Burns. The first is: The proposed changes to the HOPE for Homeowners program include an elimination of the 5-year prohibition for a second mortgage for assisted borrowers. Of the applications that HUD has received for HOPE for Homeowners, how many have not been completed because the borrower had a problem with that?

Ms. BURNS. To tell you the truth, we don't know. So at the time of what is called a case number assignment, we collect the minimal information about the consumer and their previous mortgage, and I wouldn't know exactly.

Ms. BEAN. So it is possible that has not been a problem.

Ms. BURNS. Yes.

Ms. BEAN. Well, let me go to the broader question of some of the revisions that are being proposed. We are lowering the fees to servicers, decreasing the amount of principal right now, allowing HUD to compensate servicers for the administrative costs associated with allowing people to move into a new program. In your opinion, will these changes, given the parameters that you have seen from applications received or not even considered, will this make a significant difference in the number of those who are facing foreclosure that we can assist? Can this be a significant part of a foreclosure mitigation strategy? And if not, what's missing?

Ms. BURNS. Again, I am not part of the political administration, so I can't speak to exactly what they would propose. I definitely—

Ms. BEAN. I am not asking for proposals. I am saying from what you have seen, having to look at various loans that might be given consideration, what are you hearing from servicers about, well, we would be giving you more if—

Ms. BURNS. Well, I think the elimination of the eligibility criteria that we discussed earlier in the hearing would definitely go a long way towards increasing program uptake. I think reducing some of the cost of the program would help. I definitely think the shared appreciation feature is extremely complicated for people to administer and at very high cost to the consumer. I definitely think this bill goes in the right direction.

Ms. BEAN. To go back to the shared appreciation, you also get to the issues that Congressman Sherman just raised, which suggests to those who are making their payments that somehow they are being underserved by doing so. And so keeping some degree of moral hazard in there and recouping some of the cost to taxpayers who are assisting homeowners who are already getting debt forgiveness does make a case for shared appreciation.

But is anything missing from the changes we are making that you haven't already spoken to?

Ms. BURNS. I do think that something that we have referred to earlier in the hearing that is problematic has to do with the subordinate lienholders, that there needs to be a better mechanism to address getting those liens released so that consumers can participate in the program. And we haven't quite captured a mechanism that is both efficient and effective at getting them to agree to release those leans.

Ms. BEAN. And you mentioned the shared equity piece. How many applications couldn't be completed because of that, or do you again not know?

Ms. BURNS. Could not be completed because of the shared equity? Right, I wouldn't know that. I mean, really what we could do is to go back and ask lenders, in how many cases were there eligibility criteria that the consumers couldn't meet as opposed to the shared equity portion of it. I don't think that would be a barrier to them actually getting the loan.

Ms. BEAN. It seems to me that, while some are raising it, I don't see how that would be a deal breaker.

Ms. BURNS. I would agree with you on that.

Ms. BEAN. I yield back.

The CHAIRMAN. The gentleman from Colorado.

Mr. PERLMUTTER. A couple of questions for Mr. Bovenzi; I am looking at pages 12 and 13 of your testimony. One of the things, in Colorado, I guess things are improving where every place else in the country things are not improving, or they have been. Foreclosures are down 11 percent in 2008 compared to 2007. But what we see, and what I am worried about, really has to do with banking, and that is, we are seeing the banks tighten up on credit. And when I press the bankers about that, they say the regulators are tightening up on the regulatory side of this thing, demanding more capital, looking at particular industries that in the minds of the regulators may be troubled industries like auto dealers. And so at one level, the Congress and the Treasury is saying to the lending community, lend money so small businesses and home buyers and farmers can keep staying in business, but the bankers are saying they are getting a different message from the regulators. How do you respond to that?

Mr. BOVENZI. Well, I would say that whenever we encourage banks to lend—which we are doing—it always is to creditworthy borrowers. And the examiners have certain standards they apply.

Mr. PERLMUTTER. Is the FDIC or the Comptroller demanding more capital from community banks?

Mr. BOVENZI. It depends upon the situation. For the vast majority of community banks, the answer would be no. They are very well-capitalized for the most part, but there are going to be circumstances where there are going to be individual institutions that need more capital. So it does depend on the situation.

Mr. PERLMUTTER. Let me jump in again. Has the FDIC or the Comptroller or any of the regulators, have they looked at certain borrower groups, whether it is automobile dealers or Realtors or retail establishment owners, you know, shopping center owners, and said these industries are kind of questionable right now, you better be harder on the loans that you make to them or the lines of credit that you have extended to them?

Mr. BOVENZI. Well, the FDIC is not going to pick an area and say you can't do any lending in that area. It is going to be a case-by-case review of, do you have a creditworthy borrower and do you have appropriate underwriting standards. That would be what an examiner would be looking at.

Mr. PERLMUTTER. I guess what I am saying to you—I thought it might be anecdotal—and I said this to Ms. Bair a month ago—about the tightening of credit at the local level, at the examiner level. She said it is just anecdotal. She had written a letter to Senator Schumer about it. But I am hearing it from every single banker in my community, which I am worried that it is going to keep this spiral going. So now Colorado is starting to pick itself up and get out of this malaise, but at the same time, small businesses in my communities are finding credit harder and harder to come by. So that is just a statement to you.

I would like to turn to you, Ms. Burns, and then I will be finished.

You talked about the problems with the second mortgages or the second liens as an impediment to doing HOPE for Homeowners. I have been opposed to this cramdown concept in Chapter 13, but that is the one place where you can actually take out and eliminate that second mortgage.

Do you have any other ideas as to how to deal with the second mortgages and stop them from being these impediments to the refinance?

Ms. BURNS. Well, one idea would certainly be to permit the subordinate lienholder to resubordinate that mortgage and just sit there, just sit behind the HOPE for Homeowners loan, don't permit them to collect payments on it, require that it sit as a silent second in the hopes that they recover some—

Mr. PERLMUTTER. But will they do that voluntarily?

Ms. BURNS. I don't know. You asked for ideas.

Mr. PERLMUTTER. Well, that is a good idea, but I am just concerned that HOPE for Homeowners really has been a voluntary approach. Looking for assistance from the first and the borrower, the regulators, and now the second mortgage holders, and I am just worried, there is nothing in it for them to say we will sit quietly by. They are going to say, give us a hundred bucks at least to cover our transaction fee. I mean, are we paying them anything in this process?

Ms. BURNS. Under the existing HOPE for Homeowners program, the subordinate lienholder could be paid off in an amount between 3 and 4 cents on the dollar for the principal on that loan. So if it is a $20,000 loan, they get paid 4 cents on the dollar, they get $800 to walk away. It sounds great.

As I mentioned earlier to Chairman Frank, there is a somewhat clunky mechanism to make that happen. And it doesn't seem all that enticing right now.

The CHAIRMAN. If the gentleman would yield, there is also, I believe, as far as the oversight portion, to even up the dollar amount. We are going to look at that.

One other announcement I would like to make quickly. The gentleman raised a very important issue. We do hear, all of us, from the banks and the regulators, that each one is blaming the other. They may both be right. I plan to have a hearing in the full committee on the question of whether or not and to what extent we are sending mixed messages. Now, to some extent that is inevitable. We have two goals here; we have the safety and soundness of banks, and we have increased lending; there is an inherent tension there. What I am concerned about is, if the same individual is aware of that, that is one thing.

If you have two different groups operating with different initiatives, impulses, that can be a problem. We have it with mark to market, we have it with capital requirements. So we are going to have a hearing sometime in the next few weeks and we are going to ask some bankers and some regulators to get everybody in the same room at the same table and talk about the extent to which we are sending these mixed messages, both with regard to—well, it is three things—it is capital requirements, it is lending standards, and it is mark to market. And the problem is there are legitimate and conflicting objectives. We are going to address that.

The gentleman from Ohio.

Mr. WILSON. My question will be to Mr. Bovenzi.

Let me make a couple of comments first and then get to my question. We are talking about ideas and ways to stimulate liquidity to get our economy again through the banking system. I like the idea that the FDIC now has expanded to $250,000. I think that is going to give a lot of people who may be moving out of the market or other investments a safe place to go and a place that would be hopefully encouraging for investment and provide liquidity.

My question would be this, and after having some roundtables back in Ohio and listening to different bank people and also business people, one of the ideas that came up—and I just bounce this off of you—is to encourage deposits back to the old passbook, and doing maybe a 4.5 percent tax free if we can find a place to pay for it to offset it. But what do you think of that kind of an idea, simplistic as it may be, to attract deposits to community banks throughout Ohio. For example, where I am from, and then having people be able to have a tax-free status on that earnings for a set amount of time? What do you think of that as an opportunity for liquidity?

Mr. BOVENZI. Well, I am not going to be in a position to comment on how one ought to change the Tax Code. Certainly, there are going to be tradeoffs in any kind of fiscal package, determining what type of tax cuts or spending to have. Any tax break has a cost to the government, and any reduction that encourages a certain activity is going to have a benefit for that particular activity. But I am really not in a position to give a view of what kind of tax or government spending initiatives ought to be put in place.

Mr. WILSON. Okay. Maybe I asked it to the wrong panel. I just feel that we need to come up with creativity, we need to start doing something. And as I said, as far as the tax part of it, we have a situation there where we have to find a way to offset it. But I am talking premise here. I am talking ideas of getting money into banks so that we can free up our economy and start moving.

Mr. BOVENZI. And I would just comment more generally, to the extent things are within FDIC's authority, we are certainly trying to think creatively and take steps, as appropriate, to help restimulate the economy.

Mr. WILSON. We are hoping we can do that.

There are a lot of people in society out there who feel that government and the regulators are not going outside the box for creativity and ideas, and how are we going to solve these problems if we keep doing the same old, same old? And that is where I am coming from.

Thank you.

The CHAIRMAN. Mr. Grayson.

Mr. GRAYSON. Thank you, Mr. Chairman.

Mr. Bovenzi, nice to see you again.

Mr. BOVENZI. Good to see you, too.

Mr. GRAYSON. Thank you.

I had a few questions for you about the banking system in general. The American Enterprise Institute says that ⅔ to ¾ of all the bad assets in this country are actually held by only four banks—Citigroup, Bank of America, JPMorgan Chase, and Wells Fargo. Is that correct?

Mr. BOVENZI. I don't have an answer for you offhand. Certainly, you take those four banks and they are going to comprise a large portion of the banking assets in the country and in general, so that even proportionally they would have a large portion. But offhand, I don't know the answer to that question.

Mr. GRAYSON. Well, when we pass laws and allocate money to help banks in trouble, are we basically just helping these four banks?

Mr. BOVENZI. Any program that is put in place, certainly our view is it is to help all banks—and should be to help all banks. And granted, as some of the programs are being rolled out, it is getting to the larger banks before it is getting down to the smaller banks.

But I think it is an important principle that all banks are eligible for capital investments or programs that go forward with the government.

Mr. GRAYSON. I am more interested in the practice than the principle. Why is it that it is taking more time for money to get to the small banks than it is for money to get these four giant national banks?

Mr. BOVENZI. Well, with the Capital Purchase Program, as it was originally rolled out, the first group eligible were public corporations, and by their nature, that is more of the larger institutions. It was then rolled out to private C corporations. Only recently have we been able to get the term sheets and standards in place for Subchapter S corporations so they could start receiving capital injections. And we still don't have the appropriate term sheets for how to invest in mutual organizations.

So the roll out has been slower for the smaller institutions. And that has certainly been a cause for concern from the FDIC's point of view.

Mr. GRAYSON. By giving tens of billions—or even hundreds of billions of dollars—in aid to these four banks, aren't we basically rewarding them for mistakes that they have made?

Mr. BOVENZI. I think the intent of all of these programs is to try to stimulate the economy. An important part of that is stabilizing the banking system as a whole, so we do need to take steps. As we discussed, key components of doing that are providing capital and liquidity. Larger banks are going to be an important part of restimulating the economy, and by necessity are going to be an important part of any programs that come about.

But at the same time, smaller banks lend in local communities, and that has an important effect too. And certainly with the program that the FDIC has, the Temporary Liquidity Guarantee program, we have 7,000 banks that are taking part in the non-interest-bearing transaction accounts guarantee, and about the same number of banks and thrifts and holding companies taking part in the unsecured senior debt guarantee. So it is a program that is very broadly based across the banking system.

Mr. GRAYSON. We sometimes hear the phrase "moral hazard." Isn't it basically violating the moral hazard principle to offer so much aid to these four banks because of the mistakes that they made in accumulating $1 trillion or more in bad assets and not helping the smaller banks who could provide stimulus and helping local communities around America?

Mr. BOVENZI. Well, certainly as a general principle, we want to avoid moral hazard. We want market discipline in the economy. I think as we have gone through this financial crisis, there have been a great many shareholders and senior debt holders who have lost a great deal of money. So I think they would certainly view the market as having provided some discipline.

I think when you get into a situation as severe as the one we are in, then we need to look at systemically what needs to be done at least for that period of time to take care of the bigger issue, which is the financial stability of the country.

Mr. GRAYSON. What discipline has there been for the managers of Citibank and Bank of America and JPMorgan and Wells Fargo?

Hasn't it basically been business as usual even though they have lost a trillion dollars?

The CHAIRMAN. The gentleman's time has expired.

Mr. Bovenzi, you may respond.

Mr. BOVENZI. I will just respond that there are a number of different situations. But there are certainly—I think, many people in charge of organizations who have lost their jobs. But I agree with your broader point that if the government is putting in money, we need to be looking at things like executive compensation, appropriate management and how the money—

The CHAIRMAN. The time has expired. I do want to point out, in fairness to Mr. Bovenzi, that it is the Treasury Department. The FDIC made none of these decisions. As a matter of fact, by the end, the head of the FDIC and the Secretary of the Treasury were barely on speaking terms; I know that because I was taking the messages between them.

So I think it is appropriate to note that the criticism inherent in the gentleman's comments were really towards the Treasury Department, just in fairness to the FDIC. None of those were decisions they made.

The last questioner will be the gentlewoman from Illinois.

Mrs. BIGGERT. I mentioned earlier in my opening statement that I have heard from my community bankers that they are concerned about a dual policy that they are seeing. On the one hand, the regulators are cracking down—are urging banks to lend, and on the other hand, the bank examiners are cracking down, forcing write-downs on performing loans and discouraging increased lending from smaller institutions. Even though they say they have the capital and liquidity, they don't want to go ahead with some of these loans because the regulators are being overly aggressive. And this seems to be contrary to the messages we in Washington are sending.

Have you heard this? Or is there anything that can be done about this, Mr. Bovenzi?

Mr. BOVENZI. Certainly, I am aware of the concern about whether examiners are given a mixed message. And I think, as has been said by the chairman and others, certainly it is going to be easy for people to look at others to say this is why something isn't happening. I will only say from our point of view; we are going to do everything we can to ensure that the right messages are getting across and I believe they are.

There are some appropriate underwriting standards in lending to creditworthy borrowers that have to be upheld. And yet we have to be careful that those standards aren't so severe that we are discouraging otherwise good loans. We are working each day to try to get that balance.

Mrs. BIGGERT. Thank you.

The CHAIRMAN. Earlier I did say, because the gentleman from Colorado had similar questions, we planned a hearing on this whole question of the tension between those mandates.

The panel is thanked very much for their excellent testimony. We ask the new panel to assemble very quickly. Please, let's move quickly. We will convene.

Mr. Yingling has a prior commitment of some considerable importance, so we appreciate his staying around. We will begin with Edward Yingling of the American Bankers Association.

STATEMENT OF EDWARD L. YINGLING, PRESIDENT AND CEO, AMERICAN BANKERS ASSOCIATION (ABA)

Mr. YINGLING. Mr. Chairman, I appreciate the opportunity to testify on H.R. 703, which will promote bank lending through changes to deposit insurance coverage, make improvements in the HOPE for Homeowners program, and provide prompt availability of capital through the Capital Purchase Program for community banks.

ABA supports this bill. Let me address each of the major elements.

ABA supports making permanent the $250,000 deposit insurance limit that was set on a temporary basis in the Emergency Stabilization Act. This increased coverage from $100,000 helped heighten consumer and small business confidence. It also resulted in additional funds to support bank lending. However, this increase expires at the end of 2009. It is important that this issue be addressed by Congress as quickly as possible.

As a practical matter, with each passing month it becomes more difficult for banks to effectively offer certificates of deposit over $100,000 because the expiration date on the insurance increase is moving closer. For example, by June, banks will only be able to offer 6-month CDs in the $100,000 to $250,000 range that are fully insured. Moreover, the expiration date and differing levels of insurance on CDs will be confusing to customers.

It is important to note that if the $100,000 limit had been adjusted for inflation when it was created in 1980, the level today would be $261,000.

We also believe that enlarging FDIC's borrowing authority with the Treasury is a reasonable change, giving the FDIC more flexibility to manage cash flows related to bank failures. Cash flow issues occur as the FDIC acquires assets from failures that need to be sold off in an orderly fashion. We would emphasize that this is a line of credit, and that any draws on it by the FDIC constitute a borrowing that must be repaid by the banking industry.

We reiterate our continued support for the HOPE for Homeowners program. We believe the changes to the program recently announced by the Department of Housing and Urban Development have the potential to attract many more borrowers and lenders. We are pleased to see that further changes are included in the bill.

We also support the provisions relating to securitization. It is widely agreed that the legal liability issues relating to securitization are inhibiting foreclosures.

We also support the provisions in the bill that direct the Treasury to take all necessary actions to provide capital under the Capital Purchase Program to community banks, and to do so on terms comparable to those offered to other CPP recipients.

We strongly believe that the current commitment should be fulfilled in order to prevent competitive disparities from occurring, and to ensure that every community has the same opportunity for its banks to participate. For example, in many New England communities, mutual institutions predominate. Currently, those communities do not have the same opportunity for their banks to participate in the CPP.

Finally, I feel compelled to mention, once again, another issue relating to the subject of this bill, which is lending and liquidity. While this committee works tirelessly to aid the economy, mark-to-market accounting continues to undermine any progress. As the Congress works to enhance bank capital, mark to market eats it up like a Pac Man. But it is not just banks. In the past 2 weeks, we have seen accounting rules undermine the ability of the Federal Home Loan Bank System to provide liquidity. And we have seen a financial emergency in the credit union industry because of the impact of mark to market on corporate credit unions, an emergency which appears to be offsetting, roughly, the entire earnings of the credit union industry in 2008 through deposit insurance premiums.

ABA appreciates statements by members of this committee on mark to market and urges you to make accounting policy part of your reform agenda.

And Mr. Chairman, I would just like to say that I agree completely with your comments about the conflicting signals that we have been receiving from different governing bodies, and I appreciate the fact that you are going to hold hearings.

[The prepared statement of Mr. Yingling can be found on page 191 of the appendix.]

The CHAIRMAN. And let me say, because I know you have to leave, this is not anybody's fault. These are legitimate conflicts to be managed, and it has to do with capital requirements, stricter lending requirements and mark to market, and I don't think the answer is 100 percent one way or the other with each of them. And I will be satisfied, to some extent, if I know that everybody has both of them right. What worries me, as I said, is that we have two different groups. But we will have that hearing very soon.

Next, we will go to Mr. Michael Menzies, the president and CEO of the Easton Bank and Trust Company, on behalf of the ICBA.

STATEMENT OF R. MICHAEL S. MENZIES, SR., PRESIDENT AND CEO, EASTON BANK AND TRUST COMPANY, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. MENZIES. Mr. Chairman, thank you. I am chairman and CEO, as you said, of Easton Bank and Trust in Easton, Maryland, 62 miles due east of this hearing, and it is my honor to be with you.

The CHAIRMAN. I was hoping you weren't from Easton, Massachusetts, because that would have been embarrassing. When you said Easton, I got a little worried.

Mr. MENZIES. That is a beautiful community, too.

Easton Bank and Trust is a $170 million community bank, and we are focused on our community.

I am honored to be chairman of the Independent Community Bankers of America as we focus our representation exclusively on community banks.

We applaud the efforts of this committee to promote bank liquidity, promote lending through deposit insurance, provide HOPE for Homeowners, and enhance the community banking model. These efforts strengthen banks to expand ongoing lending activities and further support economic recovery.

Community banks are the backbone of small business lending. Key provisions of your bill contribute directly to this mission, and as a result create jobs. Your improvement to HOPE for Homeowners expands the alternatives for community banks working with consumers who wish to avoid foreclosure.

We understand that the committee will mark-up some of the provisions of H.R. 703 in separate bills tomorrow, and ICBA urges swift passage of those provisions.

I want to concentrate my oral statement on community bank liquidity issues and deposit insurance. My written testimony addresses in detail all the issues covered in this hearing.

Deposits are the primary source of community bank liquidity. Today, community banks face stiff competition for deposits. The increase in deposit insurance coverage to $250,000 has helped community banks be part of the solution to the credit crisis caused by the activity of a few large financial institutions. We are pleased that the chairman's bill would make this increase permanent.

ICBA applauds the chairman for including a provision to give the banking industry more time to recapitalize the FDIC Deposit Insurance Fund, an idea that ICBA has strongly advocated.

Community banks are prepared to do their part to maintain a strong, well-capitalized deposit insurance system. However, a longer period for recapitalizing would allow the FDIC to reduce proposed assessment rates. Lower rates would keep additional funds from local communities for lending to small businesses and consumers at this critical time.

Last fall, the FDIC established a voluntary additional guarantee of all amounts above the $250,000 level in transaction accounts under the FDIC Temporary Liquidity Guarantee Program. More than 7,000 banks, including thousands of community banks, have chosen to participate in the Transaction Account Guarantee Program. The program is an important measure to enhance confidence of commercial customers and community banks, and has been an important tool for enhancing community bank liquidity.

This program allows Easton Bank and Trust the opportunity to compete with the too-big-to-fail banks while paying a 10 basis point fee to keep the FDIC fund whole.

The program also frees up capital and resources otherwise used by community banks to purchase treasuries and other securities that are used for repurchase agreements that secure commercial and public deposits. Community banks can better use the freed-up resources to promote lending in their communities. Taxpayers have no liability for the program, and the program does not reduce the FDIC reserve ratio. Participants are assessed a 10 basis point fee for the guarantee, and any deficit in the program could be made up by a special industry assessment.

Unfortunately, the program expires at the end of this year. ICBA urges the committee to include a 2-year extension of the current Transaction Account Guarantee Program with other deposit insurance provisions that the committee will consider tomorrow.

Eliminating the program at the end of this year would have a negative impact on community bank liquidity, again at a critical time. This important program should be extended by Congress to give the Nation's deposit system more time to stabilize.

Thank you so much for an opportunity to represent the community banks of America. I am happy to take any questions you may have.

[The prepared statement of Mr. Menzies can be found on page 120 of the appendix.]

Mrs. MALONEY. [presiding] Mr. Taylor is now recognized for 5 minutes.

STATEMENT OF JOHN TAYLOR, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL COMMUNITY REINVESTMENT COALITION (NCRC)

Mr. TAYLOR. Thank you, Representative Maloney, Chairman Frank, and Ranking Member Bachus for the opportunity to testify before this distinguished committee.

I am honored to testify on behalf of NCRC regarding promoting bank liquidity and lending through depositors insurance, HOPE for Homeowners—what we call H4H—and other enhancements. And I want to inform Chairman Frank and other members of the committee that NCRC does strongly support H.R. 703.

The new and amended provisions in H.R. 703 are important measures towards stemming the foreclosure crisis, restoring bank liquidity, and rebuilding consumer confidence in the financial system in the U.S. economy.

H.R. 703's proposed increase in FDIC coverage from $100,000 to $250,000 will help stabilize banks by increasing deposits. This, and the increase in the FDIC's borrowing authority from $30 billion to $100 billion, will provide liquidity for the banking system and reassure investors that expanded FDIC insurance provisions will protect consumer investments and help prop up the banks.

I want to applaud the chairman for H.R. 703's amendments to HOPE for Homeowners, which will improve upon an initiative that is really not reaching its intended goals. The proposed amendments in H.R. 703 will increase consumer demand for H4H. Eliminating the upfront premium and reducing the annual premium makes H4H a much more attractive program. Moreover, the amendments would allow FHA to eliminate H4H's annual premium payments once the borrower's equity reach levels consistent with standard FHA underwriting practices and products.

Reduced equity-sharing with the Federal Government is another welcomed enhancement to H4H. And the new H4H would allow the Federal Government to recoup its investment at the same time, while preserving significant wealth-building opportunities for borrowers.

Another major advancement offered by H.R. 703 is the safe harbor provisions for servicers which will increase the likelihood of meaningful loan modifications. This provision protects the servicers from investor lawsuits if the investor reasonably and in good faith believes that its loan modifications will exceed, on a net present value basis, the anticipated recovery of the loan principal that can be achieved through foreclosure.

H.R. 703 is a major step in the right direction towards addressing the foreclosure crisis. However, in addition to that step, NCRC urges the committee to consider a broad-scale loan purchasing program.

H.R. 703 still requires voluntary participation from the industry while offering safeguards and incentives, but there will still be the need for the government to proactively purchase whole loans, whether it is using the HELP Now proposal that the National Community Reinvestment Coalition proposed now a year ago in January of 2008, or whether it is modifying the REMIC—the Real Estate Mortgage Investment Conduit—Tax Codes to allow for the taking of all co-loans, or other approaches like using the commerce clause and the spending clause of the Constitution, which allows the government to regulate interstate financial markets. Some proactive steps like this are necessary to wrestle a lot of these loans away from the market.

In closing, H.R. 703 is an important and necessary measure to stem foreclosures and stabilize the financial markets. NCRC is pleased to endorse it, and I will take questions at the appropriate time. Thank you.

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

Mrs. MALONEY. Mr. Courson is recognized for 5 minutes.

STATEMENT OF JOHN A. COURSON, PRESIDENT AND CEO, MORTGAGE BANKERS ASSOCIATION (MBA)

Mr. COURSON. Thank you, Congresswoman Maloney, Chairman Frank, Ranking Member Bachus, and members of the committee. Thank you for the opportunity to testify this afternoon on H.R. 703, a new bill intended to promote bank liquidity in lending.

Of particular interest to MBA and its members are the changes for the HOPE for Homeowners program, the focus on addressing service reliability, and the improvements to the Troubled Asset Relief Program, or TARP.

Let me begin with the HOPE for Homeowners program, which was intended to be a tool to help delinquent homeowners avoid foreclosure, but has had trouble getting off the ground. H.R. 703 would remove the obstacles that have prevented its optimal use. For instance, the bill drops the requirement that borrowers have a housing debt-to-income ratio greater than 31 percent for participation. It also increases the maximum loan-to-value permissible under the program for 90 percent of the appraised value to 93. These changes will allow more borrowers to qualify, and also make the program more attractive to lien holders who will be able to take smaller write-downs.

MBA also supports the language in the bill that addresses HOPE for Homeowners exceedingly high annual premiums by granting FHA flexibility in setting annual premiums that are in line with other FHA products. This reduction will instantly make the HOPE for Homeowners program more affordable for troubled borrowers.

MBA appreciates the committee's efforts to provide servicers with greater legal protections for performing loss mitigation services. Although most pooling and servicing agreements allow for modifications and workouts, not all do. Some PSAs that allow modifications and workouts may contain conflicts, while others may be silent on modifications, thus increasing the risk of liability for the servicer. These problems have limited servicers' ability to help borrowers.

MBA, however, is concerned that investors may challenge the validity of this safe harbor. If these challenges prove successful, servicers will be exposed to significant legal liability and lawsuits for breaching their contracts, despite their actions being within the spirit of this law. MBA would recommend that Congress include a provision that would indemnify servicers from liability if the safe harbor provision is deemed unlawful.

Moving to the changes to TARP, MBA endorses this committee's efforts to provide additional clarity and direction to the Department of the Treasury and how these funds are allocated. Above all else, it is important to return TARP to its original purpose, which was to purchase nonperforming assets off of bank balance sheets. And while the government's focus to date has been on righting the residential mortgage market, we at MBA also recognize that the broader credit crisis has negatively impacted the commercial multifamily real estate sectors.

Mr. Chairman, because this hearing is about bank liquidity, I want to take a minute to bring to your attention an issue that has been and is hamstringing many independent mortgage bankers, and that is the shortage of warehouse lines of credit from commercial banks.

These lines of credit are used to finance loans held for sale from origination to delivery into the secondary market. Warehouse lending capacity has declined dramatically from over $200 billion in 2007 to approximately $20- to $25 billion in 2008. For the originator that depends solely on warehouse lines of credit, the reduction could reduce liquidity, extinguish their lending business and adversely impact the consumers in their market, stifling the real estate recovery before it has a chance to really get off the ground. Congress and the Administration should take steps to maintain existing lines of warehouse credit and create new lines of warehouse lending by providing a short-term Federal guarantee of warehouse lines that are collateralized by FHA, VA, GSE, and rural housing eligible mortgages or one of several other alternatives that are also available.

My written testimony discusses this issue at great length, as well as these other steps Congress and the Obama Administration can take to restore faith in the mortgage industry and avoid future foreclosures.

First and foremost, Mr. Chairman, we need stronger regulation of mortgage bankers and mortgage brokers. By working together, we can build a better regulatory system, one that works for consumers and the industry alike. MBA and its members want to be your partners as we move forward in these efforts. We also need to continue to strengthen FHA by investing in new technology, allowing them to hire staff on par with other financial regulators, and we need to increase the loan limits for the FHA and the GSEs. And we need to remember Ginnie Mae, which now securitizes 40 percent of the mortgage market and does that with less than 100 employees.

Mr. Chairman, thank you for this opportunity to share our views and ideas with the committee.

[The prepared statement of Mr. Courson can be found on page 110 of the appendix.]

The CHAIRMAN. Thank you, Mr. Courson. Just a little note. The loan limit issue has been addressed in the House version of the recovery bill. So we will be looking to keep it in there.

Next, Mr. Michael Calhoun, who is president and Chief Operating Officer for the Center for Responsible Lending.

STATEMENT OF MICHAEL CALHOUN, PRESIDENT AND CHIEF OPERATING OFFICER, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Mr. Chairman and members of the committee, thank you for—

The CHAIRMAN. Which I do want to make clear, didn't used to be an oxymoron. And we hope to get to a point in America where it once again isn't.

Please go ahead.

Mr. CALHOUN. And I am happy to report that we had a small operating gain last year on our lending to subprime borrowers.

Mr. Chairman and members of the committee, thank you for your continuing efforts to ameliorate this deepening financial crisis. We are running out of time. Two weeks ago, Goldman Sachs issued a report that projected that foreclosures could reach 13 million families, almost 1 out of 4 mortgages. This week Mark Zandi, the leading economist of Moodys.com, observed that if we do not gain control of the foreclosure crisis in the upcoming weeks, it may be too late to prevent our economy from falling into a depression.

In this context, I will comment on the bills before the committee. It is appropriate that these bills address servicers, banks, and homeowners, since the fate of all three of these are tied together in addressing the housing crisis. All are currently suffering unnecessarily severe losses due to structural obstacles accidentally embedded in the structure of mortgage securities. Studies repeatedly find that loans not caught in the labyrinth of securities are modified more frequently, more forcefully, and more successfully to the benefit of all the participants.

In reviewing these bills, it is important to note how dramatically the landscape of the financial crisis has changed over the past year. Originally, our primary concern was resetting subprime mortgages where interest rates and payments would increase. One of the few bright spots in this economy has been the decline in market interest rates and that problem has been less than expected. That interest rate improvement, though, has been more than offset by the dramatic decline in housing prices. Today more than one out of five homeowners with mortgages are underwater and owe more than their house is worth, and that number is rapidly increasing. That is what is driving the avalanche of foreclosures that continue to bury our economy.

On top of this, banks are reluctant for regulatory accounting reasons to mark down the value of mortgage assets and loans. Ironically, by the banks overstating how well they are doing, we as a country are in fact doing far worse than we should be and could be. The failure to recognize these losses and modify mortgages is making this crisis much longer and deeper than it should be. Along with that, we have the obstacles of pooling and servicing agreements.

The bills before the committee today all address aspects of this challenge. Looking first at the HOPE for Homeowners, we applaud the changes to make this program more flexible and we urge that there be even more administrative flexibility so that this program can be adapted to meet the crisis. We also urge that lenders acknowledge the need to reduce loan levels to reflect current values and that judicial loan modifications be available to borrowers as a last resort as well.

The next bill which provides a safe harbor for servicers provides an important benefit to help remove artificial obstacles to rational loan modifications. We further urge the continued advantageous tax status for mortgage securities be conditioned on meeting the safe harbor standards. The structures that loans are held in, REMICs, are tax advantage structures. They do not pay taxes. It is simply pass-through. The Congress has the authority to make it a condition of that tax authority continuing that they meet these safe harbor standards and in doing so also avoid any taking implications that either approaches may involve.

Finally, the bill addressing the FDIC provides sensible tools to strengthen our banks. As we learned a generation ago, while it may be in the best interest of any individual depositor to withdraw money at the hint of bank weakness, collectively such actions destroy our financial system, and government intervention through deposit insurance was essential.

Similarly, with today's foreclosure crisis, individual actors are pursuing needless foreclosures that may appear to be in their best interest but are devastating homeowners and the overall economy. Intervention is again essential.

In closing, we urge the committee to adopt these bills immediately as well as other needed reforms. Thank you.

[The prepared statement of Mr. Calhoun can be found on page 98 of the appendix.]

The CHAIRMAN. Next, we have Ms. Robin Staudt.

STATEMENT OF MRS. ROBIN P. STAUDT

Mrs. STAUDT. Chairman Frank, Ranking Member Bachus, and members of the committee, I appreciate the opportunity to testify before you today. I am currently residing in Orange County, North Carolina. This region is farm country on the edge of what used to be small-town America, but now abuts the Raleigh/Durham/Chapel Hill triangle. I was raised near Pittsburgh, Pennsylvania, so I do have a bit of perspective of city life as well. As a private citizen, I am honored to have this opportunity to speak to you.

Mr. Chairman and members of the committee, during the last number of months, my family has struggled to make ends meet because of the financial crisis. While I have been unemployed because of the housing construction downturn, my husband and I continue to change our activities, we cut back on unnecessary spending to make sure we can pay our mortgage on time and pay our bills. As my family and I continue to work and adjust our life, we cannot understand why we have to struggle while others are given a free pass on their mortgages.

Many of the bailouts that have been undertaken will penalize those who have been responsible. We are going to pay higher taxes, pay higher mortgage fees, and not benefit from any rate reduction. This is the wrong approach and punishes responsible behavior.

Let me be clear, I am not here asking for assistance, but I feel that it is not right for many Americans living within their means to have to pay for the cost of those who lived outside their means. I have bills to pay, and I believe I should be allowed to keep more of my money.

I am a second generation American whose grandmother taught her the marvels of freedom and all the opportunities it brings. My mother and father taught me the value of hard work, honesty, and integrity, with a reminder that pride does go before a fall. The constant lesson that was in America, you could map your success based on self-sufficiency and if you ever fell down the solution would not be found by depending on the government. You learned to get up, dust yourself off, and go for success again.

To be in the august environment of this committee is overwhelming, but I would respectfully request that if the issue is to help the people of the United States, I have no problems with that. But at what cost to the taxpayers of America?

Mr. Chairman, many Americans are angry that they are being asked to pay for the mistakes of a few. I believe that the solution is not found in bailing out a few homeowners, but in allowing individuals to keep more of their income and spend it how they see fit. This will help our economy.

Thank you very much, gentlemen.

[The prepared statement of Mrs. Staudt can be found on page 179 of the appendix.]

The CHAIRMAN. Next, Professor Edward Morrison of the Columbia Law School.

STATEMENT OF EDWARD R. MORRISON, PROFESSOR OF LAW, COLUMBIA LAW SCHOOL

Mr. MORRISON. Good afternoon, Chairman Frank, Ranking Member Bachus, and members of the committee. I am Ed Morrison, a professor at Columbia Law School.

Last year saw 2.5 million foreclosures. Another 1.7 million are expected this year. Without prompt action, the foreclosure crisis will get much worse very soon. Over 4 million Americans are now at least 60 days late on their mortgages. Parts of H.R. 703 are a step in the right direction, but we can't consider this bill in a vacuum.

The House is now considering a bankruptcy cramdown bill that permits homeowners to enter bankruptcy and ask judges to reduce their outstanding mortgage balances to the current market values of their homes. If this bill is enacted, H.R. 703 will be much more expensive and much less effective than it appears now.

First, demand for the HOPE for Homeowners Act and the cost to taxpayers could skyrocket. Homeowners will likely prefer the Act to bankruptcy cramdown because it offers a greater reduction in their mortgage balances. Lenders will also likely prefer the Act to bankruptcy cramdown because it offers immediate payment based on a manipulable appraisal value.

By contrast, bankruptcy cramdown offers only a risky promise of future payment, and because Chapter 13 plans fail ⅔ of the time, cramdown may only delay foreclosure for years. As demand for the Act spikes and the government takes on a massive number of risky mortgages, the cost to taxpayers could be enormous.

Second, consider loans that are ineligible for HOPE for Homeowners, perhaps due to HUD's qualifying standards. Among these, a cramdown will devalue the safe harbor in H.R. 703. Bankruptcy will be more attractive than mortgage modification outside of bankruptcy both to homeowners and to mortgage servicers. Homeowners will prefer cramdown because it yields a permanent writedown in the mortgage balance. Servicers will prefer it, too, because their costs are compensated in judicial proceedings, not in mortgage modifications.

The cramdown bill undercuts H.R. 703, and it is bad policy for three reasons. First, it is unnecessary for the vast majority of mortgages. The government can freely modify 35 million of the 55 million outstanding mortgages it controls through Fannie, Freddie, and the FHA. Another 12 million mortgages are in the hands of private lenders such as community banks, which are taking appreciable efforts to modify loans. These entities have strong incentives to do the right thing. They don't need interference from bankruptcy judges.

Second, cramdown would yield a flood of bankruptcy cases, overwhelm the courts, and delay the crisis potentially for years. Every bankruptcy judge handles about 2,600 cases each per year currently. The courts would have difficulty handling a dramatically increased caseload with the care necessary to successfully modify loans. And even under the current caseload, ⅔ of Chapter 13 plans ultimately fail.

Third, cramdown is expensive. Proponents argue that cramdowns will not cost taxpayers any money. That claim is simply not true. Taxpayers are on the hook for $5.6 trillion in mortgage guarantees from Fannie, Freddie, and the FHA. Other guarantees or loans have been extended to private lenders. Cramdown exposes taxpayers to the risk of losing billions of dollars as financial institutions suffer losses and need further capital injections from the government.

Cramdown is the wrong approach and so is actually HOPE for Homeowners because its guarantees impose high costs on taxpayers and because it applies a one-size-fits-all approach to mortgage modification. Columbia professors Christopher Mayer, Tomasz Piskorski and I, offer a more effective, lower-cost approach. Unlike cramdown, our proposal doesn't interfere with mortgages that are already under the control of Fannie, Freddie, and the FHA. And unlike HOPE for Homeowners, our proposal requires no government guarantees. We zero in on privately securitized mortgages. They lie at the core of the housing crisis. Although they represent only 15 percent of outstanding loans, they account for half of foreclosure starts.

Servicers of these mortgages should be paid an incentive fee equaling 10 percent of mortgage payments, not to exceed $60 per month. This fee would align incentives between servicers and investors and make modification, not foreclosure, the preferred solution. If a mortgage is ongoing, the servicer receives a monthly fee. If it goes to foreclosure, the servicer receives nothing.

In addition, the government should insulate servicers from legal liability when they have a reasonable, good faith belief that modification makes economic sense. This is precisely what the safe harbor in H.R. 703 does, but the bill should do more. It should require investors to compensate the legal cost of servicers who are sued but successfully invoke the safe harbor.

Our proposal would avoid up to one million foreclosures, but the government can do more. Even among mortgages controlled by the GSEs, modification can be inhibited by the presence of second liens. The government should therefore offer second lien holders up to $1,500 to drop their claims when a primary mortgage is being modified. This plan could facilitate 1.4 million new modifications.

Together, our proposals would address the current crisis at a cost of $12.8 billion payable by TARP funds. This approach is less costly and more effective than both cramdowns and HOPE for Homeowners.

I thank you for the opportunity to speak here.

[The prepared statement of Professor Morrison can be found on page 127 of the appendix.]

The CHAIRMAN. Let me begin briefly. Mr. Morrison, I appreciate particularly your legal analysis because we do have the problem of interfering with existing contracts. And the legal analysis—I understand you have some modifications you would make in the Castle proposal. But the legal analysis is the same and I welcome it. I think that it is very helpful and you have—the only other thing I would say to Mr. Calhoun is that I am pretty confident now, and I just spoke to Senator Dodd and spoke to Secretary Geithner, I think a very significant mortgage foreclosure reduction program with tens of billions of dollars being made available and all of the federally held mortgages involved, Fannie Mae and Freddie Mac and FDIC and the Fed, I believe, yes, at times—it is long overdue and that will be happening very soon, I believe. Obviously, it won't solve everything.

With that, I am going to yield now to Mr. Cleaver, who set a very good example that was only intermittently followed by waiving his first round of questioning. He gets to go now.

Mr. CLEAVER. Thank you, Mr. Chairman. Mr. Stewart, I am assuming you don't support the HOPE for Homeowners bill as it is currently—I am sorry, Mr.—

Mr. MORRISON. Mr. Morrison.

Mr. CLEAVER. Mr. Morrison.

Mr. MORRISON. I do not support the HOPE for Homeowners Act largely because, though it can be effective, it is much more costly than alternatives. So relative to alternatives, it costs taxpayers more money.

Mr. CLEAVER. All right. Yes. And you don't support the cramdown either?

Mr. MORRISON. Again, for the same reason.

Mr. CLEAVER. Most of your opening comments spoke to the cramdown, probably ⅔, which is not in this but it is in Judiciary.

Mr. MORRISON. Right. As it began, I think that in considering H.R. 703 and its benefits and costs, you have to consider it in context. The cramdown legislation seems to have a lot of momentum. And if the cramdown bill becomes law, it changes the way we need to think.

Mr. CLEAVER. Well, it has to be introduced first. The point is, I mean, you spoke about something that is not and you spoke, ⅔ of your talk, to something that is not. And I was wondering whether or not you had anything to say about what is.

Mr. MORRISON. Right. As I said, I think—H.R. 703 is the first step towards a low-cost, comprehensive solution to the foreclosure crisis. And this first step would be undermined by cramdown legislation. The first step—

Mr. CLEAVER. Sir, excuse me. I am sorry. You are a nice person and I am sorry to interrupt you. But you keep—

Mr. MORRISON. No. But I am getting to the safe harbor. Section 6 of H.R. 703 is the first step towards a comprehensive solution. We need the safe harbor because modifications—our foreclosure crisis is in large part driven by privately securitized mortgages. Servicers would like to modify these loans but can't. They face legal obstacles which the safe harbor would clear away. They also face economic obstacles because it is just not profitable to pursue modifications. Modifications can cost $750 to $1,000 per loan. These costs are uncompensated. Whereas if a servicer takes a loan in foreclosure, all of its out-of-pocket costs are compensated.

So my proposal, put together with my Columbia colleagues, is one that would take section 6 of H.R. 703 and use it as a foundation. What needs to be layered on top of it is at the very least a set of economic incentives that encourages servicers to modify even when they have the legal right to do so as section 6 permits.

Mr. CLEAVER. Non-judicial encouragement hasn't worked so far in this program, unless you have some evidence otherwise. I mean, that is one of the things we have talked about. And so for me, living in a community with almost 4,000 foreclosures and a whole chunk of others en route, I am concerned about what options we have available to make sure that these loan modifications occur. And what has happened—I think you would agree, wouldn't you, that it hasn't worked?

Mr. MORRISON. We have done a canvassing of the industry and discovered that what is stopping—we still have a mass of lenders who hold bonds who can't coordinate and homeowners who can't get the ear of servicers because the servicers are so overwhelmed and there is not much profit in the business of servicing. So we want to convert that into a profitable enterprise.

I am not aware of any evidence that would suggest that our proposal is flawed. What we are doing is that we are unlocking the servicing box and freeing servicers to modify when it makes economic sense. Keep in mind, a lot of servicers are failing, going bankrupt. We are offering a strong carrot that would allow these servicers to thrive, make it a profitable business for a change.

Mr. CLEAVER. Yes. I am trying to get the homeowners to survive.

Mr. MORRISON. Remember that the only way servicers get aid is by avoiding foreclosure.

The CHAIRMAN. The gentleman from Missouri—

Mr. CLEAVER. Mr. Yingling, do you support—I know the answer. But do you support some kind of judicial loan modification?

Mr. YINGLING. We support the provisions in this bill for the HOPE for Homeowners and we also support the aggressive use of TARP funds to help with foreclosure. Housing is at the root of this problem and we must address the foreclosure crisis.

Mr. CLEAVER. I was juxtaposing your position with Mr. Morrison. I guess maybe there is some kind of symbolism with the two of you on the ends. But I am wondering whether or not—

The CHAIRMAN. If the gentleman can finish the question, I will give him extra time.

Mr. CLEAVER. We have to try something. I am not going to be a part of the do-nothing crowd, to let things go. And it is your opinion that this legislation is the best thing we are considering right now or that is on the table that you have heard discussed?

Mr. YINGLING. This, but also the aggressive use of the TARP funds that the chairman referred to.

The CHAIRMAN. The gentleman from Texas, Mr. Marchant.

Mr. MARCHANT. Thank you, Mr. Chairman. I think one of the parts of this discussion that just took place—and if I could ask for a clarification. Has the chairman stated that the cramdown legislation will be merged with this before the Floor? Because if that is not the case, then maybe a lot of this discussion—

The CHAIRMAN. It is up to the Rules Committee and the leadership and it is, I think, still unclear. There was some talk about trying to put it into the omnibus. There are people talking about that. The one thing we can control is to do this by regular order. So we are going to have our hearing, we are going to have a markup tomorrow, and at that point obviously leaderships decide whether it goes to the Floor freestanding or it is packaged or whatever. There are a lot of people who talk about packaging it with bankruptcy either as a freestanding package or as part of some other package.

Mr. MARCHANT. Thank you. My question is to the two bankers and I would like for you to expand just a little bit about the mark-to-market aspect of the pressure that is on the banks with your mark-to-market—the mark-to-market influences that makes you be so reactive and how it would restrain you from pursuing modifications?

Mr. MENZIES. Congressman, speaking as a community banker, we have not had a challenge with mark-to-market on our balance sheet as of this point in time. But there are community banks throughout the country that are struggling with mark-to-market. If you make a legitimate performing 30-year mortgage loan and it is pending as agreed and you have to follow the current mark-to-market standards, it hurts your capital and it hurts your ability to leverage your bank and it hurts your ability to lend in the community. So mark-to-market has to be revisited holistically.

Mr. MARCHANT. When you say mark-to-market, you are saying a stand-alone 30-year mortgage, the regulators would come in and say what could you sell that mortgage for today and thus mark it to market?

Mr. MENZIES. We have not had that experience, no. And I don't believe the regulators are going and looking at an Easton Bank and Trust 3-year maturity, 30-year amortization loan and saying mark it to market. It is the portfolios that are making it mark-to-market. In particular, if you are into the private portfolios. We are not. We are strictly into Fannie, Freddie, short-term conforming paper, and we have not yet had a mark-to-market issue.

Mr. MARCHANT. So the community bankers are not experiencing the pressure of mark-to-market like the big bankers?

Mr. MENZIES. I would recharacterize that as the community bankers are not experiencing as much pressure as the largest banks of the Nation with mark-to-market. We are experiencing pressure on mark-to-market.

Mr. YINGLING. I would just say that I have talked to a number of community bankers where this is a huge problem, and I will give you two quick examples about how it can affect lending outside the traditional bank industry. The Federal Home Loan Banks just in the last few weeks, because the accountants came in and said we are going to take your private mortgage security portfolio and we are going to make you mark it to the market, have experienced a contraction of their capital. And yet when Moody's looked at that number—and I am doing this from memory and I will correct it if it is wrong for the record—they said it is a $13 billion writedown on capital. When they looked at the individual securities, they said we project the actual loss at $1 billion. So here you have had a $13 billion hit to capital at the Home Loan Banks, and that is cascading back down into community banks and hurting their liquidity.

The credit unions just in the last couple of weeks took a massive hit, relatively speaking, to the corporate credit unions where they had to have a huge, in effect, guarantee from the Credit Union Insurance Fund, and most of that was mark-to-market.

And I understand the committee may be looking at the way that insurance premiums for credit unions are currently paid. But right now, under our analysis, they would have to pay basically all the earnings from 2008 to their insurance fund because of this guarantee caused by mark-to-market. So that is going to have a cascading effect down to the availability of mortgages, for example, from credit unions.

Mr. MARCHANT. Mr. Chairman, I look forward to the hearing that you have announced that we will have where you are going to put the regulators and the bankers and make sure that there are not cross purposes going on here because I would contend that as hard as we push to solve these problems out in the banks during the examinations and with every aspect of banking now, there is this pressure that is preventing them from making loans, preventing them from doing business as usual. That is the biggest example here. If you buy a security and intend to hold it to maturity, then that is one—

The CHAIRMAN. Yes, we will be pursuing that. I just want to say to Mr. Yingling—and I know you had a commitment. But I especially appreciate you stayed long enough for that expression of solicitude for the credit unions. It is duly noted and appreciated.

The gentlewoman from New York.

Mrs. MALONEY. Thank you, Mr. Chairman. I would like to ask Mr. Yingling and Mr. Menzies, the HOPE for Homeowners Program has clearly not refinanced as many mortgages as we would have liked at this point, and one of the criticisms of the program has been that lender participation is voluntary. With the bill you are supporting and the changes you are supporting today, what assurances can you give us, if any, that the—with these changes we will see a greater degree of lender participation?

Mr. YINGLING. Well, I think you will see a greater degree of participation. I think also one of the important things here is that with this program and with the program that will be developed under the TARP, which we presume will look something like the FDIC program and providing flexibility in those programs to adjust to whatever problems we find going forward, we are creating a flexible system that can adjust. I think one of the problems has been that we have had to write in hard-wire requirements here and there with no ability to adjust to what has clearly been very rapidly changing circumstances.

And then again, the part about securitization is very important. A number of the members have commented on how the threat of litigation in the case of securitized loans has been maybe the biggest impediment that we have faced, and this bill deals with that.

Mrs. MALONEY. Mr. Menzies.

Mr. MENZIES. Congresswoman, I think that we absolutely will see more volume at FHA. There is no question that we need to deal with the technology side, which has been an encumbrance on this whole process. The FHA would benefit from an upgrade of its technology, but I believe we will see more and I think it does give us some hope.

Mrs. MALONEY. And, Mr. Taylor and Mr. Calhoun, would you like to comment on your belief whether or not this will increase participation by the lenders or any other incentives or proposals that might help us stem this loss of homes in our economy? I must say that throughout this process from the very beginning, the economists have said that the number one deal we should focus on is helping people stay in their homes and, if we don't do that, then the value of homes are going to fall and it is going to be a downward spiral of our economy, and yet it seems to be not getting the proper attention that it deserves, given the fact that people say this is the number one issue in order to try to stabilize our housing market and our economy. So I would like Mr. Taylor and Mr. Calhoun to comment on it if you could.

Mr. TAYLOR. Thank you, Representative Maloney. And I think there is great misperception out there that there is in fact a lot of help being offered and a lot being done to help homeowners. And when you sit here and you listen to—the HOPE for Homeowners has done 25 loans of 400,000, which even then when that number came up we were all critical that that is just a drop in the bucket. Well, they have done 25. It is almost a bad joke. But at least now with the terms and conditions that this committee and the chairman has offered, I think there is a real potential here putting the new terms and conditions which I think treat the consumer better in this process, but also create the safe harbor for servicers, put that together with some of the top funds. I think there is a real opportunity to make a dent in this. But I still think we are going to be challenged down the road. And I hope I am wrong about this, but I think unless there is a proactive step in which we step into the market and pull these loans away and direct those services, whether they are working with the FHA or whether they are working with the market because pulling these loans down, you know, at a discount, using the various methodologies that we have been proposing for a year now will reduce those mortgages in and of themselves when they are purchased so that the market itself, the mainstream banks, the community banks would be able to refinance these using the savings that occurred from purchasing these loans at a discount.

Mr. CALHOUN. If I could add, originally there was talk going way back of pairing it with the bankruptcy reform, that it would provide, if you will, a carrot and a stick, and we have had no stick here. And I note we had 300,000 foreclosure filings in December. The crisis is still going at full bore.

I would commend to everyone the Credit Suisse report on bankruptcy that they performed, a detailed analysis issued a week ago. They found that it would reduce foreclosures by 20 percent, that it would encourage more voluntary modifications by providing some pressure for those, that it would provide a good return to lenders and it would not hurt the cost or availability of future mortgages.

And I would note for Mr. Morrison's proposal, there are some things we agree with there, but it doesn't address the fundamental problem that a large percentage of these troubled mortgages are underwater and you can't refinance them easily.

The CHAIRMAN. The gentleman from New Jersey, Mr. Lance.

Mr. LANCE. Thank you, Mr. Chairman. To Professor Morrison, as I understand it, you propose a litigation safe harbor based upon a servicer's reasonable good faith belief that it was acting in the best interest of investors. Do you have a concern, Professor, that there might be conflicting interpretations across the various Federal circuits if we were to use that standard?

Mr. MORRISON. I have as much concern about that legal standard as I would be concerned about any legislation being interpreted differently by different courts. So I think this standard is as clear as any legal standard could be, other than one that absolves servicers of any liability, which we definitely do not want to do. We want to have some sort of incentivizing of servicers, not just the incentive fees that I propose, but also legal liability as a spur to act in their fiduciary capacities.

Differently, the safe harbor that we propose, and which is identical to the one in H.R. 703, uses a net present value test, which is very similar to the ones that—very similar to the test that is routinely applied in Chapter 11 reorganizations. The judge is asked to decide whether the recovery to creditors will be higher in a reorganization than in a Chapter 7 liquidation.

So this is a formula that is applied routinely, and I don't expect it to be applied in a fundamentally different way across the Nation. And moreover, the way it is structured, it is a differential test. It is based on the belief of the servicer, not on some evidence that after the fact the modification wasn't successful.

Mr. LANCE. Thank you. Regarding cramdown, I am of mixed emotion about it. Certainly, there were many who were victimized, and I think Congress in a bipartisan basis wishes to address that issue. But you do raise the point that this might create moral hazard. I think many that favor it believe that losses will occur between the lenders and the borrowers. And yet as I understand your testimony—and I have read your testimony, Professor Morrison—you believe that the taxpayers will end up bearing a substantial portion of the costs. I think you indicated in your testimony to the committee that—did I hear you correctly—$5.6 trillion involved in mortgages?

Mr. MORRISON. At least, in terms of our commitments to the GSEs. I don't think that even counts—I don't think my calculation counted the various commitments to the banks and other institutions that are exposed to the mortgage cramdowns.

Mr. LANCE. And you also indicate that you think eventually that this will lead to higher borrowing costs for everyone, that is in your written testimony. Could you explain that in a little more detail, Professor?

Mr. MORRISON. Right. So the current legislation, or at least H.R. 200, has a time limit that would apply only to mortgages originated—

Mr. LANCE. But you indicate in your testimony—and I read it—that you think Congress would be under enormous pressure in the future to modify that?

Mr. MORRISON. Right. I mean, this provision, the cramdown has been long advocated regardless of the economic environment. And it seems likely that based on our—my analysis, that bankruptcy cramdown could just defer the crisis and as the crisis lasts longer there is going to be pressure to apply mortgage cramdown laws to mortgages originated after the effective date. And if bankruptcy cramdown becomes a permanent feature of the code, there is no doubt that it will affect credit markets.

The Credit Suisse report that was just cited by Mr. Calhoun is riddled with errors, one of which is its reliance upon a study claiming no effect on credit markets from mortgage cramdown. That very study—and I can point you to the exact tables—finds just the opposite effect with respect to disadvantaged borrowers, meaning borrowers who do have imperfect credit records. And the study was not of the subprime era. It was of the early 1990's. So we are not talking about a subprime kind of borrower. We are talking about someone with marginal FICO scores. And for these people, that very study—which the Credit Suisse seems to misreport—that very study finds a reduction in loan-to-value ratios and an increase in interest rates for these disadvantaged borrowers.

Mr. LANCE. Thank you very much. I look forward to pursuing this further with you as we analyze this issue further. Thank you very much, Mr. Chairman.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. I want to get three questions in. Mr. Yingling and Mr. Courson, I would like your reaction to whether the concept of a bad bank creates a moral hazard. I would like the two of your reactions to the Credit Suisse study that Mr. Calhoun has made reference to, and if there is time I would like anybody's reaction to how this Senate proposal, the proposal that is floating around on the Senate side, for a 4.5 percent interest rate on mortgages plays into this whole situation.

Mr. Yingling.

Mr. YINGLING. First on the good bank, bad bank, it has been touched on. And I think the real problem with it, not an insurmountable problem, is valuation and I don't know how you value those assets in a way that works, given some of it is mark-to-market, given the fact that if you value them at the current mark-to-market it is way too low and if you value them higher I think some of you are going to say, well, are the taxpayers being disadvantaged.

So I believe the Administration is looking at a dual model where people could use that if they wanted. If they had already marked them down—

Mr. WATT. So your opinion is that it is a moral hazard if you don't get the valuation right?

Mr. YINGLING. I think it is almost impossible to get the valuation right. But it may be that if they combine it with people who—if the bank want to says I have marked it to market, that is what I will offer it for. And on the other hand, they could go for a guarantee where the valuation—

Mr. WATT. Mr. Courson, respond to the Credit Suisse study.

Mr. COURSON. Congressman, I am not familiar with it. I have not read that study.

Mr. WATT. Have you, Mr. Yingling?

Mr. YINGLING. I have read a summary of it.

Mr. WATT. What is your reaction to it?

Mr. YINGLING. I think it does have some problems. I think that in many ways this is a cost-benefit analysis. There is a way to reach a compromise on this because if you look at the benefits that people talk about, we can argue about how big they are, but the idea is that it will help some people stay out of foreclosure. And on the cost side, I do think that the study is wrong to the degree it may imply that there is not a cost. There will be a cost going forward in terms of higher interest rates and in terms of—

Mr. WATT. Even if you limit it to this short duration in time that the Senate proposal is—

Mr. YINGLING. That helps. One of the problems is they keep using date of enactment. So I have bankers asking me, what should I be doing right now? But I do think that most of the benefits would be on the side of looking at the kinds of mortgages that probably shouldn't have been made, and those are where the real problems are, and if you limit it to those, then you don't have as much of a cost because going forward presumably lenders aren't going to be making those kind of loans.

So I think there is a way to finesse this and get some kind of compromise in that sense.

Mr. WATT. I am glad to know you all are moving toward a compromise. That is music to my ears.

Mr. Calhoun, address this 4½ percent interest rate proposal and what impact that has in this whole equation.

Mr. CALHOUN. I think they are related. We have seen tremendous interest rate relief already, and that has been helpful but not enough to stem the foreclosure crisis. Again, I think there is agreement here. A huge part of the troubled mortgages are underwater mortgages held in private label securities. The problem there is the interest rate in terms of refinancing. You can't refinance underwater mortgages, even at favorable rates. You need some other assistance. That is why eventually there has to be some sort of writedown or subsidy involved.

And the cramdown—I think it is important—people talk of this cramdown like it is a drive-by cramdown. You go into your local Sonic and say I want a cramdown, pay for it, and drive away. It is a tough row to hoe. You have to be in a bankruptcy plan for 5 years, give up your right to any new credit, apply all of your disposable income to pay off your secured and unsecured debts. And under the compromise that came out of the Judiciary Committee, there is a so-called claw-back provision. If your home appreciates over the 5 years of the plan, you have to share a large part of that appreciation with your lender.

So people talk about this like it is an easy walk-in thing. There are a lot of safeguards there, so that it loses the potential for any moral hazard.

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

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. Ms. Staudt, let me just say this quickly. I thank you for coming. Your story is personal in a sense and we appreciate very much your sharing it with us. Thank you very much, and I thank all of you for coming of course.

But, Mr. Morrison, may I ask, have you written any white papers comparable to the one that I have or some body of knowledge that deals with cramdowns for business?

Mr. MORRISON. Cramdowns for business?

Mr. GREEN. Yes, sir. You agree that we have cramdowns for businesses, don't you?

Mr. MORRISON. Yes, we have them in Chapter 11 plans.

Mr. GREEN. Right. I would call that a cramdown. You wouldn't call that a cramdown?

Mr. MORRISON. There is a version of the cramdown—

Mr. GREEN. Have you written any papers in opposition to that?

Mr. MORRISON. No, I have not.

Mr. GREEN. Anything on cramdowns that—have you written anything opposing cramdowns for my 2nd, 3rd, 4th, or 5th home?

Mr. MORRISON. No, I have not.

Mr. GREEN. You do agree that we have cramdowns for 2nd, 3rd, 4th, and 5th homes beyond the first?

Mr. MORRISON. Yes. And we expect that the credit markets are very different for those kinds of homes.

Mr. GREEN. I understand. Well, let us just examine—

Mr. MORRISON. I can make a mention—in Chapter 11, for example—

Mr. GREEN. Before you do that, I think I am going to have to take control of the time because I have so little. Permit me to ask this. With reference to the businesses having the opportunity to cramdown, what is it about the residential homeowner that is so greatly different from that of the business having the opportunity to cramdown? And I want to talk about now for a specific window. Let us just talk about the subprime mortgages only. Let us take a 4-year window, none before, none to come after. What is it about that class of people that would make them unacceptable for a cramdown when businesses can get it?

Mr. MORRISON. I think the relevant comparison is what is—as one of your colleagues, I think it was Representative Sherman, said—is we want a solution that costs taxpayers the least amount of money. And I agree, cramdown would reduce foreclosures. HOPE for Homeowners would reduce foreclosures. But we have to ask how much do taxpayers get charged for these policies.

And I think the relevant question for policymakers is to ask what alternatives are available. And my colleagues, Christopher Mayer and Tomasz Piskorski, and I put forth a proposal that does as much work, more we think than cramdown or HOPE for Homeowners at a fraction of the cost. That for us is a strong reason not to go down the cramdown route, which we fear could delay a crisis that is of a different order of magnitude. We may talk about cramdown for businesses, but we are not talking about—

Mr. GREEN. If I may reclaim my time. The essence of your contention is that this is much more cost effective to avoid the cramdown and to go solely with the HOPE for Homeowners modification program; is this correct?

Mr. MORRISON. No. My proposal is not for HOPE for Homeowners. I think HOPE for Homeowners is relatively costly compared to the proposal I outline in the white paper I submitted.

Mr. GREEN. You are talking about 788, the safe harbor program?

Mr. MORRISON. The safe harbor tied to economic incentives for servicers to help homeowners.

Mr. GREEN. But it is your position that would be a more cost effective way to approach this?

Mr. MORRISON. Yes.

Mr. GREEN. Okay. Now, let us examine that for just a moment. I tend to like the program myself, but I do want to ask this. Do you agree that people who can win lawsuits generally speaking don't enjoy being sued or would prefer not to be sued?

Mr. MORRISON. People who—I am sorry. What do you mean—

Mr. GREEN. Who can win lawsuits, who have the law on their side, who have the long arm of the Congress having provided them a safe harbor, do you agree that they, generally speaking, don't enjoy being sued?

Mr. MORRISON. That is correct.

Mr. GREEN. Do you agree that there will be litigation with reference to persons who participate in this program, which is why someone mentioned indemnification earlier?

Mr. MORRISON. That is exactly why in my testimony I had suggested we—I agree with, I think, Mr. Courson with respect to that indemnification. I think that is a good idea. Also, we need to have a cost shifting provision such that if lawsuits are brought, the losing party pays the fees—that the losing party pays the fees of the winning party.

The CHAIRMAN. Could I—if the gentleman would yield. When you talked about your $12 billion cost, though, you didn't have indemnification in there, did you? Would that add to the cost significantly?

Mr. MORRISON. These would not be costs of the government. These would be costs—

The CHAIRMAN. Who would indemnify them? I thought indemnification was by the government.

Mr. MORRISON. We are mixing up two kinds of indemnification, one, which is not my proposal, which is Mr. Courson's, which would cost the government.

The CHAIRMAN. You said you would agree with Mr. Courson—

Mr. MORRISON. I think.

The CHAIRMAN. Stop, please. And I will give you some extra time here, but—

Mr. GREEN. That is the way I am going, Mr. Chairman.

The CHAIRMAN. You said you agree with Mr. Courson. I had understood Mr. Courson to be talking about taxpayer-funded indemnification. And if that were the case, it would be an added cost to your idea.

Mr. MORRISON. I never thought of it, but I think it is a good idea.

The CHAIRMAN. But it does add to the cost.

Mr. MORRISON. Yes. I can do the calculations.

The CHAIRMAN. I thank the gentleman.

Mr. GREEN. Thank you, Mr. Chairman. And I would yield back in the interest of time.

The CHAIRMAN. More time needed?

Mr. GREEN. I yield back. Thank you.

The CHAIRMAN. I thank the panel—oh, the gentleman from Florida, I did not realize you came back. The gentleman from Florida. I am not used to looking on the other side for—

Mr. GRAYSON. We are all struggling here with ways to try to get the economy moving again, and we are all looking to the credit markets to make that happen, to stop the declining credit, to accelerate the expansion of credit, to make the economy come alive again. We all do that with limited resources. We can help and only help to a certain extent. There are banks that have made terrible mistakes over the past few years that have led to hundreds of billions of dollars in lawsuits, and there are banks that do their jobs well. There are banks that do the jobs of banks every day, smart lending, smart borrowing, nothing goes wrong.

So I am going to ask you all individually for as much time as we have. I would like to go from left to right. You tell me, should we be helping the good banks or should we be helping the bad banks? I start with Mr. Yingling.

Mr. YINGLING. Well, I think you to some degree have to do both. I think maybe those in the middle are the ones that aren't getting the help now, and that may be correct. I think if you look at the way the capital purchase program was designed it was designed to help only healthy banks on the theory that you put capital in them, you built a strong capital base and they could go out and lend to their customers and pick up the customers of others where credit may not be available. I think there are going to be some institutions if they are systemically important that are going to have to be taken care of. And those in the middle I think under the current program are left to go to the private markets and raise capital when they can.

Mr. MENZIES. Congressman, community banks stick to their knitting. They are well-capitalized, we are well-managed, we are well-regulated, we lend into our communities and community banks can make a difference in this recovery. I can't tell you whether we should save the systemic risk banks or not. That is a big heavy decision that is up to all of you. But I do believe that community banks with greater access to deposit funds and greater access to capital can significantly improve the rate of recovery in communities throughout America. We have stuck to our knitting. We are not too big to fail. We are not too big to regulate. We are not too big to supervise. We are not too big to govern, and we are not too big to punish if we misbehave.

Mr. TAYLOR. I have trouble with answering the question because I am not sure what is in your head as to what is a good bank or a bad bank. But I think in some ways we are so beyond that discussion because, as Mike said earlier, to paraphrase him, I think the servicers, the banks, the communities, this Congress, we are all in this together. If we don't find a way to stabilize our financial services sector and to deal with these problems, it isn't going to be a matter of who was the good guy and who was the bad guy. But it is going to be a matter of how far we go into this recession and whether we go into what Zandi is calling a potential depression. And I think what we need to do is create as much liquidity as possible and do something we haven't done yet, and that is help the homeowners, help the source of what was the original impetus for this recession and stop the foreclosures and go right after the people who are still working, who are able to pay on their mortgages and would gladly continue paying on their mortgages if they could get on the one that wasn't predatory.

Mr. COURSON. Congressman, the mortgage markets and the credit markets are just seized up and we have to have liquidity. So I am not putting labels on anyone. We have to create liquidity. We have to, using the TARP funds, figure out a way that we can liquefy these balance sheets, we can get these bad loans either corralled or off the balance sheets to create liquidity and, having done that, then take control, as the chairman talks about, find a way, as we have talked about here, of dramatically and aggressively dealing with those loans once we get our arms around it. But we have to have liquidity in the marketplace regardless of whether it is a large national bank, community bank, small regional bank.

Mr. CALHOUN. I think you help both when you do that primarily through stabilizing housing market. As a lender, and I think all the lenders here will say, it is almost impossible to lend in a market with declining values. You have to charge such huge premiums.

In the Credit Suisse report, they estimate that every foreclosure imposes an externality of $300,000 in reduction in housing values on other properties. And if we allow these foreclosures to keep rolling on, there is no floor, you can't have liquidity. And I want to emphasize that while we think the cramdown isn't an essential part of that strategy, it is a part.

The CHAIRMAN. We will stop with that question. Do the other two witnesses want to add anything?

Mrs. STAUDT. I would like to say something as a homeowner and a taxpayer who is caught in the squeeze. I understand that these problems are way bigger than I can even begin to speak to. What my concern is, is that many of the moves that have been done by the government has kept an artificially inflated market going. The values of homes are staying higher than they really are. That is why we have all these underwater mortgages everywhere.

To give you a quick example—

The CHAIRMAN. We don't have a lot of time.

Mrs. STAUDT. Very, very quick. I just got a 20 percent increase on the value of my home during revaluation in our area. There are "for sale" signs everywhere. But we were all reevaluated 20 percent higher because they need to generate revenue. I just want us to—

The CHAIRMAN. I am sorry. We really are kind of pressed for time.

Mrs. STAUDT. I just want us to be careful of what we choose to do. If the government chooses to help anybody, not just the banks, please consider the taxpayers because we are overburdened. Thank you.

The CHAIRMAN. Mr. Morrison.

Mr. MORRISON. We may need regulation to prevent banks from going bad, but right now we need to stabilize our financial sector. If we don't stabilize the financial system, both good and bad banks, we will see unemployment on Main Street. Academic studies have shown this. When Worldcom defaulted on bonds held by banks, those banks suffered distress and reduced lending at local branches throughout the country. It is as simple as that.

Mr. GRAYSON. Thank you, Mr. Chairman.

The CHAIRMAN. The final questioner is the gentleman from Minnesota.

Mr. PAULSEN. Thank you, Mr. Chairman. And I just had a question for Mr. Menzies. Some of this may have already been covered before, but I know there has been a great deal of focus given to TARP obviously in a lot of the questioning that has gone on today as well as in the Congress. It has really been a means of getting capital into the hands of the lenders obviously, but I know the community banks which are obviously organized across the full range of charter types have had a variety of concerns and problems relating—about just gaining access to the program itself in general. And I am just wondering if there are other ways that Congress can specifically help get capital into the hands of the small lenders who really feed the small business community?

Mr. MENZIES. Thank you for your question, Congressman. On a very personal note as a Subchapter S bank, if Congress would authorize IRA accounts and 401(k)s to invest in Subchapter S companies, that would dramatically increase our access to capital. And there are over 2,500 Subchapter S banks of the 8,380 banks in this Nation. And if Congress would continue to encourage the Treasury to direct CPP monies to communities in the Nation, that would be great as well.

You note that most of the community banks in the Nation have not yet taken advantage of TARP. We think it is important that those banks who can take advantage of the CPP program do so and use that money to lend to their local communities. We have a local bank that took advantage of TARP and from all of our perspectives they are using it very responsibly and they are leveraging it. They are lending it out 10 to 1. They are doing a great job for the community. As a Subchapter S bank, we have yet to go through the process of interpreting the term sheet so we don't yet know if we are going to take advantage of CPP. But those would be my thoughts for community banks.

The CHAIRMAN. Do you have a term sheet yet?

Mr. MENZIES. Yes, sir, we do. We have submitted our application.

The CHAIRMAN. The mutuals don't have them, but you have them.

Mr. MENZIES. Mutuals don't have them. That is an important point, Mr. Chairman.

The CHAIRMAN. I understand, but we are not going to repeat it.

Mr. PAULSEN. I yield back, Mr. Chairman.

The CHAIRMAN. I thank the panel. Sometimes when we are running late, people's attention is more focused. Thank you all for your contributions.

[Whereupon, at 6:00 p.m., the hearing was adjourned.]

A P P E N D I X

February 3, 2009

Opening Statement of Ranking Member Spencer Bachus

Full Committee Hearing on Promoting Bank Liquidity

February 3, 2009

Thank you, Mr. Chairman, for holding this hearing today on legislative proposals to promote bank liquidity. This issue is key to getting our economy on the road to recovery, and I'm hopeful that today's hearing will shed light on the best means of achieving this shared goal.

The legislation that we will discuss today and mark up tomorrow includes provisions that I support. Permanently increasing deposit insurance coverage limits to $250,000 will, in my view, strengthen our banking system and reduce the likelihood of destabilizing bank runs. As the lead sponsor of deposit insurance reform legislation in 2006 that increased coverage levels for the first time in 26 years, I applaud Chairman Frank's efforts in this area.

Provisions placing our nation's community banks on an equal footing with their large bank counterparts in accessing funds under the Troubled Asset Relief Program (TARP) are also worthy of support. The government's efforts so far have focused on "too big to fail" institutions. This has placed many of our community banks at a competitive disadvantage because they are often considered 'too small to save." Addressing this unfairness should be a high priority for this Congress and for the new administration.

However, there are initiatives in these bills that raise great concern, namely those relating to the Hope for Homeowners program. This program, which Congress enacted last July, has been a failure by virtually every metric. And rather than cut taxpayer losses, this bill aims to fix a fundamentally unfixable program, while abandoning key taxpayer safeguards.

At the outset, Hope for Homeowners proponents claimed this program would provide relief to 400,000 borrowers. Proponents were wildly off mark. In fact, the program has received a mere 400 applications and closed on just 25 new loans.

Under the legislation we will consider tomorrow, the Hope for Homeowners program would allow FHA to insure loans with greater risk of default and require a higher per loan taxpayer subsidy. The non-partisan Congressional Budget Office projects that even with these changes, the program will help a mere 25,000 borrowers, at best. Far from the 400,000 promised, and far from a success.

During his campaign, President Obama often expressed his goal of ending wasteful, underperforming and duplicative government programs. How many times do we have to attempt to change a program that has helped 25 borrowers nationwide? Under President Obama's criteria, HOPE for Homeowners would certainly qualify as a program to be cut.

Chairman Frank's legislation would also eliminate upfront premium payments and pave the way for FHA to waive annual premiums entirely. These tools are critical to protecting taxpayer funds. Why would we expose American taxpayers to an ever greater amount of risk?

Several big questions must be answered today: who are these proposals intended to help, and is it fair? Will these proposals reward irresponsible behavior by a small amount of individuals and punish those who have played by the rules and lived within their means? And how, if at all, would the legislation stimulate the economy?

Let me conclude, Mr. Chairman, by saying that if we are truly focused on increasing liquidity, what the markets need most right now is the opportunity to absorb the historic and unprecedented amount of government intervention they have seen over the past several months. Times are tough for American families. But merely throwing good taxpayer money after bad is not the solution to our economic problems.

Thanks to our witnesses for being here today. We look forward to your testimony.

Opening Statement of Congressman Gary C. Peters
House Committee on Financial Services
Promoting Bank Liquidity and Lending Through Deposit Insurance, Hope for Homeowners, and other Enhancements
February 3, 2009

Thank you Mr. Chairman, and thank you to the witnesses appearing before the Committee today. There is perhaps no more important issue for us to address right now than foreclosure mitigation. In the state of Michigan, there were over 150,000 foreclosures last year, and millions more Americans nationwide will lose their homes in the coming years if we don't act to stem the tide of foreclosures.

The human cost of this problem is obvious, and we can all sympathize with a family that is forced to move from their home. But as we all know, foreclosures are not just a personal tragedy for the homeowners that lose their homes, but a real problem for entire communities. Foreclosures drive down the values of other homes in the neighborhood, empty and abandoned homes are an eyesore for neighbors and a public safety concern, and a home without an owner means less property tax revenue for state and local governments and less money for our schools, our police and fire departments, and for other essential services.

The Committee will be considering legislation later this week that will improve on existing programs for homeowners, shield loan services from legal liability when they seek to help a homeowner stay in his or her home, and increase the federal deposit insurance limits at our banks and credit unions. I am interested in hearing what the witnesses have to say about these measures, but I am also particularly interested in hearing from the witnesses any ideas they may have for programs that would help homeowners who are facing a temporary loss of income.

Michigan not only has one of the highest foreclosure rates in the nation, it also has the nation's highest unemployment rate. When a person loses his or her job in a high unemployment state like Michigan, it can be very difficult for that person to find another job in their home community. At the same time, if a jobless individual owes more on their home than it is currently worth, they cannot afford to move. This can lock families into an often irresolvable hardship. As more and more Americans find themselves out of work, we need to begin to think about ways to help these families stay in their homes until the economy recovers and Americans get back to work. I look forward to hearing what the witnesses have to say about this, and I thank Chairman Frank for his leadership on this critical issue.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

JOHN F. BOVENZI
DEPUTY TO THE CHAIRMAN AND CHIEF OPERATING OFFICER
FEDERAL DEPOSIT INSURANCE CORPORATION

on

PROMOTING BANK LIQUIDITY AND LENDING THROUGH DEPOSIT INSURANCE, HOPE FOR HOMEOWNERS, AND OTHER ENHANCEMENTS

before the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

February 3, 2009
Room 2128, Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding efforts to promote bank liquidity and lending. As discussed in previous statements before this committee, asset quality deterioration, especially among residential mortgages, played a large role in triggering the current crisis. However, it has become increasingly apparent that a lack of liquidity in the financial services sector has emerged as a major obstacle to efforts to return the economy to a condition where it can support normal economic activity and future economic growth.

My testimony will discuss the reasons why measures are needed to enhance liquidity sources for financial institutions and the FDIC's efforts to provide additional liquidity to institutions through our Temporary Liquidity Guarantee Program (TLGP), as well as through maintaining a strong and flexible deposit insurance system. In addition, I will discuss the role of programs funded though the Emergency Economic Stabilization Act's (EESA) Troubled Asset Relief Program (TARP) in promoting stability and liquidity.

The Importance of Liquidity

Sufficient sources of liquidity are necessary to ensure appropriate funding of financial institutions' ongoing financial obligations to depositors, debtors and creditors. The most extreme examples of financial institution's inability to meet their obligations were seen in several of the financial institution failures that occurred during the latter part of 2008. While several institutions had significant asset quality problems, their reported book capital had not yet reached the Critically Undercapitalized threshold typically seen in failing banks. While the assets of these institutions were quickly deteriorating, their liquidity positions were deteriorating at a faster rate. This deterioration was brought on in part by significant deposit outflow over a relatively short period of time that resulted in a funding shortfall, which ultimately caused their failure.

Clearly, even absent the immediate liquidity issues that led to the closure of these institutions, the continued viability of these institutions was unlikely. However, liquidity failures result in more complicated resolutions. Also, the timeframes necessary to gather deposit and loan information as well as to solicit bids from interested acquirers, become compressed, which can place greater demands on the resources of the FDIC. Stabilizing liquidity could potentially avoid unnecessary costs to the Deposit Insurance Fund (DIF) by eliminating the need to close, or prematurely close, otherwise viable institutions.

In addition, a combination of adequate liquidity and capital buttresses financial institutions' ability to lend. Higher capital, resulting from TARP capital injections or private equity, enables financial institutions to lend more from their funding sources -- with deposits now being the most important. However, institutions need both liquidity and capital. Liquidity alone does not help if capital is insufficient and capital alone is not enough if the institution cannot obtain funds to lend.

Efforts to Improve Liquidity at Insured Depository Institutions

Temporary Liquidity Guarantee Program

In October, the FDIC Board of Directors approved the TLGP to unlock inter-bank credit markets and restore rationality to credit spreads. This voluntary program is designed to free up funding for banks to make loans to creditworthy businesses and consumers. The TLGP has two components: 1) a program to guarantee senior unsecured debt of insured depository institutions and most depository institution holding companies, and 2) a program to guarantee noninterest bearing transaction deposit accounts in excess of deposit insurance limits. The TLGP has a high level of participation. Of about 8,300 FDIC-insured institutions, nearly 7,000 have opted in to the transaction account guarantee program, and nearly 7,100 banks and thrifts and their holding companies have opted in to the debt guarantee program.

The TLGP's first component -- the guarantee of senior unsecured debt of insured depository institutions -- is designed to help stabilize the funding structure of financial institutions and expand their funding base to support the extension of new credit. Indications to date suggest the program has improved access to funding and lowered banks' borrowing costs. As of January 28, outstanding debt covered by a TLGP guarantee totaled about $221 billion. Data show that FDIC-guaranteed debt is trading at considerably lower spreads than non-guaranteed debt issued by the same companies. Since the inception of the TLGP program and the other interagency measures announced in mid-October, interbank lending rates have declined. For example, the LIBOR -- Treasury (TED) spread declined from 464 basis points on October 10 to 94 basis points on January 29.

The TLGP's second component provides insured depository institutions with insurance coverage for all deposits in non-interest bearing transaction accounts unless the institution chooses to opt out. These accounts are mainly payment processing accounts such as payroll accounts used by businesses. Frequently, such accounts exceed the current temporary maximum insurance limit of $250,000. Many smaller banks have expressed concerns about deposit outflows based on market conditions. This component of the TLGP gives assurance to bank customers that their cash accounts are protected. The guarantee should help stabilize accounts at these institutions and help the FDIC avoid having to close otherwise viable banks because of large deposit withdrawals. The temporary guarantee will expire December 31, 2009, consistent with the temporary statutory increase in deposit coverage.

Systemic Risk

The FDIC's action to establish the TLGP was authorized under the systemic risk exception of the FDIC Improvement Act of 1991 and followed similar actions by the international community. It is important to note that the TLGP does not rely on taxpayer funding or the Deposit Insurance Fund. Instead, both aspects of the program will be paid for by direct user fees.

The FDIC is charging TLGP participating institutions fees to offset the FDIC's risk exposure and minimize the likelihood that there will be any losses associated with the program. If losses should occur, they would be covered through a special systemic risk assessment.

However, under current law, even though the benefits of the TLGP accrue more broadly to bank holding companies, the FDIC's authority to assess extends only to insured depository institutions, not to bank holding companies. For example, the recent actions taken under the systemic risk authority have directly and indirectly benefited holding companies and non-bank affiliates of depository institutions, including shareholders and subordinated creditors of these organizations. Among the beneficiaries are large holding companies owning depository institutions that make up only a very small part of the consolidated organization.

The FDIC would recommend amending current law to allow us to impose, through rulemaking, systemic risk special assessments on insured depository institutions or depository institution holding companies, or both, as the FDIC determines to be appropriate. This approach would be more consistent with the FDIC's other assessment authority, which is set out more generally in the statute and implemented through notice-and-comment rulemaking. In addition, such a statutory change should permit the FDIC to establish the appropriate timing for recovering any loss in its assessment rulemaking in a manner that is not procyclical or exacerbates problems in the financial industry.

The Importance of Maintaining a Strong and Flexible Deposit Insurance System

Since the creation of the FDIC during the Great Depression, deposit insurance has played a crucial role in maintaining the stability of the banking system. By protecting deposits, the FDIC ensures the security of the most important source of funding available to insured depository institutions -- funds that can be lent to businesses and consumers to support and promote economic activity. At the end of the third quarter of 2008, the DIF had a balance of $35 billion available to absorb losses from the failures of insured institutions. This fund balance is net of loss reserves set aside for failures anticipated over the next 12 months, which are subject to adjustments based on changing economic and financial conditions. In addition, the FDIC has announced premium increases that are designed to return the DIF reserve ratio to within its statutory range in the coming years.

As part of our contingency planning, the FDIC would recommend that Congress provide additional support for our deposit insurance guarantee by increasing our existing $30 billion line of credit to $100 billion. Assets in the banking industry have tripled since 1991 -- the last time the line of credit was adjusted in the FDIC Improvement Act (from $5 billion to $30 billion). The FDIC believes it would be appropriate to adjust the statutory line of credit proportionately to ensure that the public has no confusion or doubt about the government's commitment to insured depositors. Because of the FDIC's ability to adjust premiums, the FDIC has never needed to draw on the line of credit to cover losses.[1]

Last fall, as part of its restoration plan and associated proposed rulemaking on assessments, the FDIC estimated a range of possible failure cost estimates over the 2008-2013 period, with $40 billion considered the most likely outcome. Since that time, another quarter of financial data on banking industry performance has become available. These data, combined with ample evidence of deteriorating economic and industry conditions, now suggest that the range of losses to the insurance fund (and the most likely outcomes) over the next few years will probably be higher. Thus, the uncertain and changing outlook for bank failures and the events of the past year have demonstrated the importance of contingency planning to cover unexpected developments in the financial services industry. If it ever became necessary to exercise this borrowing authority, the FDIC is statutorily required to ensure repayment of any borrowing over time through assessments on the banking industry.

In addition to increasing the borrowing authority of the FDIC to $100 billion, we believe it would be prudent to provide that the line of credit could be adjusted further in exigent circumstances by a request from the FDIC Board requiring the concurrence of the Secretary of the Treasury and subject to the consultation requirements with this Committee, as outlined in the current statute. These adjustments to FDIC borrowing authority would ensure that the FDIC is fully prepared to address any contingency.

[1] The FDIC's Bank Insurance Fund did borrow funds from the Treasury's Federal Financing Bank in 1991 for working capital, which the FDIC fully repaid with interest by 1993.

With regard to proposals to make permanent the current temporary increase in deposit insurance coverage to $250,000, the FDIC believes that the level of deposit insurance coverage is a policy determination that appropriately should be made by Congress. However, because any increase in the level of deposit insurance coverage increases exposure to the DIF, such a change must also permit the FDIC to assess premiums against the newly insured deposits to maintain the DIF.

Permanently increasing the level of insurance coverage also will have the effect of immediately reducing the reserve ratio of the DIF. Because the DIF reserve ratio is currently below the statutorily mandated range for the reserve ratio, the FDIC is required to implement a restoration plan to return the reserve ratio of the DIF to at least 1.15 percent of estimated insured deposits within five years. The FDIC Board has instituted premium increases necessary to implement the restoration plan. Because of the immediate dilutive effect on the DIF of permanently increasing coverage to $250,000, extending the time period for restoring the DIF reserve ratio to within the statutorily mandated range would be appropriate.

EESA Programs

Foreclosure Mitigation Under EESA

EESA provides broad authority to the Secretary of the Treasury to take action to ameliorate the growing distress in our credit and financial markets, as well as the broader economy. EESA specifically provides the Secretary with the authority to use loan guarantees and credit enhancements to facilitate loan modifications and prevent avoidable foreclosures. We believe that it is essential to utilize this authority and accelerate the pace of loan modifications in order to halt and reverse the rising tide of foreclosures that is causing uncertainty in the financial markets.

Mortgage loan modifications have been an area of intense interest and discussion for almost two years now. Meanwhile, despite the many programs introduced to address the problem, it continues to get worse. During the third quarter of 2008, we saw mortgage loans becoming 60 days or more past due at a rate of more than 800,000 per quarter -- net of past due loans that returned to current status. No one can dispute that this remains the fundamental source of uncertainty for our financial markets and the key sector of weakness for our economy. We must decisively address the mortgage problem as part of our wider strategy to restore confidence and stability to our economy.

In previous testimony, Chairman Bair outlined an FDIC proposal for the creation of a guarantee program based on the FDIC's practical experience in modifying mortgages at IndyMac Federal Bank in California. We believe this program could prevent as many as 1.5 million avoidable foreclosures. Generally, the FDIC has proposed that the government establish standards for loan modifications and provide for a defined sharing of losses on any default by modified mortgages meeting those standards. By doing so, unaffordable loans could be converted into loans that are sustainable over the long term. This proposal is authorized by the EESA and may be implemented under the existing authority provided to the Secretary under that statute.

Redefaults are a significant concern for investors with regard to loan restructurings. One recent report[2] showed that 35 percent of mortgages modified in the second quarter of 2008 had become 60 days or more past due within 5 months of modification. However, this report did not track the quality of the modifications, defining the term broadly to include any change in contract terms, including modifications that were merely temporary or actually increased borrower payments. In contrast, the modifications achieved at IndyMac Federal lowered borrower payments to an affordable level for the life of the loan using several tools, including interest rate reductions. Other reports suggest much lower redefault rates where the borrower's payment is reduced. One study found redefault rates of 15 percent where modifications reduce interest payments.[3]

Deteriorating economic conditions will certainly cause redefault rates to increase. It should be noted, however, that even with higher redefault rates, loan modifications still

[2] OCC and OTS Mortgage Metrics Report, Third Quarter 2008.
[3] Credit Suisse, Fixed Income Research Report, Subprime Loan Modifications Update, Oct. 1, 2008.

make business sense in many cases. This is because the value preserved through a loan restructuring is generally much greater than the incremental loss from waiting a period of months before the servicer forecloses or otherwise resolves the defaulting mortgage. At IndyMac Federal, the FDIC has used a systematic approach to loan modifications to restructure thousands of unaffordable loans into more sustainable payments. Even assuming a redefault rate of 40 percent, the net present value of loans that we have modified exceeds foreclosure value by an average of $50,000, with aggregate savings of over $400 million. In fact, we believe redefault rates will be much lower, but even at higher rates, systematic loan modifications make good business sense.

Over the next two years, an estimated 4 to 5 million mortgage loans will enter foreclosure if nothing is done. One of the benefits of reducing the number of foreclosures would be the reduction of the overhang of homes that would become vacant, a phenomenon that is driving down U.S. home prices. Such an approach keeps modified mortgages within existing securitization transactions, does not require approval by second lienholders, ensures that lenders and investors retain some risk of loss, and protects servicers from the putative risks of litigation by providing a clear economic benefit from the modifications.

The FDIC generally supports the concept of a safe harbor for servicers in connection with loan modifications. However, we note that, in crafting safe harbor provisions, it is important to avoid language that would implicate a constitutionally impermissible taking through the impairment of contract rights. In addition, Congress may want to condition a servicer's eligibility for the safe harbor on the affordability of the loan modification for the borrower.

Capital Purchase Program

As a part of EESA, the Treasury Department developed a Capital Purchase Program (CPP) which allows certain financial companies to apply for capital augmentation of up to three percent of risk weighted assets. As noted earlier, the ongoing financial crisis has disrupted a number of the channels through which market-based financing is normally provided to U.S. businesses and households. Private asset-backed securitization remains virtually shut down, and the commercial paper market is now heavily dependent on credit facilities created by the Federal Reserve. In this environment, banks will need to provide a greater share of credit intermediation than in the past to support normal levels of economic activity. By contrast, a significant reduction in bank lending would be expected to have strong, negative procyclical effects on the U.S. economy that would worsen the problems of the financial sector.

Before the recent capital infusions, banks appeared to be on course to significantly reduce their supply of new credit as a response to an unusually severe combination of credit distress and financial market turmoil. Standard banking practice during previous periods of severe credit distress has been to conserve capital by curtailing lending. In the present episode, lending standards were likely to be tightened further due to higher funding costs resulting from overall financial market uncertainty. There was ample evidence in the Federal Reserve's *Senior Loan Officer Survey* in October that bank lending standards were being tightened to a degree that is unprecedented in recent history.[4]

Government intervention was needed to interrupt this self-reinforcing cycle of credit losses and reduced lending. The Treasury Department implemented the CPP as a means of countering the procyclical economic effects of financial sector de-leveraging. The federal bank regulators expect banks to actively seek ways to use this assistance by making sound loans to household and business borrowers. The FDIC recognizes that banks will need to make adjustments to their operations, even cutting back in certain areas, to cope with recent adverse credit trends. However, the goal of providing government support is to ensure that such cut-backs and adjustments are made mostly in areas such as dividend policy and management compensation, rather than in the volume of prudent bank lending. These considerations are consistent with the precept that the highest and best use by banks of CPP capital in the present crisis is to support prudent lending activity. As part of our ongoing supervisory assessments of bank earnings and capital, the FDIC is taking into account how available capital is deployed to generate income through responsible lending.

Thus far, a number of the largest banking companies in the U.S. have taken advantage of the CPP, significantly bolstering their capital base during a period of economic and financial stress. In addition, over 1,600 community financial institutions

[4] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, October 2008, http://www.federalreserve.gov/boarddocs/snloansurvey/200811/

have applied to this program. In participating in the CPP program, as well as in launching the TLGP, it was the FDIC's express understanding that $250 billion would be made available for bank capital investments and that all eligible institutions, large and small, stock and mutual, would be able to participate.

It is critically important that community banks (commonly defined as those under $1 billion in total assets) are given every opportunity to participate in this program. Although, as a group, community banks have performed somewhat better than their larger competitors, they have not entirely escaped recent economic problems. Community banks control eleven percent of industry total assets; however, their importance is especially evident in small towns and rural communities. Although the viability of community banks as a sector continues to be strong, the CPP offers an opportunity for individual institutions to strengthen their balance sheets and continue providing banking services and credit to their communities.

The Importance of Using Additional Liquidity to Lend to Creditworthy Borrowers

In light of recent and proposed measures to improve liquidity at banks and promote additional lending, the FDIC and the other banking agencies have issued guidance to financial institutions and bank examiners to underscore the importance of using these resources to support lending to creditworthy borrowers. In November 2008 the FDIC issued an *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* to all FDIC supervised institutions, encouraging institutions to:

- lend prudently and responsibly to creditworthy borrowers;
- work with borrowers to preserve homeownership and avoid preventable foreclosures;
- adjust dividend policies to preserve capital and lending capacity; and
- employ compensation structures that encourage prudent lending.

The FDIC emphasized that adherence to these standards would be reflected in examination ratings both for safety and soundness and compliance criteria.

Further, to meet these objectives, it is crucial that banking organizations track the use of the funds made available through federal programs and provide appropriate information about the use of these funds. The FDIC recently issued another Financial Institution Letter advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community. Equally important to this process is providing this information to investors and the public. As a result, this Financial Institution Letter advises insured institutions to include information about their use of the funds in public reports, such as shareholder reports and financial statements.

Internally at the FDIC, we are preparing guidance to our bank examiners for evaluating participating banks' compliance with EESA, the CPP securities purchase agreements, and success in implementing the goals of the November 12 interagency statement. Importantly, this examiner guidance will focus on banks' use of TARP CPP funds and how their capital subscription was used to promote lending and encourage foreclosure prevention efforts. During examinations, our supervisory staff will be reviewing banks' efforts in these areas and will make comments as appropriate in FDIC Reports of Examination. Our examiners will also be considering these issues when they assign CAMELS composite component ratings. The banking agencies will measure and assess participating institutions' success in deploying TARP capital and other financial support from various federal initiatives to ensure that funds are used in a manner consistent with the intent of Congress.

Conclusion

I appreciate the opportunity to testify on behalf of the FDIC regarding the measures that need to be taken to restore liquidity to the banking system so that lenders can provide needed credit to creditworthy borrowers. A number of approaches will be necessary to shore up the stability of the banking system and promote liquidity. The FDIC will continue to work with Congress to ensure the banking system is able to support economic activity in these difficult times.

I would be pleased to answer any questions from the Committee.

WRITTEN STATEMENT OF MEG BURNS

Director, Office of Single Family Program Development
U.S. Department of Housing and Urban Development

Hearing before the Committee on Financial Services
United States House of Representatives

"Promoting Bank Liquidity and Lending Through Deposit Insurance,
HOPE for Homeowners, and other Enhancements"

February 3, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to speak to you today about your proposal to modify the HOPE for Homeowners Program.

My name is Meg Burns and I am the Director of Single Family Program Development for the Federal Housing Administration (FHA), and I am here representing the Secretary of the Department of Housing and Urban Development (HUD), Shaun Donovan. This past August I was appointed to serve as the Executive Director of the Board of Directors of the HOPE for Homeowners Program. As you know, the Board is composed of designees the Secretary of HUD, the Secretary of the Treasury, the Board of the FDIC, and the Board of Governors of the Federal Reserve. In my capacity as Executive Director, I am responsible for day-to-day oversight of the program. Given my direct involvement in all aspects of the program – from development of the policy guidance to industry outreach to program delivery – I am very pleased to be here today to share HUD's perspective on the HOPE for Homeowners section of your bill, HR 703. I want to emphasize that this testimony represents HUD's and not the HOPE for Homeowners Board's perspective

All of us at HUD welcome and applaud that you are proposing to make changes to the HOPE for Homeowners Program. As you are well aware, the initial program data, which we have shared with the committee each month since the program's inception, clearly indicates that changes are not only appropriate, but necessary. Furthermore, changes are needed as quickly as possible.

Status of Program

Let me start by reviewing the most current program data, which certainly makes the case for your proposed changes. To date, FHA has insured no loans under the program; FHA-approved lenders have taken 451 applications and 25 loans have closed. To put these figures in perspective, according to the Congressional Budget Office's original projection that the program would assist 400,000 families over three years, FHA should have insured approximately 40,000 loans by this point in time.

From my personal experience and that of my colleagues, collectively speaking to literally thousands of representatives from servicing, originating, and counseling organizations – programmatic restrictions and high costs have contributed to low participation rates.

Since the law passed, on July 30, 2008, we have conducted more than 100 outreach sessions in communities across the nation. We have a very extensive web site devoted to the program, which includes information for consumers, lenders, and counselors. We've posted comprehensive written training materials and a special webcast-webinar developed by Neighborworks America, so that people can simply listen and learn about the program. Between this aggressive educational campaign and the tremendous amount of publicity the program has received from the press, there is no doubt that homeowners in need of help are fully aware that it is available. In fact, since last September, the FHA call center has received more than 66,000consumer and industry inquires regarding the program, which represents about 45 percent of all incoming calls.

The other conjecture for low program participation is that lenders are not willing to accept losses on the existing liens – which are required to put the borrower into the new HOPE for Homeowners loan, which carries a maximum loan-to-value ratio of 96.5 percent. Even those lenders willing to accept principal write-downs report that they are having tremendous difficulty fitting borrowers into the program due to the severely restricted eligibility criteria. Moreover, we have heard an outcry from many, many counselors and consumer advocates that they cannot, in good conscience, recommend the program to struggling homeowners because the immediate and future cost to consumers is simply too high.

Support for Changes

The HOPE for Homeowners changes, proposed in HR 703, cut to the heart of the problems with the program – overly restrictive eligibility standards and extremely high costs to consumers.

We believe that modifications to the program, including the elimination of a number of the eligibility criteria could result in significant program uptake. The program restrictions have proven to be more and more difficult over time, as economic conditions have worsened.

Of particular note, the March affordability test, in particular, prevents families who have suffered financial hardship since that time from participating, unless they have an adjustable rate mortgage. Under the terms of the existing HOPE for Homeowners law, families with fixed-rate mortgages who were capable of making their mortgage payments last March, but who have lost some source of income during the past year and are now unable to afford their mortgage payments, are not eligible to participate in the program.

To the extent that the criteria were originally proposed as measures to prevent fraudulent practices from slipping into the HOPE for Homeowners program or persons who committed fraud from participating in the program, there are better ways to effectively identify and address the problem. At this stage in the mortgage crisis, program standards that effectively shut out large numbers of families in trouble may only perpetuate the foreclosure crisis. Clearly, HOPE for Homeowners is a product that is intended to help as many families as possible retain homeownership with the larger goal of breaking the cycle of foreclosures and home price depreciation affecting communities all across the nation.

The proposals to reduce consumer costs are worthwhile as well, and HUD agrees that the shared appreciation feature has been very problematic, though notes that any reduction to shared appreciation will increase the costs to the government. The way the existing law is written, borrowers are being asked to pay the Federal government for the benefit of program participation in an amount that could exceed the principal write-down they received. Under the existing HOPE for Homeowners law, there is no cap on the amount of shared appreciation, either in terms of dollars or time; a borrower can only pay off the shared appreciation mortgage by selling the home. The payment is based solely on the increase in value from the time of origination of the HOPE for Homeowners loan until the sale. If the borrower remains in the property for 20 years and the value increases by $70,000 (which is very feasible over that period of time) the obligation to the Federal government is $35,000 – even if the original principal write-down the borrower received was for, say, $20,000. In light of these concerns, HUD supports some significant change to this shared appreciation feature.

Finally, FHA appreciates and welcomes the proposed language requiring the HOPE for Homeowners program to be run in accordance with existing FHA practices. One of the comments that we at HUD made early on in implementing the program cycle was that lenders need to feel comfortable with the program to offer it and that the fewer changes they need to make to their own origination, underwriting, processing, and closing practices, the better. Every minor deviation from FHA's existing standards requires that large lenders train staff, modify systems, and establish new quality control measures. Any disparities within the loan operations of a large institution require a great deal of time and resources, both of which hinder program uptake and certainly slow lender implementation timeframes.

Appropriate Proposals that Could Benefit from Additional Modification

While HUD fully supports program changes, there are a few that could benefit from some additional consideration.

Upfront Mortgage Insurance Premium

Regarding consumer costs, again, the shared appreciation is only one expense to the consumer. Under current law, the borrower also pays an upfront mortgage insurance premium of 3 percent and an annual premium of 1.5 percent. They also pay a shared equity mortgage, which generally equals a percentage of the difference between the value of the home and the new HOPE for Homeowners loan.

The new proposal would retain the shared equity arrangement, but eliminate the upfront mortgage insurance premium altogether, and reduce the annual premium by 55 percent of the principal balance of the mortgage not to exceed 75 percent as based upon the credit risk of the mortgage.

As a guarantee program, upfront premium reduces the subsidy cost from potential losses from foreclosures and claims on the insurance fund. The upfront premium helps to defray subsidy expenses in a way that stretches the insurance authority farther, enabling FHA to help more families in need.

HUD agrees that the upfront and annual fees are too high and that reductions are appropriate. However, additional evaluation of the impact that the complete elimination of the upfront fee would have on the total costs of the program is warranted.

Subordinate Liens

One of the key features of the HOPE for Homeowners program is the mandatory principal write-down, a feature that FHA supports in theory, but that has proven more difficult in practice. In particular, many subordinate lienholders are not willing to accept the losses that are necessary to put borrowers into a HOPE for Homeowners loan. The program currently permits an immediate payment - now set at 3 or 4 cents on the dollar – to release their liens. In markets where recovery is fairly likely, it's not clear that this incentive is sufficient.

Moreover, the mechanism by which FHA can make payments to subordinate lienholders is cumbersome, making this component of the program a real disincentive for lenders. HUD would suggest that additional discussion and consideration of this element of the program is appropriate. Clearly, HUD supports the overarching Congressional objective to reduce the borrowers' debt loads and put them into sustainable situations, but it may be possible to accomplish the objective with a stronger incentive for subordinate lienholders.

Federal Pre-Emption for Shared Equity Mortgage

Finally, the lending community has expressed tremendous concerns that the shared appreciation and shared equity mortgages, which serve as contracts between HOPE for Homeowners borrowers and HUD, may violate state laws. They are reluctant to engage in the program in states like Texas where the state laws seem to prohibit these types of loans. Some lawyers representing the lending community have suggested that FHA should develop model shared equity and shared appreciation documents for every state in the nation or Federal pre-emption of state laws. We at HUD believe that additional discussion on this issue is certainly worthwhile, to ensure that HOPE for Homeowners can be a vehicle to help struggling homeowners in every state in the nation.

Conclusion

Again, I'd like to thank you for the opportunity to participate in today's Hearing on the proposed legislation, HR 703, and commend the Committee for proposing changes to the HOPE for Homeowners Program. We look forward to discussing with you HOPE for Homeowners Program changes as well as other tools to address the mortgage crisis. I'd be happy to answer any questions you may have.

Testimony of Michael Calhoun, Center for Responsible Lending
Before the U.S. House of Representatives Committee on Financial Services

"Promoting Bank Liquidity and Lending Through Deposit Insurance, The HOPE for Homeowners Program, And Other Enhancements"

February 3, 2009

Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. Thank you for inviting me to testify on H.R. 703, a bill to promote bank liquidity and lending through deposit insurance, the HOPE for Homeowners program, and other enhancements.

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

With the constant barrage of statistics and staggering dollar figures that have become commonplace during this financial crisis, it is easy to become numb to the depth and scope of the financial pain American families are experiencing today. However, the numbers paint a picture we cannot ignore. Our most recent report on subprime mortgages shows that over 1.5 million homes have already been lost to foreclosure, and another two million families with subprime loans are currently delinquent and in danger of losing their homes in the near future.[1] New projections of foreclosures on all types of mortgages during the next five years estimate 13 million defaults from 2008Q4 until 2014.[2] On subprime mortgages alone, the spillover costs are massive. At least 40 million homes—households where, for the most part, people have paid their mortgages on time every month—are suffering a decrease in their property values that amounts to hundreds of billions of dollars in losses.[3] These losses, in turn, are impacting nearly every aspect of American communities, from police and fire protection to community resources for education.

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

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

So far, voluntary, loan-by-loan modification efforts are not effectively stemming the tide of foreclosures. Modifications being made are too often unsustainable, and many structural, legal, and financial obstacles exist to making modifications at all. Streamlined and sustainable modifications are necessary to get ahead of the foreclosure curve, and servicers and creditors need substantial incentives to get them to participate in such programs. Changes to the law such as those contained in the Servicer Safe Harbor provisions of H.R. 703 can help remove some obstacles to using streamlined loan modification programs for securitized loans, particularly if paired with changes to REMIC laws. Strengthened incentives for mortgage holders and homeowners to participate in the FHA Hope for Homeowners program will help more people into sustainable mortgages, and that program will be even more useful if combined with a TARP-backed streamlined loan modification program along with a change to the bankruptcy code that permits judicial modification of mortgages on primary residences.

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

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

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

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

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

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

In fact, other studies tracking the results obtained by different types of modifications show that certain types of modifications are much more successful than other types. According to a recent Lehman Brothers analysis, rate reduction modifications result in a more significant improvement in performance than principal and interest capitalizations that add past-due amounts onto the balance of the loan.[13] Credit Suisse reports that when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.[14] In a January 13 paper, Goldman Sachs concluded, "Principal writedowns are always more effective in reducing default rates than note rate reductions."[15] And the OCC report suggests that modifications of mortgages held by a lender, rather than ones pooled into a mortgage-backed security, have been defaulting at lower rates, which further supports the notion that sustainable modifications can be made if obstacles to doing so can be overcome.[16]

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

A recent Federal Reserve Staff Working Paper identifies a number of obstacles that limit the scale of modifications.[17] These obstacles help explain why voluntary loss mitigation cannot keep up with demand.

- *Investor and PSA Concerns:* Servicers may shy away from modifications for fear of investor lawsuits.[18] While some Pooling and Servicing Agreements (PSAs) provide adequate authority to modify loans, these modifications may cause disproportionate harm to certain tranches of securities over other classes. Other PSAs include serious impediments to modifying securitized loans. For example, some limit the number or percentage of loans in a pool that can be modified.[19] Some impose modification costs on the servicers. And the FAS 140 accounting standards limit the selling of whole loans out of pools.

- *Second Liens:* Additional liens on a property pose a structural obstacle that is often impossible for servicers of the first lien to overcome. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,[20] and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, "it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications," thereby dooming the effort.[21]

- *Servicer Incentives:* The way servicers are compensated by lenders creates a market-distorting bias for moving forward with foreclosure rather than engaging in foreclosure prevention. Servicers are often not paid for modifications, but are reimbursed for foreclosure costs.[22] The Federal Reserve concludes, "Loan loss mitigation is labor intensive and thus raises servicing costs, which in turn make it more likely that a servicer would forego loss mitigation and pursue foreclosure even if the investor would be better off if foreclosure were avoided."[23]

- *Limited Servicer Staff and Technology:* With few but welcome recent exceptions, servicers have continued to process loan modifications through a labor-intensive, case-by-case review. While they have added staff and enhanced systems, the lack of transparent, standardized formulas has limited the number of modifications that have been produced.[24] Even when a servicer has a uniform methodology, the lack of transparency in the inputs to its net present value analysis, such as its selection of an appropriate discount rate, prevents borrowers and the public from properly evaluating modification decisions.

III. The Hope for Homeowners program could help many troubled homeowners, but changes must be made to encourage both creditors and homeowners to participate.

The Hope for Homeowners program meets three crucial policy criteria, the importance of which has only increased since the time the initial legislation creating the program was passed:

- It does not disproportionately bail out the lenders and investors whose actions led to the current crisis;
- It creates sustainable, affordable mortgages to preserve homeownership and family wealth; and
- It does not place taxpayers at undue risk.

Unfortunately, for a variety of reasons, the program has not caught on as an option for mortgage holders. We suggest a number of changes that can be made to Hope for Homeowners to make it more attractive both to lenders and homeowners. Some of these changes are proposed in H.R. 703, and others would need to be added either by statute or regulation. Most important, the FHA needs to have more flexibility to make changes to the program design to respond to rapidly changing market conditions and government policies, especially in terms of eligibility requirements and pricing.

A. Improve incentives for servicers, mortgage holders, and homeowners to participate in the program.

At present, the Hope for Homeowners program is running into problems on both the lender and homeowner side with respect to core incentives to participate in the program. The various administrative simplification measures proposed by H.R. 703 are all useful,[25] but changing the incentives described below is necessary to significantly increase program usage.

1. Provide more flexibility regarding the amount of the write-down that mortgage holders must take.

The Hope for Homeowners Act is structured to avoid bailing out lenders or investors or rewarding the irresponsible lending that helped create the current crisis. The core principle of the Act is that mortgage holders must write down the value of the mortgaged property to reflect current market value. Requiring mortgage holders to take this "haircut" ensures that lenders and investors shoulder a significant portion of the loss resulting from the poor lending and investing practices in which they engaged.

However, the write-down requirement appears to be discouraging participation to the extent that the program will be of little use at all unless this provision is revised. H.R. 703 proposes reducing the so-called haircut from 90% to 93%. This change is a move in the right direction and will hopefully encourage more mortgage holders to participate. We suggest, however, rather than enshrining a particular percentage in legislation, it may be more useful for the legislation to provide the FHA with flexibility in this area, capped at a maximum of 100%.

2. Eliminate the requirement that homeowners share appreciation with the government.

It is quite clear that the Hope for Homeowners requirement that homeowners share any appreciation above the market value of the home at the time of the FHA refinancing discourages homeowners from participating in this program. The possibility of appreciation is one of the key incentives that drives people to become homeowners, and the combination of appreciation and equity-building is a powerful tool for helping families build wealth over time. Several recent analyses identify the ability to build equity through mortgage payments and home appreciation as a bulwark against future defaults.[26] We agree that the shared appreciation provision should be eliminated. In our view, the equity-sharing provision provides adequate recapture for the government and is a fair way of splitting the opposing interests of repaying the government and leaving core homeownership incentives in place.

3. Provide financial incentives for servicers to participate in the program.

As noted above, the compensation model prevailing in the servicing industry today rewards servicers for holding delinquent accounts and for foreclosing on those accounts, but does not reward servicers for modifying loans or helping homeowners refinance into other loans. For this reason, it is crucial to provide monetary incentives to servicers to participate in Hope for Homeowners. We support H.R. 703 in this effort.

4. Reduce premiums to keep costs down for all participants.

One of the reported reasons for the lack of applications for Hope for Homeowners is the very high cost of premiums – both upfront and annual – that participants must pay under the current program. It is true that the Hope for Homeowners program was initially designed to be self-sustaining. However, as recent economic events have played out, it is clear that even if the program requires some infusion of government funding, it will still be a low-cost alternative to the more direct government subsidies that may otherwise be required to ameliorate the foreclosure crisis. Therefore, we agree that the upfront premium should be removed and the annual premiums reduced. However, we believe that Congress should delegate to FHA the ability to set the premiums at a level that maximizes participation yet covers some portion of the costs.

B. Hope for Homeowners must find a way to deal with second liens before it will become a key tool for homeowners.

The Hope for Homeowners program currently requires that all junior liens be extinguished for a mortgage to be eligible for refinancing. The existence of second liens on so many mortgages (see II above) means that this requirement creates a significant barrier to participation. Congress should consider creating a way to purchase these second liens– current estimates are that they can be purchased at 5 cents on the dollar or less[27] – and eliminate this barrier. Such a purchase program could be run through the TARP program[28] (loans otherwise eligible for H4H would be referred to TARP to buy out the second liens) or could be run through a fund located at FHA itself.

C. Congress can make two key legislative changes to other laws that will significantly promote participation in the Hope for Homeowners Program.

Hope for Homeowners will be most effective as part of a multi-faceted, comprehensive approach to foreclosure prevention. Other components to this approach include the servicer safe harbor discussed below, and the use of the TARP program's powers to prevent foreclosure. Below, we briefly lay out two other important changes to the law that we believe will strengthen the Hope for Homeowners program specifically as well as help achieve the overarching goals of foreclosure prevention and market stabilization.

1. Eliminate the onerous tax burden on homeowners who receive principal writedown either through Hope for Homeowners or through other foreclosure-prevention programs.

When lenders forgive any mortgage principal, such as the lenders would do in taking the write-down required under the Hope for Homeowners program, that amount of forgiven debt is considered to be income to the homeowner. There are some circumstances under which the homeowner can exclude the income from tax, such as if the debt is "qualified principal residence indebtedness (QPRI)" under the Mortgage Forgiveness Debt Relief Act of 2007 or if the homeowner is insolvent. However, for many potential program participants, the debt forgiven through the Hope for Homeowners program will not count as QPRI. This problem will occur if homeowners refinanced their mortgages to make home repairs that did not increase the basis of the house, such as fixing a roof, or where homeowners refinanced their home and consolidated other debt.

Even for homeowners whose forgiven debt will qualify as QPRI, it is extremely burdensome to take advantage of the exception. To do so, the taxpayer must fill out a long form 1040 (which makes them ineligible for any assistance from the various tax clinics offered by the IRS and others for lower-income taxpayers) and must also fill out a Form 982, a form so complicated that the IRS estimates it can take over 10 hours to complete and the IRS National Taxpayer Advocate has identified it as one of the obstacles that prevent taxpayers from claiming exclusions to which they are entitled.[29] If a taxpayer fails to include the reported amount on their tax return or to claim an authorized exemption using Form 982, the IRS's automated documented matching system will flag the return and the IRS may attempt to collect the tax.

To increase participation in the Hope for Homeowners program and to support other solutions that involve the write-down of principal, Congress should expand the definition of QPRI to include all mortgage debt and should streamline the tax filing process to ensure that all taxpayers have the ability to claim the exemption.

2. Permit judicial modifications of principal residences as a backstop to Hope for Homeowners and other foreclosure-prevention programs.

Right now, judicial modification of loans in bankruptcy court is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century and investment banks like Lehman Bros., yet current law makes a mortgage on a primary residence *the only debt* that bankruptcy courts are *not* permitted to modify in Chapter 13 payment plans. Eliminating this exception will provide a backstop for homeowners in trouble and will provide an incentive for mortgage holders to participate in the voluntary Hope for Homeowners program.

While this change to the bankruptcy code has been the subject of much debate in Congress, in light of the failure of voluntary modifications described above, an increasing number of market participants are coming to the conclusion that the change must be made. For example, last week, Credit Suisse released a report on judicial loan modications, concluding, "We expect the new bankruptcy reform will increase loan mods, particularly principal reduction mods, as it is likely to both pressure and also give justification to servicers to more actively pursue principal reduction mods."[30] Most tellingly, a few weeks ago, Citigroup reached an agreement with Congressional leaders to support court-supervised loan modifications in bankruptcy with some additional limitations in the bill.

D. Congress must ensure that FHA not become the new locus of predatory lending and broker abuses.

Finally, the administrators of the program will need to issue rules to protect against mortgage broker abuses in originating loans under the program. As the subprime and Alt-A credit markets have dried up, lenders and brokers are increasingly looking to the FHA as a source of loan funds for those who can't receive a conventional mortgage. Between January and July of 2008, government-guaranteed loan originations increased from 9.4% to 29.1% of the market,[31] most of which are FHA loans. We are already seeing evidence that bad actors are moving into the FHA space as the subprime market dries up.[32] It's critical that FHA loans are governed by appropriate standards to ensure that they are sustainable, contribute to helping low- and moderate-income families to build wealth, and help curb, rather than perpetuate, the current financial crisis.

1. Prohibit abuses in originating loans by brokers and lenders.

Most important, the FHA must avoid becoming the next victim of the origination abuses that plagued the subprime market. To keep its mortgages safe, the FHA should ban the use of yield-spread premiums (payments to brokers or retail lenders in exchange for selling the borrower a loan with a higher interest rate than the borrower qualifies for), which were one of the key drivers of the foreclosure crisis.

The FHA also must police loan terms to ensure that brokers and lenders are not charging excessive fees or interest rates, particularly since these loans are fully government-guaranteed. One approach would be to limit broker fees in coordination with current FHA limits on origination fees. Currently, some brokers are arguing that adding their compensation to lender fees and to the significant upfront mortgage insurance premiums for FHA loans[33] causes fees on FHA loans to exceed 5% of the loan amount, which can trigger many states' anti-predatory lending laws.[34] These groups are asking state lawmakers to exclude FHA upfront MI premiums from the points and fees threshold, thereby allowing room for significant YSPs. Instead, FHA should cap the total points and fees that can be charged on an FHA loan.

In addition, FHA should hold its originators accountable for any loans they originate that do not meet a long-term affordability standard or that otherwise violate FHA lending standards. Now that FHA is the main game in town, it has more leverage to require lenders to repurchase loans that don't comply with its standards. This is vital not only to protect consumers from abusive practices but also to preserve the sustainability of the program by protecting it from potentially debilitating losses.

2. Increase FHA's personnel capacity and information system technology to deal with increased volume and program participants.

HUD officials recently told Congress that they lack "sufficient staff, adequate technology and legal authority to screen questionable lenders who seek to participate in the issuance of federally backed loans," and that they are having the same problems with respect to appraisers.[35] It is crucial that FHA receive adequate funding to be able to ramp up its resources quickly and keep processes flowing, while also protecting the public purse.

It's not clear that FHA can clearly "pierce the corporate veil" to assess the personalities behind new applicants, but there should be some procedures in place that require FHA to consider qualifications of senior management in new applicants. One possibility is a "watch list" of any originators who have filed for bankruptcy or been involved in fraudulent activity against which FHA staff could compare new applicants; additional measures should be explored and implemented immediately for upfront screening, rather than trying to fix or sanction bad actors at the back end.

Additionally, since Fannie Mae and Freddie Mac are in government conservatorship and therefore are no longer real FHA competitors, FHA should take advantage of the GSEs' risk analytics to evaluate the credit risk of its portfolio and recent originations. Further, FHA should evaluate its underwriting criteria, particularly the areas in which large lenders have imposed voluntary screens to reject loans that would meet FHA standards, but which the lenders believe are too risky.

IV. A servicer safe harbor combined with changes to the REMIC law could help overcome some current obstacles to sustainable modifications.

Providing servicers with protection from investor lawsuits is an important way to encourage more sustainable modifications. H.R. 703 aptly recognizes that current restrictions in the contracts between servicers and investors are standing in the way of economically rational modifications that would both keep families in their homes and also provide a greater net present value return to investors as a whole. Specifically, roughly half of subprime PSAs have restrictions that limit servicers' and trustees' discretion to modify mortgages even when such modifications are in the best interests of investors as a whole.[36]

Yet in most cases, the net present value of a modification is greater than foreclosing, even factoring in the possibility that the modified loan will redefault in a declining market, which means that the PSA restrictions are affirmatively harming the financial interests of investors. What's more, the requirement that servicers must repurchase a mortgage before modifying it is, as H.R. 703 recognizes, a substantial disincentive for liquidity- and capital-starved servicers to make these modifications.

There is substantial empirical evidence that servicers are unable to effectively modify loans in securities compared with whole loans sitting on banks' balance sheets.[37] One of the main reasons for this poor performance is that servicers fear being sued by investors if they modify too aggressively, both because of restrictions in the PSAs and because many modifications may advantage one tranche of investors over another, even when benefiting investors as a group. H.R. 703 addresses these obstacles by providing that servicers can modify mortgages regardless of any limitations contained in a PSA and that servicers are not required to repurchase loans out of pools to make such modifications. In addition, it creates a safe harbor from lawsuits for servicers attempting to do the right thing.

We support these changes, but would suggest an alternative method to achieve the first goal: a change to REMIC laws to make favorable REMIC pass-through tax status contingent on changing the PSAs to remove artificial obstacles to modifications. Right now, the loans in the vast majority of private label securities are held in real estate mortgage investment conduits (REMICs). REMICs are tax-favored instruments (income is not taxed at the entity level), and are therefore a creature of social policy. Given that there is no investment-based expectation that tax law will forever remain unchanged, the government could, entirely safe from any takings challenge, condition future REMIC status on trustees amending the agreements to remove any artificial restrictions hamstringing modifications. Since the vast majority of PSAs require the trustee to conform the agreements to maintain REMIC status on an on-going basis without the need to seek permission from investors, trustees will need to permit the modifications.

This approach could be paired with a servicer safe harbor similar to Section 6 of H.R. 703; however, with the restrictions on modifications taken out of the PSAs, the language could be softened to say something to the effect of "unless otherwise established in the PSA" there shall be a safe harbor, and pulling in the criteria from Section 6(a)(2)(B).

Finally, with respect to the language of Section 6, it is crucial that we not harm anyone who has a legitimate claim against a servicer. Any safe harbor for servicers needs to be carefully drawn to prevent the scammers from using it to protect themselves. Therefore, we suggest either removing or clarifying Sec. 6(a)(1)(B), which we believe could be misused to prevent homeowners from making claims related to the improper origination of these loans. In our view, Sec. 6(a)(1)(A) covers all the necessary parties by referring to any person with "any interest" in either a pool of loans or in securities, as that definition should cover even investors in derivative products. However, if it is important to keep 6(a) (1) (B) intact, the words "other than the consumer" should be added after "any person."

Conclusion

Today's financial crisis is a monument to destructive lending practices—bad lending that never before had been practiced on such a large scale and with so little oversight. These practices have now undermined not only just the entire US economy, but the world economy as well. There is no single solution to the challenges facing us today, but we support the provisions of H.R. 703 that would add additional tools to the toolkit of those attempting to increase the number of families who can stay in their homes.

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

[2] Goldman Sachs Global ECS Research, *Home Prices and Credit Losses: Projections and Policy Options* (Jan. 13, 2009), p. 16 [hereinafter *Home Prices and Credit Losses*]; *see also* Credit Suisse Fixed Income Research, *Foreclosure Update: Over 8 Million Foreclosures Expected* (Dec. 4, 2008), p.1.

[3] *Continued Decay* p. 3.

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

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

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

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

[8] Id. at 6.

[9] Id. at 7-9.

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

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

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

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

[14] Credit Suisse Update, p.1.

[15] *Home Prices and Credit Losses,* p. 19.

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

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

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

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

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

[21] Credit Suisse Update, p. 8.

[22] *See* Testimony of Stein Testimony October 2008 at fn 30.

[23] *Myths and Realities*, p 15.

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

[25] H.R. 703 makes the following administrative changes: (1) eliminates borrower certification regarding not intentionally defaulting on any debt; (2) eliminates requirement to collect two years of tax returns; (3) eliminates originator liability for first payment default; (4) eliminates deadline of March 1, 2008, for DTI test; (5) eliminates prohibition against taking out future second loans; and (6) requires Board to make documents, forms, and procedures conform to those used for normal FHA loans to the maximum extent possible.

[26] *See* Kristopher Gerardi, Adam Hale Shapiro, and Paul S. Willen. "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures" (homeowners with negative equity are significantly more vulnerable to foreclosure since they often cannot sell or refinance the home or obtain a home equity loan to withstand a short-term financial difficulty), Federal Reserve Bank of Boston, Working Paper 07-15 (Rev. May 4, 2008); *see also Home Prices and Credit Losses,* ("principal writedowns are always more effective in reducing default rates than note rate reductions"), p. 19.

[27] *Myths and Realities,* p. 27.

[28] *See* Testimony of Michael Calhoun, Center for Responsible Lending, Before the U.S. House of Representatives Committee on Financial Services, January 13, 2009, at pp. 9-10, *available at* http://www.responsiblelending.org/pdfs/calhoun-testimony-1-13-09-final.pdf.

[29] National Taxpayer Advocate, *2008 Annual Report to Congress*, p. 341, 391-396.

[30] Credit Suisse, *Bankruptcy Law Reform – A New Tool for Foreclosure Avoidance* (Jan. 26, 2009), p. 1.

[31] Mortgage Bankers Association Press Release, MBA Study Shows Government-Insured Share of Mortgage Applications for JulyTripled in the Past Year, Aug. 18, 2008, http://www.mortgagebankers.org/NewsandMedia/PressCenter/64461.htm.

[32] See Chad Terhune and Robert Berner, "FHA-Backed Loans: The New Subprime--The same people whose reckless practices triggered the global financial crisis are onto a similar scheme that could cost taxpayers tons more," Business Week, Nov. 19, 2008 (noting that originators who engaged in aggressive sales tactics and outright fraud in the subprime or Alt A markets have reconstituted themselves as FHA originators). Since June 2007, the number of lenders and brokers approved to market federally insured mortgage loans has more than doubled from 16,000 to 36,000.

[33] 1.75% for purchase and refinances of conventional loans, 1.5% for refinancing an existing FHA borrower into another FHA loan, and 3% for delinquent borrowers refinancing into an FHA Secure loan.

[34] Currently, given other lender fees incurred on FHA loans, it is possible for many low-income families (and veterans using similar VA programs) to pay as much as $10,000 in fees or more on a $150,000 brokered FHA loan, which is excessive.

[35] Neil Roland, *Shady subprime lenders creeping into federal mortgage program: Short-staffed Federal Housing Authority unable to adequately police loan originators; 'bad actors',* Financial Week, Jan. 12, 2009; *see generally* testimony of James A. Heist, Department Of Housing And Urban Development, before the U.S. House of Representatives Committee on Financial Services, Jan. 9, 2009.

[36] Such restrictions include limits on the type of modification that can be done (such as prohibiting principal reduction, interest rate reduction or term extensions) or require approval by a third party (NIMS insurer, ratings agency, master servicer or subordinate tranche holder) before doing any modification at all or exceeding a 5% cap on a pool's number of loan modifications. *See* Kevin Byers, CPA, *Summary of Analysis: Loss Mitigation Provisions in Selected Subprime Securitizations*, 12/20/08.

[37] See Note 16; see also Citi, *U.S. Mortgage Lending Data and Servicing Foreclosure Prevention Efforts*, Third Quarter 2008; Piskorski, Tomasz, Seru, Amit, and Vig, Vikrant, *Securitization and Distressed Loan Renegotiation: Evidence From the Subprime Mortgage Crisis*, Dec. 2008 ("This evidence supports the view that, relative to servicers of securitized loans, servicers of portfolio loans undertook actions that resulted in lower rates of foreclosure").

Statement of

John A. Courson

President and Chief Executive Officer

Mortgage Bankers Association

Before the

House Financial Services Committee

United States House of Representatives

February 3, 2009

Hearing on

"Promoting Bank Liquidity and Lending Through Deposit Insurance, HOPE for Homeowners, and Other Enhancements"

Mr. Chairman, Ranking Member Bachus and members of the committee, I am John Courson, President and Chief Executive Officer of the Mortgage Bankers Association (MBA).[1] I appreciate the opportunity to appear before you today to testify on behalf of MBA. My remarks will address the situation in today's housing market, efforts to help families save their homes as well as the proposed bill to promote bank liquidity and lending through deposit insurance, the HOPE for Homeowners Program, and other enhancements. I will begin my comments today by providing a brief update of the residential real estate and mortgage markets.

From 2003 through 2006, home prices increased at a pace that far exceeded inflation. During that time, many mortgages were written with adjustable interest rates and/or negative amortization features. In 2007, the real estate "bubble" burst, leading to record borrower defaults. The resulting glut of foreclosed properties coming on the market helped swell the homes for sale nationwide in 2008 from a normal 2.6 million units to 4.6 million units. This further reduced real estate prices and caused a backlog of homes for sale in excess of one year's supply. The reset of adjustable rate mortgages (ARMs) coupled with the number of homes where the mortgage balance exceeds the home value has limited borrowers' options to manage their financial needs or sell their properties.

More alarming still is the current trend in delinquency rates and the record migration of 30-day delinquent loans to foreclosure. Historically, the percent of 30-day delinquent loans that eventually resulted in foreclosure has been in the range of 5 to 15 percent. It has grown to around 35 percent. The increase in delinquency is resulting in additional homes being placed on the market, pressuring home prices into a further downward spiral.

While servicers have executed a record number of repayment plans and loan modifications to bring delinquent borrowers current, servicers can only execute loss mitigation options permitted by their investor contracts. The ability to amend investor contracts or obtain investor approval to exceed contractual limits has proven to be a challenging, if not prohibitive obstacle, for many servicers.

On the new mortgage production front, interest rates for 30-year fixed-rate mortgages dropped from 6.3 percent in 2007 to 6.0 percent in 2008, and they are expected to average 5.1 percent during 2009. Although MBA forecasts an

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 370,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

increase in mortgage production in 2009 to $1.9 trillion, from just under $1.8 trillion in 2008, purchase mortgages are expected to decline, again pointing to a stalled market for existing homes. Many homeowners cannot afford to sell their properties because of falling property values, while others cannot refinance their mortgages from costly adjustable-rate or option ARM loans to fixed-rate loans due to credit problems.

In addition to these market woes, banks and independent mortgage companies are struggling with a variety of other challenges including an unprecedented volume of repurchase requests from Fannie Mae and Freddie Mac and dealing with record numbers of delinquent loans, loan modifications and foreclosures. In addition, the independent mortgage bankers are facing a sub-crisis of the credit crisis that jeopardizes their businesses. This sub-crisis is the result of a shortage of warehouse lines of credit, meaning independent mortgage bankers are doubly hamstrung to originate new mortgages threatening their viability.

Warehouse lines of credit are used to finance loans held for sale from origination to delivery into the secondary market. Currently, some warehouse lenders are going out of business, and the remaining ones are either terminating warehouse lines of credit, or adding restrictions to their warehouse lines of credit. The phenomenon is causing independent mortgage lenders to struggle to maintain their ability to serve consumers. Warehouse lending capacity has declined dramatically – from over $200 billion in 2007 to approximately $20-$25 billion in 2008, a decline exceeding 85 percent. For the mortgage originator that depends solely on warehouse lines of credit, this reduction threatens to extinguish their lending business and adversely impact consumers in their market, stifling the real estate recovery before it has a chance to get off the ground.

In light of this market backdrop, a need exists for legislation that will assist borrowers to stay in their homes. MBA commends the committee for demonstrating willingness to make improvements to the HOPE for Homeowners (H4H) program, reduce servicer liability and extend the Troubled Asset Relief Program (TARP) to smaller institutions. However, MBA recognizes that much more must be done to stem the current foreclosure crisis and re-stabilize the mortgage market. We will highlight solutions to the problem throughout this testimony.

HOPE for Homeowners

The H4H program was created by the Housing and Economic Recovery Act of 2008 (HERA), as a tool to help delinquent homeowners avoid foreclosure, as well as to assist in stabilizing the mortgage market. While well intentioned, the H4H program, in its current state, contains statutory obstacles that prevent its optimal use. MBA applauds the committee's efforts to amend the program by removing those obstacles and increase its effectiveness.

The bill removes the requirement that borrowers have a housing debt-to-income (DTI) ratio greater than 31 percent. This change will allow more borrowers to qualify. The bill further expands the H4H program by increasing the maximum loan-to-value (LTV) permissible under the program from 90 percent of the appraised value of the property to 93 percent. While this change is directionally correct, we would like the LTV raised under the H4H program to 96.5 percent in order to be more aligned with other FHA programs. The additional 3.5 percentage points will make the H4H program more attractive to lienholders, as they will be able to take a smaller principal write down for borrowers to qualify. MBA believes that the H4H program could be further enhanced by reintroducing an appreciation sharing feature and providing lenders protection that the mortgage and notes used in this context are enforceable in all states.

In addition to improving the H4H program, the bill reduces lender liability in the program by removing legal impediments that currently deny Federal Housing Administration (FHA) insurance benefits in cases where there are late endorsements. MBA believes the reduction in lender liability also serves to increase the viability of the H4H program.

Furthermore, MBA appreciates that the bill addresses the program's exceedingly high annual premiums for borrowers. Currently, the H4H program requires an upfront premium payment of 3 percent of the mortgage amount, and an additional annual premium of 1.5 percent of the remaining principal balance of the mortgage. The new bill would grant FHA flexibility in setting the annual premium between 0.55 and 0.75 percent of the remaining principal balance – in line with other FHA products. The reduction in premium payments will make the H4H program more affordable for borrowers.

The bill also provides additional security to the servicer and helps cover the cost of managing the refinance program by allowing the H4H Board to pay the servicer a fee for each loan refinanced through this program, similar to incentive fees granted by FHA on other loss mitigation tools.

Servicer Liability

MBA appreciates the committee's efforts to provide servicers with greater legal protections for performing loss mitigation activities. Although most pooling and servicing agreements (PSAs) allow for modifications and workouts, not all do. Some PSAs that allow modifications and workouts may contain conflicts, while others may be silent on modification, thus increasing the risk of liability for the servicer. These problems have limited servicers' ability to help borrowers.

While MBA appreciates enhanced servicer protections, MBA does not support abrogating contracts. As a conflict resolution tool, MBA is concerned that investors may challenge the validity of this safe harbor. The cost of such challenges will be borne by the servicer community. Ultimately, if investors succeed in their challenge, servicers will be exposed to legal liability and losses for breaching their contracts despite such actions being within the spirit of the law.

Because of these concerns, we would encourage this committee to consider the following enhancements to the bill:

- A provision that would indemnify servicers from liability for legal fees and losses if the safe harbor provision is deemed unlawful; and
- A provision clarifying that real estate mortgage investment conduit (REMIC) tax status will not be negatively affected by the servicers' or trustees' loss mitigation actions pursuant to this safe harbor.

Mini-Miranda Change

Another barrier that servicers face in attempting to perform loss mitigation is the Fair Debt Collection Practices Act (FDCPA) (the so-called "Miranda" warning) that chills the borrowers' willingness to communicate with servicers on loss mitigation. The FDCPA regulates the practices of independent debt collectors. While creditors collecting their own debts are generally exempt from the FDCPA, creditors that acquire delinquent loans and their servicers are not exempt.

In addition to its substantive anti-abuse protections for debtors, the FDCPA requires a debt collector to notify the borrower in the first written communication with the borrower that it is attempting to collect a debt and that any information obtained will be used for that purpose and to indicate that each subsequent communication is from a debt collector, even after the borrower has brought the loan current. These disclosure requirements create unique difficulties for mortgage loan servicers because they chill the borrower's willingness to discuss options with the servicer that may prevent foreclosure.

The Miranda provision is designed to prevent debt collectors from concealing their true identity when they attempt to obtain information from a consumer. Mortgage servicers are not true debt collectors despite the treatment under FDCPA. Moreover, there is never any question as to the mortgage servicer's identity. The mortgage servicer is the party responsible for receiving the borrower's monthly mortgage payments. If a borrower gets behind on those payments, the mortgage servicer is expected to contact the borrower to assist the borrower in catching up. This process is the same whether or not the servicing responsibilities are transferred to a new servicer.

MBA is confident that an amendment to FDCPA along with a reduction in servicer liability will provide lienholders with the much needed freedom to assist more borrowers.

Troubled Asset Relief Program

MBA greatly values all that Congress has already done to address the current economic crisis, particularly passage of the Emergency Economic Stabilization Act (EESA), which established TARP. Above all else, we believe it is important to return TARP to its original purpose, which was to purchase non-performing assets off banks' balance sheets.
MBA would like to endorse this committee's efforts to provide additional clarity and direction to the Department of the Treasury in using funds allocated to TARP. For example, the bill directs the Treasury Department to give priority to TARP funds that would channel TARP funds to smaller community focused financial institutions, as well as financial institutions whose corporate structures preclude them from participating in existing TARP funding programs.

MBA fully supports measures to provide financial assistance to those lenders with limited access to some of the funding channels available to large, complex financial institutions. We note Congress' definition of financial institution in EESA includes an expansive range of financial services providers to be eligible for TARP funds. Nevertheless, most existing TARP programs limit eligibility to depository institutions chartered by a federal or state bank regulator. Many financial institutions do not meet TARP's eligibility criteria. Consequently, they are unable to access funds Congress made available to them – while financial institutions with non-housing product lines can.

Commercial/Multifamily Issues

MBA also recognizes that the broader credit crisis has negatively impacted the $6 trillion commercial real estate market, which is financed in part through more than $3 trillion of debt. Currently, there are significant challenges associated with the refinancing of maturing performing loans collateralized by commercial real estate, which may result in increased defaults.

An immediate action that could be readily implemented is for the Treasury Department to provide TARP funds to revive the broader private commercial mortgage markets. Specifically, we recommend that the Federal Reserve Bank of New York utilize TARP funds to create a commercial lending facility that would provide the private market with liquidity and allow for the extension of new credit, as well as assist in refinancing performing loans held by banks or in commercial real estate mortgage-backed securities (CMBS) pools. We expect this credit facility to generate meaningful results and to jumpstart the broader private commercial mortgage markets.

In addition to the commercial lending facility, there are many options in which commercial loans and CMBS can be included in the TARP program. The complexity of the commercial real estate finance industry combined with the varied market participants has, thus far, not yielded a "magic bullet" that would resolve the many challenges facing the commercial finance industry. We encourage Congress to consider and implement a range of programs that holistically address this multifaceted industry. Because multifamily properties are income producing and are generally classified as commercial real estate, we would encourage multifamily loans and CMBS to be included in all TARP commercially-related programs.

Restoring Stability and Confidence

As the mortgage and capital markets continue to readjust following a once-in-a-generation upheaval, MBA supports actions by Congress and the administration that would restore stability and confidence in these markets. However, we caution federal policymakers to avoid taking steps that could worsen the situation and make it more difficult for the markets to recover.

Mortgage Improvement and Regulation Act

MBA believes all borrowers, including future borrowers seeking to realize the dream of homeownership, would benefit most by a long overdue overhaul of the regulatory framework for mortgage lending. MBA has been developing a legislative proposal that would do just that.

We believe such a plan should include a new federal regulator for mortgage lending, empowered to apply rigorous uniform national mortgage standards. Such a regulator would work in partnership with federal and state financial regulatory authorities to supplement, examine and vigorously enforce these standards. Our plan would also assure federal regulation of independent mortgage bankers and mortgage brokers, establish national counseling and financial literacy responsibility, fight mortgage fraud, and greatly increase transparency in the mortgage process. These new efforts would replace the uneven patchwork of state and federal mortgage lending laws that are costly and do not always protect borrowers.

MBA's proposal would offer a steady stream of resources to effectively fund regulation by assessments on regulated entities. By including substantive requirements and consistent regulation, these proposals would return stability to the nation's financial system, ensure fairness, facilitate greater secondary market investment, and lower costs to borrowers.

FHA Improvements

MBA supports the following key ways to protect FHA and, in turn, restore confidence in the entire mortgage industry. The prudent strategies below will help FHA support the housing market while controlling risk:

- Increase technology investment. Improvements to FHA's technology will allow it to more effectively manage its portfolio, garner efficiencies and lower operational costs, and enable it to monitor its operations and partners more closely to mitigate loss.
- Increase staff resources at FHA and Ginnie Mae. FHA now accounts for over 20 percent of single-family originations, compared to 3 percent a year and half ago. This dramatic increase in demand has put a strain on the staff at bothr FHA and Ginnie Mae.
- Ensure the quality of originations. Several steps should be taken to maintain the quality of FHA loans and ensure performance, including raising standards and qualifications for mortgage brokers; enabling FHA to expose and expel "bad actors" from programs; and making available fraud protection tools.
- Provide authority to FHA to address current market conditions. FHA should have increased flexibility to respond to current dynamic market conditions, such as being granted legislative authority to have flexible use of Hope for Homeowners.
- Increase loan limits to enable FHA and Ginnie Mae to provide secondary market support to the broadest spectrum of home prices during this period of market instability and beyond.
- Explore restoring the risk-based premium structure. Depending on the structure, a risk-based premium structure would allow FHA to serve more borrowers, and do so with a lower risk to the MMIF.
- Increase borrower protection for HECMs. Policies and practices that protect seniors from abuse and fraud are necessary to protect homeowners and the industry.

In order to further restore confidence and improve consumer protections in the mortgage market, MBA supports legislative and regulatory action to assure reasonable net worth, bonding and transparency requirements for mortgage bankers and mortgage brokers.

Specifically, we believe mortgage bankers should maintain a minimum corporate net worth requirement of the greater of $500,000 or one percent of FHA loan volume up to a maximum of $1.5 million, as evidenced by audited financial statements. New requirements for mortgage bankers should be uniform across all states in order to protect consumers and lower costs through maximum competition. Mortgage brokers' should also have increased corporate net worth requirements. Mortgage brokers requirements should be the greater of $150,000 or 0.5 percent of FHA loan volume up to the minimum for a Full Eagle status (currently $250,000 – or, if increased as recommended, $500,000).

MBA also supports a strong Ginnie Mae dedicated to its mission as the primary vehicle for the securitization of FHA, Veterans Administration (VA) and Rural Housing Services (RHS) mortgages. MBA believes Ginnie Mae's funding for human resources should be increased and that any increase in the current Ginnie Mae multifamily guarantee fee is unnecessary and would create disincentives and result in less use of the current programs. Ginnie Mae should continue to work with MBA members, investors and dealers to refine its programs, add products and to improve MBS disclosure.

Maintain Warehouse Credit Lines

In order to provide much needed capacity in the mortgage market to reach consumers for purchase and refinance transactions, Congress and the administration should take steps to help maintain existing lines of warehouse credit and create new lines of warehouse lending. One option would be to provide a short-term (i.e. 12-24 months) federal guarantee of warehouse lines that are collateralized by Fannie Mae, Freddie Mac, FHA, VA, and RHS-eligible residential mortgages that are held for sale by mortgage lenders.

This action by the federal government could be immediately implemented to maintain the mortgage funding structure consumers depend upon, especially consumers who rely on independent, non-depository lenders. An additional solution to explore is temporarily allowing Fannie Mae and Freddie Mac, within the means of their charters, to help improve the flow of funds to financial institutions whose lines of credit have been restricted or eliminated. These solutions could include the expansion of current short-term lending programs or an authorization by the Federal Housing Financing Authority (FHFA) to permit Fannie Mae and Freddie Mac to purchase participation or syndicated interests in warehouse lines of credit in order to expand the supply of funds to warehouse lending. MBA believes such programs should not be permanent and we would strongly advocate establishing a sunset date. Designing and implementing any program should be closely monitored by FHFA with specific requirements regarding the program's scope and longevity, as to not blur the line between the primary and secondary markets.

Secondary Market Issues

Much of the economic crisis is attributable to a lack of confidence in the secondary mortgage market, the market in which lenders sell pools of mortgages to investors in exchange for funds that are used to finance additional mortgages in the primary market. The secondary market was once a vibrant source of liquidity, teeming with private investors along with Ginnie Mae, Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLB). Now, private investors are virtually nonexistent, leaving government programs to fill the void. Exacerbating the crisis of confidence is the fact that Fannie Mae and Freddie Mac are in conservatorship, FHA is bumping up against its funding ceiling, and

Federal Home Loan Bank System activity has slowed as a result of capital constraints triggered by tightening accounting standards.

MBA believes that additional measures must be taken so that existing government run or government sponsored programs have the capacity to perform their vital roles as liquidity providers of last resort. For example, the GSE Credit Facility expires at the end of this year, as does the Treasury's authority to purchase GSE MBS in the open market. We believe it is imperative to suspend the expiration date for these programs until such time as an economic recovery is reasonably foreseeable.

MBA Views

MBA is committed to revitalizing the housing finance system and develop programs to foster sustainable homeownership. Please find more details on MBA's ideas on ways to stem the current housing crisis and curtail foreclosures at http://www.mortgagebankers.org/Advocacy/IssuePapers.

Conclusion

Again, MBA appreciates the committee's efforts to stabilize the mortgage market and help avoid future foreclosures. We are confident that the H4H enhancements, the limitations on servicers' liability and the expanded use of TARP funds in the bill will further the committee's efforts.

We strongly urge Members of this committee and the entire Congress to closely examine the proposals in this testimony in order to restore confidence and stability to the mortgage market. MBA looks forward to working with you through that process.

Thank you for this opportunity to share our views and ideas with this committee.

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of
R. Michael S. Menzies, Sr.
President and CEO, Easton Bank and Trust Company

On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Financial Services

Hearing on

"Promoting Bank Liquidity and Lending Through Deposit Insurance, Hope for Homeowners, and other Enhancements"

February 3, 2009
Washington, DC

Chairman Frank, Ranking Member Bachus, Members of the Committee, my name is Michael Menzies, and I am the President and CEO of Easton Bank and Trust Company, Easton, MD, and the Chairman-Elect of the Independent Community Bankers of America[1]. Easton Bank is a state-chartered community bank with $150 million in assets. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on "Promoting Bank Liquidity and Lending Through Deposit Insurance, Hope for Homeowners, and other Enhancements" and H.R. 703.

Introduction & Summary

Today's hearing is focused on improving bank liquidity, promote lending and address the foreclosure crisis through improvements in deposit insurance, the Hope for Homeowners Program and other enhancements. We will focus our comments on the Chairman's bill, H.R. 703, which address many of these issues. My testimony addresses the following issues:

- Deposit insurance issues related to the current economic crisis
- Community bank access to the TARP's Capital Purchase Program
- Foreclosure mitigation and improvements to FHA programs

We believe each of these issues will have a direct impact on the prospects for a strong recovery. We applaud the Chairman for addressing many of these issues by introducing H.R. 703. We understand that the Committee will mark up some of the provisions in H.R. 703 in separate bills tomorrow, and ICBA urges swift passage of those provisions.

ICBA applauds the Chairman for including a provision to give the banking industry more time to recapitalize the FDIC Deposit Insurance Fund – an idea the ICBA has strongly advocated. The bill makes permanent the increase in deposit insurance coverage from $100,000 to $250,000. And, as the ICBA recently advocated in a comment letter to the FDIC, the bill makes clear bank holding

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[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $1 trillion in assets, $800 billion in deposits, and more than $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

companies with significant non-bank subsidiaries will pay their fair share of any deficit in the FDIC Temporary Liquidity Guarantee Program (TLGP).

As part of the FDIC's efforts to promote stability and liquidity in banks, the agency established an optional guarantee of all amounts above $250,000 in non-interest and very-low interest bearing transaction accounts in FDIC-insured institutions under its TLGP. The program has been a useful tool for community banks that face stiff competition for deposits, the main source of community bank liquidity. ICBA urges the Committee to include a two-year extension of the transaction account guarantee program in the deposit insurance provisions.

ICBA is pleased that H.R. 703 addresses community bank access to the CPP by requiring the Secretary of the Treasury to promptly allow access to the CPP by small financial institutions, and to do so on terms comparable to those applicable to the largest banks that have already received capital infusions under the TARP.

Deposit Insurance Issues

The Emergency Economic Stabilization Act temporarily increased deposit insurance coverage from $100,000 to $250,000. The additional coverage has helped community banks be a part of solution to the credit crisis caused in large part by the activities of larger financial institutions. We are pleased that the Chairman's bill would make this increase permanent.

The FDIC has proposed increases in deposit insurance assessments that double existing premium rates because the FDIC's Deposit Insurance Fund reserves are significantly below required levels due to recent bank failures. Community banks are prepared to do their part to maintain a strong and well-capitalized deposit insurance system. However, the nation is currently faced with the most severe economic crisis it has faced in many generations. Holding down deposit insurance premiums at this time would be consistent with the government's efforts to restore stability to the markets and the financial sector. We commend the Chairman's approach to this issue by increasing the period for recapitalization of the DIF from five years to eight years. A longer period for recapitalization would allow the FDIC to reduce proposed assessment rates. Lower rates would keep additional funds in local communities for lending to small businesses and consumers at this critical time.

H.R. 703 addresses another issue that the ICBA has raised with respect to the FDIC's Temporary Liquidity Guarantee Program (TLGP). The FDIC used its systemic risk authority to establish the TLGP. The net costs of any activity under the systemic risk authority must eventually be borne by all FDIC-insured banks and thrifts through an assessment based on the institutions' assets minus equity. The statute does not expressly authorize the FDIC to assess non-bank and non-thrift affiliates, including holding companies. The Debt Guarantee Program has been extended to holding companies because much of the bank debt is issued at the holding company level. However, should a special assessment be needed to make up for any deficit in the TLGP, the FDIC cannot levy an assessment against the non-bank assets of a holding company. We applaud the Chairman and the FDIC for their support of a provision in the bill that would allow the FDIC to ensure holding companies with significant non-bank assets pay their fair share of any deficit in the TLGP.

ICBA also supports a provision in the bill increasing the FDIC's standby line of credit with Treasury. Although the FDIC has never used the line of credit, an increase in the amount will insure that the FDIC will have adequate resources to meet future challenges in the banking sector.

Extension of the FDIC's Transaction Account Guarantee Program

As part of the FDIC's efforts to promote stability and liquidity in banks, the agency established an optional guarantee of all amounts above $250,000 in transaction accounts in FDIC-insured institutions under its TLGP. More than 6,000 banks, including thousands of community banks have chosen to participate in this program.

Community banks in many markets face stiff competition for deposits, the primary source of liquidity for community banks. The program has been a useful tool for community banks competing with larger banks, including the too-big-too-fail banks, for commercial deposits.

Participation in the program also frees up capital and resources used by community banks to purchase Treasuries and other securities for repurchase agreements that secure commercial and public deposits. Community banks can use the freed up resources to promote lending in their communities.

Taxpayers have no liability for the program, and the program does not reduce the FDIC reserve ratio. Participants are assessed a 10 basis points fee for the guarantee, and any deficit in the program would be made up by a special industry assessment under the FDI Act's systemic risk provision.

Unfortunately, the transaction action account guarantee program will expire at the end of the year. We strongly urge Congress to preserve this important support of community bank liquidity during the current economic crisis. We propose that the Committee include a two-year extension of the program in H.R. 703.

Limited Availability of Community Banks to TARP/CPP

It is vital to note that community banks had no role in creating the current problems we face. They did not engage in irresponsible subprime lending and have remained strongly capitalized. There are more than 8,000 community banks nationwide, and they are well positioned to extend lending to their communities using capital from the Capital Purchase Program. Including interested community banks in the Capital Purchase Program will stimulate additional lending in local communities throughout the country.

ICBA has had significant concerns with the pace of implementation of the Troubled Asset Relief Program's CPP. We are pleased that Treasury released a term sheet for Subchapter S banks last month. ICBA is also pleased to see Treasury's latest round of TARP CPP capital purchase transactions include a good number of community banks.

However, mutual savings banks and thrifts still do not have a term sheet available. These institutions play critical roles in their communities, particularly in small towns and in the New England states where they are the predominant local and small business lenders.

H.R. 703 directly addresses this concern. It explicitly directs the Treasury "to promptly make funds available for smaller community institutions." It is entirely feasible to craft workable terms for mutual banks so they can access CPP funds under similar economic terms as the big publicly traded banks. We urge Treasury to act quickly to include all mutual institutions in the CPP.

ICBA members are growing increasingly concerned with the lack of information on pending CPP applications. While some community banks have begun to receive funds under the CPP, many other banks are having difficulty determining the status of their applications, which are reviewed by their primary federal regulators and then sent to Treasury. ICBA is pleased that Treasury has announced plans to make the CPP process more transparent. We urge Treasury and the regulators to make available application status information to individual banks.

We are pleased that H.R. 703 would ensure that most new conditions in the CPP would not apply to community banks with pending applications and institutions, such as Subchapter S and mutual banks, which, through no fault of their own, have been unable to apply for the CPP. H.R. 703 recognizes that applying such conditions retroactively would place an unfair burden on community banks.

Allowing all community banks to participate in the TARP CPP will help boost lending to families and small businesses. For every dollar in new capital a community bank can raise it will help facilitate an additional seven to ten dollars of lending in their communities. The cost of this CPP capital is not inexpensive for community banks, at some 7.5% tax effective rate in the first five years with additional warrant-related costs on top. So community banks participating in the program will put the capital to good use by doing what they do best – lend on Main Street.

Foreclosure Mitigation Steps

Community banks are truly invested in long-term relationships with their customers and their communities. When community banks service mortgages, often mortgages they have kept on their books, they have a strong interest in maintaining those relationships, and not just guarding the interests of investors. They know their community will be hurt too by empty homes. Community banks' involvement in finding solutions for consumers extends beyond their own customers as community banks have offered refinancing to troubled borrowers with loans from other institutions as well.

Since community banks, by and large, did not engage in the subprime lending practices at the heart of the current crisis, they are not currently experiencing unusual levels of mortgage defaults. And, ICBA members are still making mortgage loans. Community bank mortgage originations remained steady throughout 2008. ICBA Mortgage Corporation helped 1,000 community banks write approximately 40,000 mortgages totaling $6.2 billion. Assuming ICBA Mortgage Corporation's share of the community bank market is five percent, we estimate community banks have originated approximately 800,000 mortgage loans for an aggregate principal amount of approximately $125 billion in 2008.

We agree minimizing foreclosures is an important part of the effort to stabilize the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes and has a devastating impact on families and communities.

Community banks that service their own mortgages monitor payment activity for changes that might signal a borrower could have difficulty paying the mortgage. If default occurs, they contact the borrower quickly to avoid potential problems. Community banks do not rush to foreclosure.

Community banks will continue to work with individual borrowers to find the best solution to keep borrowers in their homes, including through a loan modification under the Hope for Homeowners Program or under any new government programs that would support mortgage modification. ICBA supports the revisions to the Hope for Homeowners Program included in HR 703 and makes the following suggestions to improve the prospects of any mortgage modification program:

1) Loan-to-Value Determination —-Any program depends on a credible valuation of the property. The federal banking agencies currently have interagency appraisal guidelines and have proposed additional guidance for federally related transactions. The agencies in charge of loan modification support programs should ensure that their valuation procedures are the same or consistent with the appraisal guidelines and once the value of a property is properly determined, there should be an agreement by the banking regulators that they won't second guess the value of the collateral in a subsequent bank examination, at least for a reasonable period of time.

2) Regulatory and Accounting Forbearance – When a lender modifies a mortgage, it must recognize a loss on the original loan. There should be a relaxation of accounting standards for the recognition of the losses, and the banking regulators should relax regulatory capital standards vis-à-vis these losses.

Unleash FHA Potential

ICBA supports increasing capacity for the Federal Housing Administration to serve homebuyers, homeowners and lenders. As credit for home purchases and refinancing has seriously contracted, FHA insurance has taken on an expanded role. FHA is vital to the provision of affordable housing and the recovery of the housing market. Increasing capacity, by hiring more personnel at FHA and Ginnie Mae will allow the agencies to carry out their mission and assist homebuyers, lenders and communities. Due to FHA's resurgence in the marketplace, FHA lender approval can take as much as 180 days. Additional resources for FHA would help speed up the approval process.

In reports on FHA modernization, the GAO has stated that subpar technology is impeding the FHA's effectiveness. FHA told GAO its systems are poorly integrated, expensive to maintain, and do not fully support the agency's operations and business requirements. We urge Congress to address these critical concerns. FHA has an important role to play in the market in saving homes and assisting the underserved.

Conclusion

ICBA appreciates this opportunity to testify on these critical issues. We look forward to working with this Committee and Congress on these and other steps that will help us emerge from this current crisis and improve our financial system for the long run.

Testimony of
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on

PROMOTING BANK LIQUIDITY AND LENDING THROUGH
DEPOSIT INSURANCE, HOPE FOR HOMEOWNERS,
AND OTHER ENHANCEMENTS

Before the
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

2:00 p.m., February 3, 2009
Room 2128, Rayburn House Office Building

Good morning, Chairman Frank, Ranking Member Bachus, and Members of the Committee. Thank you for inviting me to speak today. I am Edward R. Morrison, Professor of Law at Columbia Law School. I have studied bankruptcy law and credit markets for ten years. I hold a law degree and a Ph.D. in economics from the University of Chicago. I completed judicial clerkships on the Seventh Circuit Court of Appeals and the Supreme Court of the United States. I am also a member of the National Bankruptcy Conference, but my testimony today does not necessarily reflect the views of other Conference members.

Today I would like to make four points regarding H.R. 703.

First, it would be a mistake to include both H.R. 703 and H.R. 200 ("Helping Families Save Their Homes in Bankruptcy Act of 2009") in the Consolidated Appropriations Act for Fiscal Year 2009. H.R. 200 would permit homeowners to cramdown their mortgages in a Chapter 13 bankruptcy case. This bill is costly and unnecessary. It is costly because cramdown will expose our financial institutions to large losses and generate a host of undesirable consequences for homeowners. Cramdown is also unnecessary because Section 6 ("Safe Harbor") of H.R. 703 can be augmented to accomplish the same objectives as cramdown but at lower cost, as I explain below.

Second, it is unnecessary to salvage the Hope for Homeowners Act, as Section 5 attempts. That Section would increase the permissible loan-to-value ratio on refinancings and take other steps to make the program more attractive to lenders and homeowners. These amendments are unnecessary. If Section 6 of H.R. 703 is augmented instead, as I explain below, it can avoid more foreclosures than Hope for Homeowners at a fraction of the cost.

Third, Section 6 of the Bill takes an important step in the right direction by creating a safe harbor for servicers. Under Section 6, servicers can modify mortgages, and avoid legal liability for doing so—even if the securitization contract forbids modification—provided they modify mortgages in a reasonable, good faith belief that modification will increase returns, on a net present value basis, to investors. This "safe harbor" is an integral element of a proposal that I have developed with Christopher Mayer and Tomasz Piskorski of Columbia Business School. But the safe harbor in Section 6 is insufficient to assure that modifications will be done when they make economic sense. To begin with, Section 6 does not do enough to protect servicers from costly litigation or to give them economic incentives to modify mortgages. H.R. 703 should include a cost-shifting provision that reimburses the actual legal costs of servicers who are sued but successfully invoke the safe harbor. In addition, the bill should include an incentive program that increases the gain to servicers from successful mortgage modifications. Currently, many servicers prefer foreclosure to modification because they receive greater compensation from foreclosure.

Fourth, and finally, H.R. 703 should also include incentives that encourage second lien lenders to surrender their claims (and not hold up modification efforts by servicers of primary mortgages) when these second liens are unlikely to be paid anything in a foreclosure. Currently, an appreciable percentage of primary mortgages—both those that are privately securitized and those held by Fannie Mae, Freddie Mac, and other government-sponsored entities—are held by homeowners with second liens. Without the cooperation of second lien lenders, it is often difficult to modify primary mortgages.

1. WHY BANKRUPTCY CRAMDOWN IS COSTLY AND UNNECESSARY

There can be little doubt that we face a crisis in our housing markets. House prices dropped about 18 percent in the last year according to Case and Shiller/S&P, likely the largest national decline in prices since the Great Depression. This has led to a crisis of foreclosures, with 2.25 million foreclosures started last year[1] and another 1.7 million expected during 2009.[2] Foreclosures contribute to declining house prices, deteriorating communities, and failing banks.

The crisis is likely to deepen without prompt action. Housing prices have not hit bottom. As of September 2008, there were more than 2.2 million vacant homes, 4 million vacant rental properties, and 4.5 million houses on the market, unsold. Unless we take steps to reduce this massive inventory of homes, house prices will continue falling.

Nor have foreclosures hit their peak. As of October 2008, sixty-day delinquency rates exceeded thirty-three percent among the 2.8 million outstanding securitized subprime loans and seventeen percent among the 2.2 million securitized Alt-A loans. Equally important, many securitized option ARMs will hit negative amortization limits between 2009 and 2011. An option ARM gives the borrower the option to make monthly payments that are less than the accruing interest on the loan. The unpaid interest is added to the principal balance. If that balance grows sufficiently large relative to the original loan, it will hit a "negative amortization limit." Once that limit is reached, the homeowner is obligated to make large minimum monthly payments that assure full repayment of the mortgage over the remaining term. Many homeowners will soon be at their "negative amortization limits," and we can expect foreclosures to spike as homeowners suddenly face significantly larger monthly mortgage payments.

The housing crisis is an important social problem, meriting government intervention, for several reasons. First, as house prices fall, so does the wealth of homeowners and the assets of financial institutions. More than two-thirds of all American households own their own homes. Most homeowners have relatively modest stock and pension holdings; the bulk of their wealth is tied up in their homes. As house prices keep falling, these households suffer increasing wealth declines, making them more likely to retrench and cut spending.

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[1] http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm
[2] http://www.nhc.org/Credit Suisse Update 04 Dec 08.doc

Additionally, the crisis in our financial sector is tied inextricably to the crisis in our housing markets. Home mortgages—and financial instruments tied to home mortgages—are a major asset of banks and other financial institutions. As home values fall and foreclosures spike, financial institutions see their balance sheets (and their ability to supply credit) deteriorate. As these institutions have suffered significant losses recently, they have necessarily reduced lending. This has led to government assistance through the TARP.

Immediate action is essential. But we need government policies that yield quick results without bankrupting taxpayers and our financial system. Cramdown legislation goes in the wrong direction. Bankruptcy amendments, allowing cramdown of home mortgages, would be costly, generate serious risks and unintended consequences, and likely delay the resolution of our housing crisis.

The government and motivated lenders already control most mortgages and have strong incentives to avoid unnecessary foreclosures. An oft-overlooked but important point is that we do not need the bankruptcy courts to intervene in the foreclosure process for most mortgages. Recent data show that taxpayers already control the fate of 35 million of the 55 million outstanding mortgages—nearly two-thirds of all mortgages—through Fannie Mae, Freddie Mac, and the FHA.[3] The government is therefore positioned to control the bulk of workouts without bankruptcy reform. Cramdowns would just delay this process, and in fact entangle the government in costly cramdown litigation. Additionally, taxpayers would bear the bulk of all losses from cramdowns.

Who holds the remaining third of outstanding mortgagees? Securitized lenders control about 8 million mortgages.[4] The remaining 12 million mortgages are presumably in the hands of private lenders, including not only the large money center banks, but also community banks and credit unions. These private lenders are taking aggressive, new efforts to modify loans. It is really only the privately securitized

[3] According to the Mortgage Bankers Association, there are about 55 million mortgages outstanding. Fannie Mae and Freddie Mac control 30.7 million as of Sept 30, 2008 (http://www.fhfa.gov/webfiles/406/FederalPropertyMgrReport11609.pdf). The Federal Housing Administration controls another 4.8 million (http://portal.hud.gov/portal/page?_pageid=73,1828027&_dad=portal&_schema=PORTAL).

[4] Authors calculations from data from Black Box Logic, LLC as of October, 2008.

mortgages where modification efforts have been failing. In Section 3 below I show how H.R. 703 can be augmented to address these mortgages directly.

The government, accordingly, already has the power to mitigate foreclosures among the vast majority of mortgages. Indeed, President Obama has promised to spend between $50 billion and $100 billion reducing foreclosures as part of the second $350 billion that was authorized under TARP. The government, therefore, is preparing to allocate significant resources to reducing foreclosures among mortgages over which it has control. Among the remaining mortgages, a narrowly-tailored legislative strategy can mitigate foreclosures, as I discuss below. Bankruptcy cramdown, by contrast, will (i) undermine government efforts to modify mortgages that are already under its control and (ii) generate high costs and undesirable effects with respect to other mortgages.

Cramdown applies a costly one-size-fits-all approach to mortgage modification. The proposed bankruptcy reforms in H.R. 200 apply a one-size-fits-all approach to all mortgages. But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing losses to investors and default by homeowners. Introducing cramdown would inhibit this kind of experimentation. Proposed legislation[5] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan.

Some claim that a one-size-fits-all approach is actually a virtue, because it would be cumbersome and costly for judges (or trustees) to tailor mortgage modifications to the particular needs and abilities of homeowners. This claim, however, points to an additional problem with cramdown: it imposes burdens that bankruptcy judges and trustees are unable to shoulder.

An overwhelmed judiciary may lead to delayed resolutions. Bankruptcy reform would likely delay the resolution of the crisis for years, especially if millions of borrowers file for Chapter 13 bankruptcy. Currently the federal judiciary has 368

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[5] See House Bill H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009."

bankruptcy judges.[6] During the 12-month period ending June 30, 2008, there were 967,831 bankruptcy filings.[7] Thus the average judge managed 2,630 bankruptcy filings in the past year, even without home mortgage cramdowns. Now these judges would be asked to oversee a new process on potentially millions of additional filings.

Some cramdown advocates believe that it would not impose excessive burdens on bankruptcy judges and trustees. They point to the fact that, in the current environment, judges already handle massive caseloads. Yet this massive caseload has prompted Congressional hearings on the excessive burden shouldered by bankruptcy judges.[8] As well, more than two-thirds of bankruptcy plans fail, suggesting that it is not easy to increase judicial caseloads without adding significant cost to the bankrupt process. And while some advocates of cramdown downplay its judicial burden, others seem to point to this burden as a reason why a one-size-fits-all approach is actually a virtue, because it reduces the complexity of mortgage modification in bankruptcy courts.[9] When advocates of cramdown have conflicting views on its virtues and costs, policymakers should take seriously alternative policies, such as the one I propose below.

Losses to taxpayers and lenders could be enormous and unnecessary. Proponents of bankruptcy reform believe it would impose no (or minimal) costs on taxpayers. That is untrue. Cramdown may be no more costly than *doing nothing* about the foreclosure crisis. But doing nothing is not the only alternative. There are many alternatives, such as

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[6] The most recent data we could find are from Sept. 30, 2007, and appear in "Judicial Business of the United States Courts" by the Administrative Office of the U.S. Courts, available at http://www.uscourts.gov/judbus2007/contents.html. This publication reports that Congress has authorized the appointment of 352 bankruptcy judges. However, as of Sept. 30, 2007, there were 11 vacancies. In addition, 27 retired bankruptcy judges had been "recalled" to serve on a part-time or full-time basis. This means that there were (352-11)+27=368 judges handling bankruptcy cases as of Sept. 30, 2007.

[7] This statistic is reported by the Administrative
Office of the U.S. Courts at http://www.uscourts.gov/bnkrpctystats/statistics.htm#calendar

[8] See, e.g., Statement of Judge Michael J. Melloy before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives (May 22, 2003).

[9] Statement of Rep. Brad Miller before the Committee on the Judiciary (Jan. 22, 2009) ("One witness today criticizes the legislation before this committee as 'one size fits all.' Mr. Chairman, with ten million families facing foreclosure, we can't afford a lot of elaborate, individualized tailoring.").

the one I discuss in Section 3 below. Relative to these alternatives, cramdown exposes taxpayers to enormous losses. This is true for two reasons.

First, taxpayers lose money when mortgage lenders and investors lose money. This is because the federal government has loaned to or guaranteed the debt of many major financial institutions that participate in mortgage markets:

- Outstanding debt and mortgage guarantees from Freddie Mac and Fannie Mae represent more than $5 trillion.
- The Federal Housing Authority originated hundreds of billions of loans that are now at risk.
- The FDIC has many billions more at risk as a result of loan guarantees issued during the takeovers of Indy Mac, Washington Mutual, and other failed lenders.
- The government has guaranteed loans to AIG, Citigroup, and now Bank of America. Future efforts to save the banking system would undoubtedly cause taxpayers to shoulder further mortgage-related losses due to cramdown.
- The Federal Reserve has risks from former Bear Stearns securities and many other securities it now holds as collateral.

We therefore need a policy that minimizes losses to investors, while at the same time avoiding as many foreclosures as possible.

Second, cramdown exposes lenders to greater losses than alternative policies. Although housing prices fluctuate, mortgage cramdown, by definition, results in a permanent reduction in principal. Many lenders have developed mortgage modification strategies that are as effective as cramdowns but less expensive to lenders. Many of these strategies, such as forbearance, do not involve principal write-downs. The FDIC/Indy Mac program, for example, provides for reductions in interest rates and forbearance on principal payments.[10] The recently announced effort by JP Morgan/Chase uses a similar strategy of loan forbearance. Many of the Bank of America

[10] Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

and Citigroup modifications to subprime loans involve interest rate reductions rather than principal reductions. Fannie Mae and Freddie Mac have rolled out their own programs that do not rely on principal write-downs.

Different modification strategies, therefore, will be appropriate for different borrowers, in order to simultaneously avoid foreclosure and minimize losses to lenders. Bankruptcy cramdown, as noted above, does little (or nothing) to tailor modifications to the needs and abilities of borrowers. It instead applies a costly, one-size-fits-all approach.

Equally important, once cramdown is an option, it will prevent other kinds of modifications that are less costly but equally effective. Borrowers have little incentive to accept a lender's modification proposal when they can go to bankruptcy court and have a judge strip down their principal balances to conform to a *temporary* condition in the housing market. If the borrower has already defaulted, the costs of a bankruptcy filing will be small relative to the gains available from cramdown, which allows for a permanent reduction in the principal balance on the mortgage. When housing prices rise again, as they eventually will, the borrower will enjoy most of this appreciation if the home is sold more two years after the Chapter 13 filing (and all of the appreciation if it is sold more than four years after the filing). Cramdowns will have eliminated the possibility that a lender can ever recover its losses on borrowing. This is deeply problematic because (i) cramdowns are no more effective than less costly alternatives and (ii) the higher costs of cramdowns are borne by taxpayers.

Moral hazard could make the situation worse. Up to twelve million homeowners hold mortgage debt that exceeds the value of their homes.[11] These homeowners have negative equity. Yet most of these homeowners are still current on their mortgages, because (thus far) only about four million borrowers are 60 days or more delinquent.[12] Although they are current on their mortgages, homeowners with negative equity may find bankruptcy attractive once cramdown is possible. They may stop paying their mortgages—or at least stop paying before taking other, difficult steps to address their financial difficulties. If they do stop paying, bankruptcy filings will

[11] This estimate is provided by Moody's Economy.com and reported in CNNMoney.com.

[12] In December 2008, the Mortgage Bankers Association reported a delinquency rate equal to 6.99 percent. With 55 million outstanding mortgages, this implies that 3.85 million mortgages were delinquent at that time. The number is likely significantly higher today.

surge dramatically. This is not a hypothetical. The 1990s saw bankruptcy filings surge as credit card debts mounted. Many individuals viewed bankruptcy as a low-cost avenue for discharging these debts. It would be troubling if we saw the same occur with respect to mortgage debts. The losses to investors (and taxpayers generally) would be large.

Cramdown legislation could delay the foreclosure crisis and generate a massive number of bankruptcy filings. Bankruptcy is no panacea for consumers. Around two-thirds of all Chapter 13 cases terminate prematurely,[13] often leading to a Chapter 7 liquidation or a state-law foreclosure, and leaving creditors in a much worse position relative to having addressed the problem at the time of the original bankruptcy filing.

Equally devastating, third-party servicers might find it more attractive to deal with a homeowner in bankruptcy than to attempt a loan modification outside of bankruptcy. Proponents argue that bankruptcy reform would give borrowers a tool to fight back against servicers. Yet, the opposite could be the case. Servicers might prefer bankruptcy to loan modification for the same reason that servicers now prefer foreclosure to modification. Under most securitization agreements, servicers would likely be able to recover expenses incurred in connection with a homeowner's bankruptcy filing, just as they now recover expenses incurred in connection with a foreclosure. There is no reimbursement for costs incurred in performing a loan modification. This could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and appreciably delay resolution of the crisis.

The cost of future credit could rise significantly, especially for individuals with imperfect credit records. Empirical evidence suggests that if mortgages are subject to strip-down in bankruptcy, the cost of future credit will rise as lenders incorporate this new risk into their lending decisions.[14] Future mortgage amounts will be smaller and borrowing costs will be higher. While many would argue that cheap and easy credit was what got us into this economic crisis, lenders are likely to raise the cost of

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[13] Wenli Li, *What Do We Know About Chapter 13 Personal Bankruptcy Filings*, Bus. Rev., 4th Quarter, p. 19 (2007)

[14] *See* Tables 2a and 4a of Adam J. Levitin and Joshua Goodman, "The Effect of Bankruptcy Strip-Down on Mortgage Markets," Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 1087816 (2008). *See also* Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, 88 Rev. Econ. & Stat. 177 (2006).

borrowing already as a result of this crisis. Bankruptcy reform would increase borrowing costs further, resulting in even less borrowing and likely further reduce demand for housing.

To be sure, H.R. 200 applies only to mortgages originated before its effective date. But it seems likely that Congress will face strong pressure, in the future, to apply cramdown to mortgages originated after that date. This is especially likely if the housing crisis continues, and bankruptcy cramdown legislation could contribute to a delayed resolution of the crisis.

2. IT IS UNNECESSARY TO SALVAGE THE HOPE FOR HOMEOWNERS ACT

In its current form, and in the form proposed by H.R. 703, the Hope for Homeowners Act will likely generate large costs and small benefits. Costs are large because taxpayers will bear the risk of redefault after the FHA refinances the homeowner's mortgage, and CBO estimates point to a fairly high (forty percent) re-default rate. Benefits are small from the Act because it, like bankruptcy cramdown proposals, applies a one-size-fits-all approach to mortgage modification. Only one kind of modification is permitted: a reduction in principal to ninety percent (ninety-three percent under H.R. 703) of current appraised value and refinancing the mortgage as a fixed-rate thirty-year mortgage (longer durations are possible). Less aggressive modifications can be just as successful in averting foreclosure, but less costly to investors and taxpayers. I outline an approach that is more effective and less costly in Section 3 below.

3. SECTION 6 OF H.R. 703 SHOULD BE THE FOCUS OF POLICY REFORMS NOW.

H.R. 703 points in the right direction. Section 6 would create a "safe harbor" for servicers who modify mortgages in a reasonable, good faith belief that modification will increase recoveries from the mortgages, on a net present value basis, relative to foreclosure. The safe harbor would insulate these servicers from legal liability, even if modifications are prohibited by their agreements with securitization trusts or investors.

This is an essential first step towards a comprehensive policy for addressing the foreclosure crisis. But it is only a first step. In a new proposal—co-authored with Christopher Mayer and Tomasz Piskorski of Columbia Business School—I identify the next steps. The proposal has two parts. The first eliminates barriers to modification among *primary* mortgages that have been privately securitized. The second clears another important obstacle to modification of primary mortgages: resistance by *second* lien lenders. I briefly outline my proposal below. A detailed description, along with supplemental cost-benefit calculations and constitutional analysis, is attached to this testimony.

Part 1: Addressing Foreclosures Among Securitized Primary Mortgages

Privately securitized mortgages lie at the core of the housing crisis, accounting for more than 50 percent of foreclosure starts. Recent research shows that when these mortgages become delinquent, servicers opt for foreclosure over mortgage modification much more often than private lenders who service their own mortgages.[15]

The solution to this problem is to facilitate modification by:

1. ***Compensating servicers who modify mortgages.*** Using TARP funds, the federal government should increase the fee that servicers receive from continuing a mortgage and avoiding foreclosure, thereby aligning servicers' incentives with the interests of borrowers and investors. The increased fee—an Incentive Fee—should equal ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of $60 per month ($720 per year). Servicers should also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage, rewarding servicers that accept short sales. These payments would be in addition to the normal servicing fees as specified by the PSA. This Incentive Fee program should exist for only three years, after which improvements in the economy will likely reduce the need for it.

2. ***Removing legal constraints that inhibit modification.*** The federal government should enact "safe harbor" legislation that eliminates explicit restraints on modification and creates a safe harbor from litigation for reasonable, good faith modifications that raise returns to investors. This safe harbor should be an affirmative defense, which servicers can assert in the event of litigation. If investors bring suit, but a servicer successfully

[15] See "Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis" by Tomasz Piskorski, Amit Seru, and Vikrant Vig available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646

> invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees. Investors, of course, will need adequate information to assess whether litigation is appropriate. Therefore, the safe-harbor legislation should require servicers to make public the details of any modification.

Together, the Incentive Fee and the Safe Harbor will prevent up to one million foreclosures over three years, at a cost of no more than $10.7 billion.

H.R. 703 tracks part, but not all, of our proposal. Section 6 offers a safe harbor that is similar to the one we propose, but is missing two key elements. First, it does not require plaintiff-investors to reimburse the legal costs of defendant-servicers who successfully invoke the safe harbor in a court of law. Second, it does not require servicers to publish detailed information about their modification efforts. Both elements are essential to a meaningful safe harbor.

More importantly, H.R. 703 offers no Incentive Fees to servicers. Without Incentive Fees, servicers will be reluctant to pursue modification, even if they enjoy the protection of a safe harbor. This is because most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification. Consequently, servicers often choose to foreclose, even when modification makes good economic sense for borrowers and investors.

Our Incentive Fee proposal would strongly encourage servicers to modify mortgages when it makes economic sense. Servicing fees would more than cover the direct costs of modifications, estimated to be as much as $750 to $1,000.[16] Equally important, the Incentive Fee proposal better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few

[16] See for example Barclays 2008 Global Securitization Annual.

Incentive Fees.[17] Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender deals with in its own loans. Of course, there will still be circumstances when costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Part 2: Addressing Second Liens as Obstacles to Modification

There is one other appreciable barrier to modifications that appears to be a major concern—the existence of second liens on properties with a delinquent or potentially delinquent first mortgage. According to our calculations from deeds records, about one-third of mortgages originated after 2000 have either a second lien or a piggyback loan (a piggyback loan is a second lien that is taken on at the same time as the first mortgage).[18] Typically, these loans provided additional credit for homeowners to purchase the house or to finance additional expenditures after the purchase.

Second liens can be a barrier to successful modifications of first mortgages. There are some cases in which modification of the first mortgage might yield greater recovery than a foreclosure to first mortgage lenders, but the servicer of the first mortgage is unwilling to pursue modification unless the second lien lender agrees to relinquish its claims. If the second lien lender does not relinquish (or reduce) its claim, a modification of the first mortgage will just allow the homeowner to allocate more of her income to the second lien.

Even if the first mortgage exceeds the home's expected foreclosure value—implying zero recovery to the second lien lenders in foreclosure—the second lien servicer has little incentive to agree to a modification that extinguishes the second lien. As long as there is some uncertainty surrounding foreclosure value, no matter how small, the servicer of the second lien would prefer foreclosure to loan modification. The former offers a slight chance of recovery to second lien lenders; the latter offers no recovery. Moreover, the terms of securitization agreements might prevent the second

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[17] Evidence suggests that more than one half of loan modifications in the first quarter of 2008 re-defaulted within 6 months, so it is important only to reward servicers for pursuing successful loan modifications (OCC/OTS Report, 12/2008).

[18] About 81 percent of mortgages with a second lien have only a second lien, while another 15 percent have a second and third lien, and 4 percent have 3 or more additional liens.

lien servicer from agreeing to any modification that extinguishes the mortgage. Finally, by delaying and appearing obstinate, the second lien lender might convince the first mortgage servicer to "buy out" the second lien at a price above its true value. This is often called a "hold-up" problem.

Professors Mayer and Piskorski and I have developed a new, voluntary proposal that would give second lien lenders financial incentives to relinquish their claims whenever a first mortgage servicer pursues modification. Under our proposal, the government would pay compensation to a second lien holder who agrees to relinquish all of its claims against the home and the borrower. This compensation would equal five percent of the current balance of the second lien, capped at $1,500 per property. If multiple liens exist, this payment would be split between the liens. This compensation could be paid using TARP funds.

In order to limit taxpayer costs, and focus primarily on foreclosure prevention, we would limit compensation to second lien lenders who relinquish their claims in response to a decision by the first mortgage servicer to conduct a significant modification of the primary mortgage. By significant, we mean a modification that reduces the borrower's monthly payments by at least 10 percent. This program would only apply to primary residences. As well, compensation would be available only when the first and second liens are held by different lenders. Finally, our proposal would apply to all second liens, because the hold-up problem poses an appreciable barrier to modification beyond just privately securitized mortgages.

This proposal would deal with the one remaining impediment to loan modifications—second liens—that impacts all mortgages. Our proposal would facilitate up to 1.1 million mortgage modifications at a cost of approximately $1.65 billion.[19] This

[19] We compute the cost of compensation as follows. Using deeds records, we estimate that about 13.3 million homes are subject to both first mortgages and second liens as of October 2008. Among these homes, 8.9 million homes have loan-to-value ratios exceeding 92 percent. (In our calculations, we assume a loan-to-value ratio equal to 92 percent; this allows for future house price declines of 8 percent or more.) When the loan-to-value ratio is only 92 percent, a second lien lender is unlikely to agree to relinquish its claim, for obvious reasons. We assume that around one-quarter of these mortgages are at risk of foreclosure. Among those, modification might make sense half of the time. Thus about 1.1 million second lien mortgages might require compensation for the relinquishment of their rights. If all second lien holders agree to relinquish their rights, the total cost of compensating them will be no more than $1.65 billon.

cost is quite moderate compared to the possible expenditure of $50 to $100 billion to reduce foreclosures. Our proposal is superior to bankruptcy cramdown for many of the same reasons that cramdown does not make sense for primary mortgages.

CONCLUSION

The Administration and Congress must take immediate action to address the foreclosure crisis. House prices continue to spiral downward in much of the country. Foreclosures are taking place at an alarming rate and will grow if we do not act quickly.

But quick action must be accompanied by sensible, narrowly-tailored policies that minimize the impact on taxpayers. Bankruptcy cramdown reforms will only delay resolution of the current crisis and impose large, avoidable costs on taxpayers.

Instead, the Administration and Congress should build on Section 6 of H.R. 703, which points to an effective, low-cost strategy. This strategy includes a safe harbor for servicers, much like the one set out in Section 6, but also (1) an incentive plan that encourages sensible loan modifications, (2) a cost-shifting provision that reimburses the actual legal costs of servicers who are sued even though they are acting consistent with the terms of the safe harbor, and (3) a separate incentive plan that encourages second lien lenders to cooperate when servicers attempt to modify primary mortgages. Elements (1) and (2) of this strategy can prevent up to one million foreclosures at a modest cost to taxpayers of $10.7 billion. Element (3) would facilitate as many as 1.1 million loan modifications at a cost of $1.65 billion. Together these programs put us on the road to recovery.

I am grateful for the opportunity to address you today and look forward to answering your questions.

Draft 11: January 6, 2009

A New Proposal for Loan Modifications
by Christopher Mayer, Edward Morrison, and Tomasz Piskorski*

Executive Summary

We are witnessing an unprecedented housing and foreclosure crisis, with 2.25 million foreclosures started last year and at least 1.7 million foreclosure starts expected this year. Privately securitized mortgages are at the core of the problem. These mortgages—which were originated without a guarantee from government-sponsored entities—account for more than one-half of foreclosure starts, despite accounting for about fifteen percent of all outstanding mortgages. Servicers of these securitized mortgages make the critical decision of what to do when a mortgage becomes delinquent; choosing to pursue a foreclosure or a modification of the mortgage. Existing research suggests that these servicers opt for foreclosure much more often than private lenders that service their own mortgages. While Fannie Mae, Freddie Mac, the FHA, and private lenders are actively and aggressively pursuing mortgage modifications, servicers of securitized loans are still lagging behind.

Two factors are driving servicers' reluctance to modify loans when modification makes economic sense. First, servicers are not properly compensated for loan modification. Second, legal constraints prohibit many servicers from pursuing modification. Even when legal constraints are absent, significant litigation risk attends any loan modification.

Securitization investors are undoubtedly aware of these problems, which reduce their returns. But the number of investors is so large—and their interests so divergent—that they are unable to reach consensus in favoring of rewriting securitization agreements and giving servicers greater freedom to modify loans. The typical securitization has as complicated a capital structure as many corporations. No one is surprised when a troubled corporation needs government assistance (via Chapter 11 reorganizations) to rewrite contracts with investors. It is simply too costly and complicated to reach a consensus among investors without government assistance.

We propose a comprehensive solution to this crisis:

1) **Compensate servicers who modify mortgages.** Using TARP funds, the federal government should increase the fee that servicers receive from continuing a mortgage and avoiding foreclosure, thereby aligning servicers' incentives with interests of borrowers and investors.

2) **Remove legal constraints that inhibit modification.** The federal government should enact legislation that modifies existing securitization contracts. The legislation should

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eliminate explicit restraints on modification and create a safe harbor from litigation that protects reasonable, good faith modification that raises returns to investors.

We estimate that our plan will prevent nearly one million foreclosures over three years, at a cost of no more than $10.7 billion. It also raises no constitutional concerns, because it builds on well-established Supreme Court case law.

It is important to emphasize that our proposal benefits homeowners as much as it helps servicers and investors. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that, over time, exceed the foreclosure value of her home. This standard—payments exceeding the home's foreclosure value—is the same standard applied in proposals to change the Bankruptcy Code.

But proposals to change the Bankruptcy Code are deeply problematic. These proposals would allow homeowners to strip-down mortgages to the current home value and reduce interest rates. These proposals would raise future borrowing costs and could encourage solvent borrowers to miss payments (a form of moral hazard). The financial crisis would be much worse if fifty-two million borrowers, who are now current, attempt to invalidate their mortgages. Equally important, proposals to change the Code could dramatically increase bankruptcy-filing rates. Servicers will prefer mortgage modification in bankruptcy because their expenses are reimbursed in bankruptcy, not outside it. Thus, proposed reforms could push millions of borrowers into bankruptcy, delaying the resolution of the current crisis for years. Finally, bankruptcy reform is a blunt tool: it applies a one-size-fits-all approach to loan modification, and it would impact all mortgages, including the majority of outstanding loans now owned by Fannie Mae and Freddie Mac. The federal government can already encourage effective mortgage modifications through its conservatorship of these organizations, while taxpayers would likely be on the hook for losses to GSE mortgages through the bankruptcy process. Banks are now aggressively modifying their own mortgages.

Another alternative, the FDIC proposal, has many virtues but would have limited success and high costs. This proposal would pay servicers $1,000 for every modified loan, and would have the government share up to fifty percent of losses from unsuccessful modifications. This proposal does nothing to eliminate legal barriers, which would continue to deter modification. Further, the costs to taxpayers would be very large. The government, not investors, would bear the costs of failed modifications.

Introduction

The recent flood of foreclosures has reached crisis levels, with 2.25 million foreclosures started last year (Federal Reserve) and the forecast of 1.7 million foreclosures started in 2009 (Credit Suisse Foreclosure Update). Foreclosures contribute to falling house prices and deteriorating communities. Policy makers have struggled to stem this rising tide. Despite good intentions and appreciable effort, public policy to encourage write-downs or other loan modifications by servicers has had limited success.

Much research has pointed to falling house prices as a key contributor to the foreclosure crisis (Gerardi, Lehnert, Sherlund, and Willen). While government policy cannot restore house prices to their previous levels, policies that restore the normal functioning of the mortgage market can help stabilize house prices and reduce the likelihood of future defaults and foreclosures (Hubbard and Mayer). Nonetheless, even in the most optimistic scenario, we likely face millions of defaulting mortgages in the coming years.

We offer a new approach to foreclosure prevention that focuses on what has been the most intractable part of the foreclosure problem: the behavior of third-party servicers who manage portfolios of securitized portfolios. Why focus on servicers of securitized mortgages? Because securitized subprime, alt-A, and prime/jumbo loans accounted for more than one-half of foreclosure starts in 2008 despite representing about fifteen percent of all outstanding mortgages.[1] While the Fannie Mae, Freddie Mac, the FHA, and the largest private banks and portfolio lenders have announced their own aggressive programs to pursue mortgage modification, servicers of securitized mortgages lag behind.

We must address the foreclosure problem for securitized mortgages now, because the forecast for 2009 is even bleaker. As of October 2008, more than one-third of the 2.8 million outstanding securitized subprime loans and seventeen percent of the 2.2 million securitized alt-A loans were sixty days or more delinquent (Federal Reserve Bank of NY). Even worse, many of the alt-A option ARMs will hit their negative amortization limits between 2009 and 2011, resulting in rising payments and likely much higher default rates. Rumors suggest that some smaller servicers will soon face bankruptcy.

Our approach to combating foreclosures builds on recent research showing that portfolio lenders—lenders who service loans that they own—are significantly more successful in stemming foreclosures than third-party servicers, who service loans owned by other parties (Piskorski, Seru, and Vig). The researchers show that portfolio lenders achieve foreclosure rates that are nineteen to thirty-three percent lower than the rates experienced by third-party servicers. In fact, portfolio lenders are even more successful in reducing foreclosures for the highest quality loans, where current delinquency rates are rising the fastest (portfolio lenders achieve foreclosure rates thirty to fifty percent lower than third-party servicers). Finally, as we explain below, recent efforts to avoid foreclosures appear to be more successful. Portfolio lenders have rolled out programs applying forbearance and principal reduction to their own portfolios.

Third-party servicers, however, are often unable or unwilling to use the same tools as portfolio lenders are currently using.[2] Recent research also documents the failures of servicers to

[1] According to the Mortgage Bankers Association, about 1.64 million loans started the foreclosure process as of the third quarter of 2008. Our own calculations from data obtained from Braddock Financial shows that about 900,000 securitized loans began the foreclosure process as of October, 2008.

[2] Of course, many other foreclosures come from FHA programs and Fannie Mae and Freddie Mac, where the government already has appreciable influence in guiding programs to reduce foreclosures.

successfully modify loans. (See research by Alan White as well as a recent update.) White shows that loan modifications by servicers rarely reduce principal and many loan modifications raise payments, rather than lower them. His report provides great detail on the failings of servicers of securitized mortgages.

Our proposal eliminates barriers that prevent third-party servicers from effectively managing the foreclosure crisis. Commentary and evidence suggests servicers face two appreciable barriers: 1) Servicing contracts makes little economic sense in the current crisis. No one anticipated the extent of the current crisis and servicers are poorly compensated as a result. As well, servicers have too few incentives to pursue loan modification instead of foreclosure, even when modification makes good economic sense for investors. Most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification. Consequently, servicers often choose to foreclose, even when modification makes good economic sense for borrower and investors. 2) Servicers face explicit and implicit legal barriers to modifying mortgages successfully. Some pooling and servicing agreements (PSAs) place explicit limits on loan modifications. In other cases, vague provisions in the PSAs, and the consequent threat of lawsuits, serve to limit servicers' ability to modify loans successfully.

These barriers could be overcome if investors agreed to rewrite their PSAs. But a rewrite typically requires unanimous investor consent, especially if it would give servicers freedom to reduce principal or interest rates. This unanimity requirement serves as another barrier to successful loan modification. The typical mortgage pool has issued many securities in as many as twenty or more tranches, which have different priorities with respect to interest or principal, or both. The number of investors is so large—and their interests so divergent—that consensus is a near-impossibility. Put differently, mortgage securitization has dramatically increased the number of creditors to whom a homeowner is indebted. The typical securitization has as many creditors, and as complicated a capital structure, as many large corporations. No one is surprised when a distressed corporation—whether a small business or General Motors—is unable to convince creditors to rewrite their debt contracts. There are too many creditors with divergent interests. This is why we have Chapter 11 bankruptcy, which gives corporations power to rewrite contracts. Today, securitizations face precisely the same problem as General Motors: there is no way (at a reasonable cost) to reach a consensus among creditors. But homeowners bear the consequences of this standstill.

This is why government intervention is needed. We propose two steps to get around the barriers to successful loan modification: 1) an Incentive Fee structure that increases payments to servicers and better aligns their incentives with investors, and 2) a Legislative Proposal that removes explicit barriers to modification in PSAs and that reduces the litigation exposure of servicers who do modify loans.

Our proposal might prevent as many as one million foreclosures at a cost of no more than $10.7 billion that can be funded by TARP money. Other proposals do not address both barriers that servicers face. As well, our proposal would cost taxpayers considerably less money than other programs currently under consideration, with no requirement to provide costly loan guarantees. Losses for bad loans remain with private investors rather than taxpayers.

Our Proposal in Detail

Servicer Incentive Fees: We believe that servicers need greater resources and stronger incentives to modify loans. We propose that servicers of privately securitized mortgages be paid a monthly Incentive Fee equal to ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of $60 per month ($720 per year). The servicer would also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage. These payments would be in addition to the normal servicing fees as specified by the PSA. The program would be limited to any securitized mortgage that is below the conforming loan limit at the origination date. The Incentive Fees, which would equal about $9 billion (see Appendix 2), can be paid from money authorized under the US Treasury's TARP program. The Incentive Fees should remain in place for a period of three years, after which improvements in the economy will likely reduce the need for the incentive program.

Our Incentive Fee program would substantially encourage servicers to modify mortgages. Servicing fees would now more than cover the direct costs of modifications, estimated to be as much as $750 to $1,000.[3] Equally important, the Incentive Fee program better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few Incentive Fees.[4] Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender deals with in its own loans. Of course, there will still be circumstances when costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Our proposal increases servicer fees in much the same way that fees are elevated in some securitizations in which investors have been able to coordinate as a group. However, appreciable barriers—such as hold-up problems and conflicts of interest across various tranche holders—prevent coordination in the bulk of securitizations.

Our proposal also encourages short sales if they make economic sense. If a borrower prepays a mortgage for any reason, the servicer would receive a one-time Incentive Fee equal to twelve times the previous month's Incentive Fee. A prepayment could occur because for two reasons: the borrower may refinance the mortgage, or he or she may pursue a short sale. In some cases, short sales can make sense for both borrowers and lenders. The one-year Incentive Fee encourages a lender to accept a short sale when the alternative is a more expensive foreclosure. The lump sum Incentive Fee also ensures that loan modification costs are covered for borrowers who are likely to prepay.

Finally, our Incentive Fee program would apply only to securitized mortgages that fell below the conforming loan limit in the year in which the loan was originated. So-called jumbo mortgages do not face the same incentive problems as subprime and alt-A mortgages with lower loan balances. In particular, with an average mortgage balance exceeding $500,000, servicers receive much greater financial benefits when they modify a jumbo mortgage. Keeping a jumbo mortgage in the securitized pool instead of foreclosing can result in annual payments of $1,250

[3] See for example Barclays 2008 Global Securitization Annual.

[4] Evidence suggests that more than one half of loan modifications in the first quarter of 2008 re-defaulted within 6 months, so it is important only to reward servicers for pursuing successful loan modifications (OCC/OTS Report, 12/2008).

or more, enough to justify substantial effort by servicers to modify troubled mortgages. As well, the volume of jumbo mortgage defaults is lower, enabling servicers to give these loans more attention. Servicers of jumbo loans, however, would still see substantial legal relief from the second part of our proposal, described next.

Legislative Proposal: We propose specific, temporary legislation to eliminate legal barriers to loan modification in PSAs for all securitized loans. We believe that Congress has the authority, under the Commerce and Spending Clauses, to modify the terms of securitization contracts.

We propose two kinds of legislated changes to PSAs. First, Congress should enact legislation that eliminates explicit limits on modification, including both outright prohibitions and provisions that constrain the range of permissible modifications. The legislation should be temporary, lasting only three years. Second, Congress should create a "litigation safe harbor" that insulates servicers from costly litigation, provided they modify loans in a reasonable, good faith belief that they are acting in the best interests of investors as a group. The safe harbor is an affirmative defense, which servicers can assert in the event of litigation. Importantly, the defense is based on evidence that the servicer held a reasonable, good faith belief in the benefit of modification, not on evidence that the modification was in fact successful or not. If investors bring suit, but a servicer successfully invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees.

Investors will, however, need information about modifications in order to assess their reasonability. Our proposal therefore requires servicers to make public the details of any modification. This reporting requirement will not only help investors understand and evaluate modifications, but will also provide useful information to other servicers and lenders, who can study previous modifications, assess what works and what does not, and thereby develop successful standards for the future.

We also recommend that servicers halt foreclosure proceedings during the first few months after our proposed legislation becomes effective. Servicers will need time to assess whether pending foreclosures should be halted in favor of modification that advances the best interests of investors.

Our Legislative Proposal raises no meaningful constitutional concerns and has been vetted by leading constitutional scholars. The Proposal is a temporary program to moderate an avalanche of foreclosures during an economic crisis. It is more tailored and potentially less burdensome on investors than temporary legislation enacted during the Great Depression and upheld by the Supreme Court. Indeed, our program should benefit investors, because it fosters loan modification only when it increases returns—relative to foreclosure—to investors as a group. Appendix 3 presents our legal analysis in detail and presents specific legislation.

These two elements of our Legislative Proposal address a number of flaws in existing PSAs, which were created when investors and underwriters did not envision a housing collapse of the magnitude we are now seeing. Although the proposed legislation will abrogate contractual rights of investors, it will also free servicers to undertake loan modifications that increase payments—relative to a foreclosure—to investors as a group. Thus, the bulk of investors will benefit from this legislation, despite the loss of contractual rights.

Most PSAs do not explicitly limit modifications, but instead contain vague language that can paralyze servicers. With respect to these securitizations, our proposal can best be viewed as clarifying the interpretation of the PSAs. For example, the typical PSA advises the servicer to act in the "best interests" of the securitization trust. Yet the contracts do not specify what counts as the "best interests" of the trust. Modification could reduce the cash flow rights of some investors, particularly junior-tranche investors, relative to foreclosure. These investors can often expect a share of coupon payments during the foreclosure process, which can last eighteen months. Modification might eliminate these cash flow rights. Indeed, some junior tranche holders have sued servicers that actively pursue modifications. Our legislative proposal (a) clarifies that servicers' primary duty is to act in the economic interest of investors as a group and (b) provides protection against lawsuits when the servicer can show that its actions were consistent with this duty.

Our Legislative Proposal is slightly more complicated for the minority of PSAs that contain explicit provisions barring modifications. These provisions can include outright prohibitions on modification, caps on the number of mortgages that can be modified (e.g., five percent of the pool), limits on the frequency of modifications (e.g., no more than once during a twelve month period), limits on the range of permissible modifications (e.g., the modified interest rate cannot fall below a set floor), and requirements that a servicer purchase any modified loans—at par value—from the securitization trust. Our proposal will abrogate provisions like these. It is important to note, however, that our legislation enables modification only when it increases overall investor value. To be sure, some junior tranche holders might be harmed. But this effect of our proposal likely raises no constitutional concerns. Moreover, we believe that our proposal makes sense given the economic crisis we are facing in the housing market. The benefits from modification far outweigh the burdens on a small class of investors. Nonetheless, we believe that policymakers should provide compensation to these investors, who have suffered economic losses.[5] Note, however, that compensation to junior-tranche investors will be necessary only when legislation abrogates contractual provisions that would have guaranteed, absent abrogation, cash flow rights to these investors. Our computations indicate that the total cost of this compensation would be no more than $1.7 billion (see Appendix 4).

Cost-Benefit Analysis

Our plan can reduce foreclosures by between 675,000 and one million at a cost of about $9 billion, or $10.7 billion if we include compensation to junior investors. We propose that these expenditures come from TARP funds, but an alternative funding mechanism could be a tax on the industry. No matter how such a program is funded, the reduction in foreclosures will be relatively cheap compared to the costs and risks of other plans, as we discuss below. We present simple estimates of our program's cost-benefit tradeoffs in Appendix 2. These computations are based on the assumption that, by breaking down barriers that currently prevent servicers from

[5] Our Legislative Proposal, described in Appendix 3, would give the Federal Housing Authority (FHA) responsibility for compensating aggrieved investors. After loan modification, investors could bring claims for compensation, but they would bear the burden of proving their losses from modification, relative to foreclosure. The FHA's budget for this compensation program would come from TARP funds. By vesting the FHA with authority to deliver compensation to aggrieved investors, our proposal does not place a costly burden on servicers to estimate, prior to modification, the particular harm suffered by particular investors. Servicers can take quick action to pursue modifications that increase returns to investors overall; the harm suffered by particular constituencies can be ignored. At the same time, aggrieved investors can look to the federal government for compensation.

modifying loans, our program will allow servicers to achieve the same success in reducing foreclosures as portfolio lenders. We build on computations in Piskorski, et. al. (2008).

In pursuing this two-pronged approach we are opening markets. Currently, there is a perverse divide between mortgages that are serviced by portfolio lenders and those that are serviced by third-party servicers. The former can and do modify when modification makes sense from borrowers' and lenders' perspectives. The latter are constrained by contracts that, we now realize, are highly inefficient. Our proposal therefore permits loan modifications where they make economic sense.

As well, this proposal changes the economics of mortgage servicing from being a loss leader to a profitable business. This has two large benefits. First, we substantially reduce the likelihood of highly disruptive bankruptcies among smaller, so-called monoline servicers, who now manage about one-third of all securitized mortgages. We also relax the liquidity constraints faced by smaller servicers, who now are barely able to cover the costs of a substantial mortgage modification program. As well, by making mortgage servicing profitable, we encourage larger servicers to purchase smaller servicers. Such consolidation could provide important economic benefits. There are substantial economies of scale in mortgage servicing, particularly with large fixed costs and benefits from learning in pursuing mortgage modification.

Our proposal imposes no burdensome obligations on servicers that might generate large additional losses on lenders and investors. It does not create incentives to default by homeowners who are currently making their mortgage payments. It does not systematically limit credit availability to potential borrowers, as alternative proposals do. Instead, our proposal encourages lenders and servicers to continue finding ways to limit future foreclosures.

It is also important to emphasize that our proposal benefits homeowners as much as it helps servicers and investors. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that, over time, exceed the foreclosure value of her home. This standard—payments exceeding the home's foreclosure value—is the same standard applied in alternative proposals, such as amendments to the Bankruptcy Code (described next). Our proposal, therefore, goes a long way toward protecting homeowners, while at the same time avoiding the pitfalls of alternative proposals.

<u>Alternative Proposals</u>

Alternative proposals generally fall into three categories: 1) allowing judges to modify mortgages and "cram down" principal amounts in bankruptcy; 2) making explicit payments to servicers that modify loans; and 3) allowing homeowners to take on second liens from the government, with personal liability for the loan balances. We briefly address the reasons that we think these alternatives are less attractive than our proposal and provide more detail in Appendix 1.

Bankruptcy Reform. Bankruptcy Code amendments would generate important risks and unintended consequences. While three million borrowers are sixty days or more delinquent, fifty-two million borrowers are current on their mortgages. During the 1990s, when it was relatively easy to discharge credit card debt in bankruptcy, bankruptcy filings skyrocketed as credit card balances grew. Proposed reforms would make it easier to discharge mortgage debt in bankruptcy. It would be problematic if, in response to these reforms, many borrowers saw bankruptcy as a vehicle for eliminating mortgage debt. If many additional homeowners stop paying their mortgage, the losses in the financial system would skyrocket, as would the cost to taxpayers through the implicit guarantee of Fannie Mae and Freddie Mac debt (more than $5.25 trillion of mortgage guarantees), losses to Ginnie Mae, the FDCI, and many financial institutions that may be bailed-out as they are "too-big-to-fail." And bankruptcy is no panacea for consumers. Around two-thirds of all Chapter 13 cases terminate prematurely (see Wenli Li), leaving the homeowner liable for her mortgage debt and creditors in a much worse position relative to having addressed the problem at the time of the bankruptcy filing.

Additionally, third-party servicers might find it more attractive to deal with a homeowner in bankruptcy than to attempt an out-of-court loan modification. Proponents argue that bankruptcy reform would not increase bankruptcy filings; it would instead give borrowers leverage in out-of-court negotiations. But the opposite might be the case. Servicers might prefer bankruptcy to loan modification for the same reason that servicers now prefer foreclosure to modification. Under most PSAs, servicers would likely recover expenses incurred in connection with a homeowner's bankruptcy filing, just as they now recover expenses incurred in connection with a foreclosure. There is no reimbursement for costs incurred in performing a loan modification. This could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and appreciably delay a resolution of the crisis.

Equally troubling, bankruptcy reforms apply a one-size-fits-all approach to delinquent mortgages. Proposed legislation[6] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan—when a homeowner files for Chapter 13. But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing both losses to investors and defaults by homeowners. Bankruptcy reform would inhibit this kind of experimentation.

Because they contemplate a one-size-fits-all approach, recent proposals would be quite harmful to lenders, who have developed alternative modification strategies that may be more successful in avoiding unnecessary foreclosures and less expensive to lenders. Forbearance is one such an alternative: it reduces the principal to which the lender applies interest when computing monthly mortgage payments. A borrower, for example, might be asked to pay interest on only eighty percent of the loan balance. The FDIC/Indy Mac program, for example, provides for reductions in interest rates as well as forbearance on principal payments.[7] J.P. Morgan/Chase recently announced a similar strategy of loan forbearance. Some recent modification programs involve neither forbearance nor strip-down. They instead involve only interest-rate reductions. Bank of America and Citigroup, for example, have pursued many sub-prime modifications involving interest rate reductions. Similarly, Fannie Mae and Freddie Mac have rolled out programs that do not rely on principal write-downs (bankruptcy reform would harm not only private lenders, but also government sponsored entities).

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[6] *See, e.g.*, Senate Bill S. 2636, Foreclosure Prevention Act of 2008 (Feb. 13, 2008); Helping Families Save Their Homes in Bankruptcy Act of 2008 (July 29, 2008).

[7] There are problems with the FDIC/Indy Mac program, because it encourages borrowers to miss payments in order to qualify for a loan modification. Nonetheless, this program can be rolled-out in a large enough scale to make a significant dent in foreclosures over a short period of time and thus has significant benefits.

Borrowers have little incentive to accept proposed modifications like these when they can simply go to court and have a judge strip-down their principal balances. Strip down causes a permanent reduction in the outstanding mortgage debt. When house prices rise, as they eventually will, the homeowner enjoys all of the appreciation. Strip-down therefore eliminates the possibility that a lender will ever recover its losses on borrowing. Because of this, borrowers have strong incentives to reject modification proposals, hold out for a better deal, file for bankruptcy if necessary, and thereby delay the resolution of housing problems for years. Instead of fostering innovative and tailored modifications by servicers, as our proposal would, proposed bankruptcy reforms would encourage bankruptcy filings and produce loan modifications that impose excessive losses on investors and do too much or too little to minimize the risk of homeowner default.

There are further problems with proposed bankruptcy reforms. In some legislative proposals, modification would be available only to Chapter 13 debtors "who, after allowance for expenses permitted by the [Bankruptcy Code's] means test ..., cannot afford to" cure past defaults and continue paying the original mortgage debt.[8] Additionally, the debtor's mortgage must be subprime or "nontraditional."[9] These limits are troubling. Modification may be sensible even if a homeowner fails the Code's means test, which computes important "expenses" based on IRS standards, not the homeowner's actual history of expenses.[10] Likewise, modification may be sensible even if a loan does not qualify as "nontraditional." As Appendix 2 explains, a significant number of prime jumbo mortgages are likely to enter foreclosure during the next three years.

Finally, empirical evidence suggests that if mortgages are subject to strip-down in bankruptcy, the cost of future credit will rise as lenders incorporate this new risk into their lending decisions. Future mortgage amounts will be smaller, and borrowing costs will be higher, for homeowners with low credit scores. Although many would argue that cheap and easy credit is what got us into this economic crisis, lenders have already tightened the supply of credit. Bankruptcy reform would increase borrowing costs further, resulting in even less borrowing and a further reduction in demand for housing.

Payments to Servicers. A recent FDIC proposal would pay servicers $1,000 to modify a loan and have the government share up to fifty percent of any losses from post-modification default as long as the borrower made at least six payments under the new plan. This program provides a specific formula for the type of modification and for eligibility (full documentation, owner-occupied properties, mortgage payment-to-income ratios as low as thirty-one percent). This proposal is a big step forward and our proposal has many features in common with the FDIC plan. But the FDIC program has several important risks. Modification payments are made based on a formula that encourages servicers to "modify" as many loans as possible (a modification only qualifies if it cuts payments by at least ten percent). Thus, servicers' incentives are no longer aligned with those of investors. Servicers might prefer to modify all loans, whether or not a modification is necessary in order to receive the incentive payment and the government loan guarantee, reducing ultimate payments to investors. As well, servicers would not be free to use their own modification programs with features such as loan forgiveness, which have been employed successfully by many portfolio lenders. Servicers would be encouraged to reduce

[8] Sen. Rep. 110-514, p. 11 (Sept. 26, 2008).
[9] *See* Senate Bill S. 2136, Helping Families Save Their Homes in Bankruptcy Act of 2008, § 101.
[10] 11 U.S.C. § 707(b)(2)(A)(ii)(I).

borrowers' payments to a very low level, which greatly increases the likelihood of a borrower making six payments, but also reduces the payoff to investors. Larger than necessary losses for investors might place additional financial institutions at risk and further delay the recovery of the credit markets. Finally, the cost to taxpayers could be quite high. Servicers would surely endeavor to "modify" as many loans as possible in order to be eligible for the mortgage guarantee, appreciably raising the cost of such a program. Taxpayers would face large liabilities for years to come based on the possibility that modified loans might again fail. Our proposal does not impose any such taxpayer liability, which is very difficult to estimate but could be enormously expensive.

The FDIC program also does not fully address the question of servicer liability. Without changing PSAs, incentive payments might make servicers more susceptible to litigation alleging that they violated their duties to the trusts in order to earn increase fees from loan modifications.[11] And, of course, some PSAs prohibit or limit loan modification. Nonetheless, one could combine parts of the FDIC proposal with the legislation envisioned in our proposal to further encourage servicers to modify loans.

Government loans. A third group of proposals suggests that borrowers take on full-recourse second mortgages to help work out of the crisis.[12] Of course, most homeowners would not want to take on a personal liability to stay in a house that is now substantially underwater. In order to induce homeowners to take on the second mortgages, the government would provide a substantial benefit in the form of a very low interest rate and/or some loan future forgiveness. Even with these inducements, it is uncertain why borrowers would choose to take on personal liability as opposed to defaulting or attempting to obtain a modified mortgage with the lender if that were possible. These programs have many unappealing features for the government as well. First, they set a dangerous precedent: the government would lend at its own borrowing rate, rather than a rate that is privately profitable. This precedent could be applied to all sorts of credit market problems in the future. Additionally, these proposals envision a form of personal liability that would not be dischargeable in bankruptcy. But it is hard to imagine the government collecting from a sick or unemployed borrower. Thus, the risks of default and the costs of loan forgiveness are substantial under these programs, yet taxpayers would receive no compensation.

At the same time, some programs would result in lenders being "bailed out" without sharing in the government losses on the second liens. The Homeownership Vesting Plan pushed by Mark Zandi, for example, would cost over $100 billion and would impact 1.7 million homeowners—a cost of $57,000 per homeowner. None of these costs would be covered by the industry or investors. Hubbard and Mayer provide a more attractive program to absorb negative equity. Under the Hubbard-Mayer plan, lenders and taxpayers would share in the losses from negative equity, but taxpayers would also receive a benefit based on future appreciation of house values. The net cost to taxpayers would be much lower under such a plan and it would cover millions more additional homeowners. Such a program of shared losses seems much more attractive than pursuing personal liability. In this sense, the Hubbard-Mayer proposal is complementary to this proposal. Their plan deals predominantly with borrowers who can make

[11] See, for example, the recent lawsuit filed by Grais and Ellsworth LLP on behalf of two private investors when Countrywide agreed to modify 400,000 loans as part of a settlement with fifteen state Attorneys General over predatory lending practices.
[12] See, for example, proposals on Homeownership Vesting Plan by Mark Zandi of Moodys/Economy.com or Helping People Whose Homes are Underwater by Martin Feldstein.

payments and have good credit. If the Hubbard-Mayer proposal were enacted, it would reduce, but not eliminate the need to deal with loan modifications as described above.

Below we discuss our proposal in more detail. Appendix 1 provides detailed support for the claims underlying our proposal, as well as critiques of selective alternative proposals. Appendix 2 describes our servicer Incentive Fee proposal and provides cost-benefit calculations. Appendix 3 presents our legislative proposal as well as the arguments as to its constitutionality. We also present draft legislation. Appendix 4 presents the cost-benefit analysis for the compensation of potentially aggrieved investors.

APPENDIX 1: IMPORTANT SUPPORTING EVIDENCE FOR OUR PROPOSAL

- **Portfolio lenders do many more modifications than servicers of securitized pools**
- **Servicers face many disincentives to modify mortgages under the typical PSA. Our proposal substantially improves incentives for servicers to pursue successful loan modifications.**
- **Not all foreclosures can or should be stopped. Many loan modifications fail for good reasons. As many as 2/3 of Chapter 13 plans fail.**
- **What are the problems with proposals to allow first liens to be stripped down in Chapter 13 bankruptcy?**
- **What is the FDIC proposal in more detail?**
- **How does our proposal compare to the Hope for Homeowners Act?**

1) **Portfolio lenders do many more modifications than servicers of securitized pools.**

   a) Piskorski, Seru, and Vig (2008) show that seriously delinquent mortgages controlled by servicers of securitizations enter foreclosure much more quickly than portfolio loans. The results suggest that delinquent loans are modified much more aggressively when they are held in a lender's portfolio than when they have been securitized and managed by a third-party servicer. Conditional on a loan becoming delinquent, loans held by the lending institution have a 19 to 33 percent lower foreclosure rate when compared to similar loans that are securitized. When the results are split out by credit quality, the differences are larger for loans to the highest quality borrowers. For mortgages with the best credit quality, portfolio lenders achieve default rates that are 30 to 50% lower than rates experienced by third-party servicers. This evidence is consistent with the view that, relative to servicers of securitized loans, servicers of portfolio loans undertook actions that resulted in substantially lower foreclosure rates. These findings suggest that securitization imposes significant renegotiation costs and a failure to modify securitized loans may have substantially contributed to the recent surge in foreclosure rates. A recent OCC/OTS report finds similar results, although it does not control for the risk factors that differ across the various types of mortgages. [13]

   b) Portfolio lenders appear to be making appreciable progress in reducing foreclosures. While historically mortgage modifications were relatively rare there are compelling arguments that in time of big adverse shocks (like substantial decline of house prices) debt renegotiation could create value for both lenders and borrowers. The increased mortgage modification activity by lenders supports this point of view.

   c) Recent programs use modification tools that have had much greater success, suggesting that portfolio lenders are likely to be even more successful than in the past. In November 2008, the largest portfolio lenders announced mortgage modification programs that are much more aggressive than earlier programs and thus may have even greater success in

[13] *See* *OCC and OTS Mortgage Metrics Report 3Q 2008*.

reducing foreclosures. These programs rely on forbearance and in some cases permanent reductions in outstanding balances.

Thus, portfolio lenders' success in reducing foreclosures could be underestimated in Piskorski et. al. (2008). This conclusion is consistent with evidence on the performance of recent mortgage modifications. For example, a recent study by Credit Suisse (Subprime Loan Modifications Update, October 1, 2008) finds that the re-default rate of loan modifications depends crucially on the type of modification. Rate freezes (where the rate is frozen around the ARM reset date) and principal reduction modifications (where principal is permanently forgiven) have re-default rates less than half of those for more traditional modifications. Eight months after modification during the fourth quarter of 2007, only 15% of rate modifications and 23% of principal modifications were 60+ days delinquent. The delinquency rate was much higher (44%) among traditional modifications, which involved higher payments after modification. The 23% re-default rate among principal modifications is particularly encouraging in light of the fact that more than 80% of loans were delinquent prior to modification. Therefore, the historical re-default rate associated with traditional modifications may not be applicable to recent modification efforts. The industry is identifying more efficient ways to modify loans in the current environment.

2) **Servicers face many disincentives to modify mortgages under the typical PSA. Our proposal substantially improves incentives for servicers to pursue successful loan modifications.**

   a) Loan modifications typically cost more than servicers are paid to pursue a modification. Third-party servicers have strong economic incentives to push borrowers into foreclosure rather than pursue substantial mortgage modifications. A loan modification may cost the servicer as much as $750 to $1,000 (see Mason). If the modification is successful, the servicer receives the normal fee (0.25 percent per year) for keeping the loan in the portfolio. With much uncertainty about the likelihood of success, loan modification does not pay for many servicers. Earlier research shows that servicers respond to economic incentives in servicing commercial mortgages.[14]

   To make the above argument concrete, consider a seriously delinquent subprime loan with outstanding balance of $180,000. The servicer is facing a choice: start foreclosure, or offer a loan modification that reduces the loan balance by 20 percent to $144,000. Suppose that, with a modification, there is a 50 percent chance the modification will be successful and the borrower will resume paying. However, there is also a 50 percent chance that modification will fail and the servicer will need to pursue foreclosure 6 months later. The foreclosure process takes 18 months; recoveries in foreclosure are equal to 50 percent of the loan balance, here $90,000. Assume that the servicer receives its fee (.25%) on all outstanding loan balances until the foreclosure is complete, whether or not the borrower makes payments. Thus, if the balance is $180,000, the servicer's annual fee is .25% * $180,000 = $450. Assume, as well, that there is no discount rate (reasonable given that short-term interest rates are quite low) and that interest payments on the modified mortgage amount ($144,000) will at least cover the risk-adjusted rate of return for new investments.

[14] *See* Yingjin Gan and Christopher Mayer, "Agency Conflicts, Asset Substitution and Securitization," working paper (2007).

Investors would strongly prefer that the servicer try the modification. The expected value of recoveries is $124,000 with modification and $90,000 with foreclosure.[15]

Now consider a servicer who is choosing whether to implement a modification plan that costs $1,000 per modification. Without modification, the servicer will receive $675: the foreclosure process takes 18 months; during that time, the servicer will receive fees at the rate of $450 per year. Over 18 months, fees will total $675.

Modification will reduce the servicer's annual fee to $360 (0.25% * 144,000). If modification is unsuccessful, the servicer will lose $280: from the date of the modification through the end of the foreclosure process (24 months), it will receive fees equal to $720 ($360*24), but it will also spend $1,000 on modification. Thus, unsuccessful modification yields a net loss. On the other hand, if mortgage modification is successful, the servicer's payoff depends on the duration of the loan. The servicer will net $800 if the modified loan continues for 5 years (5 years of fees, or $1,800, offset against the $1,000 cost of modification). It will net $1,880 if it continues for 8 years.

Now compare modification to foreclosure. Foreclosure yields a certain payoff of $675. Modification yields a 50 percent chance of a $280 loss and a 50 percent chance of a gain that depends on how long the loan continues. Suppose the successfully modified loan will continue for five years. Then the servicer will not modify: the expected gain from modification is only $260: 50%*(-$280)+50%*(800). The servicer will only choose modification if the successfully modified loan will continue for nearly eight years or longer. Thus, the borrower must make payments according to the modification, without refinancing or defaulting, for almost 8 years for the servicer to break even, not at all a sure outcome. In addition, the servicer must cover the cost of modification up-front, while receiving the revenue well into the future, not a sure thing given the extent to which many servicers face appreciable funding and liquidity constraints. As a result many servicers decide to foreclose.

b) <u>If a mortgage goes to foreclosure, fees associated with foreclosure are reimbursed, providing financial benefits to servicers.</u> Servicers might contract out services that they would otherwise perform in order to obtain additional financial payments from a foreclosure. And these additional fees are senior to everything else, so they are sure to be paid. As well, servicers are paid their servicing fee based on the outstanding balance during the entire foreclosure process, which can last as long as a year or two. This is true even if the recovery from a foreclosure is expected to be much lower than the mortgage balance. Thus in most cases, the cost-benefit analysis clearly favors foreclosure over modification, even if successful modifications save investors tens of thousands of dollars.

c) <u>Under our proposal, incentives for servicers and investors are more closely aligned.</u> Servicers are paid an Incentive Fee only if the borrower makes his/her payments every month. Since servicers are paid a percentage of the monthly principle and interest payments, the servicer has an incentive to make those payments high enough to generate a good return to investors, but low enough to be affordable to borrowers. Incentive fees are not paid if the borrower stops paying or if the servicer begins the foreclosure process.

3) **Not all foreclosures can or should be stopped. Many loan modifications fail for good reasons. As many as 2/3 of Chapter 13 plans fail.**

[15] The investors receive 0.5*$144,000 + 0.5*$90,000= $124,000.

a) Many mortgages cannot be saved. Comments by lenders suggest that many defaulted mortgages are on properties that are owned by investors or households who have no reasonable way to make their payments. Unemployed households will not be able to make payments even with the most generous modification program. Under-reporting of second liens and investor-owned properties is rampant and makes many loans simply unsalvageable. These factors help explain the often high rate of failure for loan modifications, even those pursued by portfolio lenders.

b) About 2/3 of all Chapter 13 plans fail within 5 years.[16] While some argue that this is because mortgages cannot be restructured in Chapter 13, we know that loan modifications also fail frequently. We cannot realistically expect to help everyone under any plan.

4) **What are the problems with proposals to allow first liens to be stripped down in Chapter 13 bankruptcy?**

a) Moral Hazard: Bankruptcy reform might well appreciably reduce the incentive of many solvent borrowers to keep making their payments on mortgages. It is important to understand that while 3 million borrowers are 60 days or more delinquent, 52 million borrowers are current on their mortgages. We know that easier bankruptcy laws for credit cards have led to millions of bankruptcy filings. We will have a catastrophe if most borrowers get the idea that they do not have to pay their mortgages.

b) Bankruptcy reform may have the unintended effect of encouraging servicers to *push* borrowers to file for bankruptcy in order to renegotiate their mortgages. Under most Pooling and Servicing Agreements, servicers are not reimbursed for expenses incurred in renegotiating mortgages. But our read of PSAs suggests that servicers can be reimbursed for some fees in bankruptcy, just as they now are reimbursed for those fees in the foreclosure process. If this is true, servicers might prefer bankruptcy to straight loan modifications. In a bankruptcy case, servicers can contract out some services that they now perform in-house, reducing costs and collecting higher fees. As well, the bankruptcy process might provide a litigation safe harbor for investor suits that servicers are modifying too many loans or that servicers need to repurchase certain modified loans. This is opposite the claims by many bankruptcy proponents who argue that the threat of bankruptcy will force servicers to finally renegotiate outside of bankruptcy. It could be that servicers will only renegotiate in bankruptcy, forcing millions of borrower to have their credit ruined and pursue an expensive process in order to get a mortgage reduction.

c) Bankruptcy Code amendments will almost surely raise borrowing costs and lower available credit for housing to risky borrowers. Current proposals would amend Chapter 13 to permit mortgage strip down. Homeowners could use the Chapter 13 process to reduce their mortgage debt to the current value of their homes, as estimated by a bankruptcy judge. The judge would also be given authority to adjust the rate and term of the mortgage. Two recent papers show that this kind of reform—which imposes losses on lenders—reduces the credit available to homeowners, especially those with low credit scores. Karen Pence[17] studied state laws that increase foreclosure costs by forcing

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[16] Wenli Li, *What Do We Know About Chapter 13 Personal Bankruptcy Filings?*, Federal Reserve Bank of Philadelphia (Fourth Quarter 2007).

[17] See Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*," 88 Rev. Econ. & Stat. 177 (2006).

creditors to use costly judicial procedures. These procedures can generate costs equal to 10 percent of the loan balance. Pence compares mortgage markets in states with and without these costly foreclosure processes. She finds loan sizes are 3 to 7 percent smaller in states with the costly processes. This study offers strong evidence that credit is less accessible to potential homeowners when laws restrict lender recoveries. Similar evidence is provided by Adam Levitin and Joshua Goodman, who study mortgage markets during the late 1980s and early 1990s, when a number of bankruptcy courts permitted homeowners to strip-down mortgages in Chapter 13 bankruptcy.[18] Levitin and Goodman find that, within six months after courts permitted strip downs, loan-to-value ratios fell by nearly 2.8 percent among homeowners in the 80th percentile of the interest-rate distribution (see Table 4a). Among homeowners with interest rates at or below the median, mortgage rates rose between 0.15 and 0.27 percentage points within 6 months after courts permitted strip down (see Table 2a). The Levitin and Goodman evidence might well underestimate the effect of allowing strip down on credit availability. There was significant uncertainty, across judicial districts regarding the validity of court rulings permitting strip down. Lenders must have recognized a significant risk that courts or Congress might eventually clarify the law to allow prohibit strip down in all states (as the Supreme Court did in 1994). The Pence results, by contrast, are based on relatively stable differences in state laws and find larger impacts of reduced creditor rights on mortgage credit availability.

d) <u>While some proposals would place a limit on bankruptcy reform provisions, nothing prevents a future Congress from applying bankruptcy to additional cohorts of mortgages.</u> Once the precedent has been set, it is easier to apply the Bankruptcy Code to first lien mortgages in the future. By contrast, our legal proposal relies on a specific legal precedent that applies *only* in a major economic crisis (the precedent was set during the Great Depression). As a result, absent an economic crisis, the government would be unable to extend our proposal to modify contracts into the future. In that sense, our proposal is credibly tied to the economic crisis and not beyond.

e) <u>Bankruptcy reform applies a one-size-fits-all approach to all mortgages and home owners.</u> Some versions of the proposed legislation would limit modification to subprime and other "nontraditional" mortgages.[19] But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing losses to investors and default by homeowners. Bankruptcy reform would inhibit this kind of experimentation. Proposed legislation[20] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan.

   Bankruptcy modifications would only be available to Chapter 13 debtors "who, after allowance for expenses permitted by the [Bankruptcy Code's] means test ..., cannot

[18] Adam J. Levitin and Joshua Goodman, "<u>The Effect of Bankruptcy Strip-Down on Mortgage Markets,</u>" Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 1087816 (2008).

[19] *See* Senate Bill S. 2136, Helping Families Save Their Homes in Bankruptcy Act of 2008, § 101.

[20] *See, e.g.*, Senate Bill S. 2636, Foreclosure Prevention Act of 2008 (Feb. 13, 2008); Helping Families Save Their Homes in Bankruptcy Act of 2008 (July 29, 2008).

afford to" cure past defaults and continue paying the original mortgage debt.[21] Moreover, modification may be sensible even if a homeowner fails the Code's means test, which computes important "expenses" based on IRS standards, not the homeowner's actual history of expenses.[22] Likewise, modification may be sensible even if a loan does not qualify as "nontraditional." As Appendix 2 explains, a significant number of prime jumbo mortgages are likely to enter foreclosure during the next three years. Instead of fostering innovative and tailored modifications by servicers, as our proposal would, proposed bankruptcy reforms would encourage bankruptcy filings and produce loan modifications that impose excessive losses on investors and do too much or too little to minimize the risk of homeowner default.

f) The one-size-fits-all approach could be quite harmful to lenders, who have come up with other alternatives that may be equally or even more successful in reducing unnecessary foreclosures, but are less expensive to lenders. Forbearance is one such an alternative. The FDIC/Indy Mac program provides for reductions in both interest rates and forbearance on principal payments.[23] While there are some problems with the incentives in the FDIC/Indy Mac program that encourage borrowers to miss payments in order to qualify for a loan modification, this program can be rolled-out in a large enough scale to make a significant dent in foreclosures over a short period of time and thus has significant benefits. The recently announced effort by JP Morgan/Chase uses a similar strategy of loan forbearance. Many of the Bank of America and Citigroup modifications to subprime loans involve interest rate reductions rather than principal reductions. Fannie Mae and Freddie Mac have rolled out their own programs that do not rely on principal write-downs (bankruptcy reform would not only harm private lenders, but also government sponsored entities). Borrowers have little incentive to accept a lender's offer of forbearance (or interest-rate reduction) when they can go to court and have a judge strip-down their principal balance, leading to a permanent reduction in the amount of money they owe on their mortgage. When house prices rise, as they eventually will, strip-downs eliminate the possibility that a lender will ever recover its losses on borrowing. Thus borrowers have incentives to hold out for a better deal than they are likely to be currently offered, potentially delaying the resolution of housing problems for years.

5) **What is the FDIC proposal in more detail?**

a) The FDIC proposes paying servicers $1,000 for each loan re-worked under a systematic and sustainable loan modification program. The proposal describes a sustainable loan as a loan with a debt-to-income ratio of as low as 31% and documented income. The IndyMac model combines interest rate reductions, term length extensions, and principal forbearance to achieve lower monthly payments. Under this proposal, if a modified loan re-defaults, the government will share up to 50% of the losses from the re-default. The loss sharing guarantee takes effect only after the borrower has made six payments following modification, and ends eight years after the modification. Loan modifications are limited to owner-occupied properties. Modifications are structured so that the net present value of modification is greater than the net present value of foreclosure. Servicers must modify all loans that pass the NPV test, i.e. they cannot cherry-pick loans

[21] Sen. Rep. 110-514, p. 11 (Sept. 26, 2008).
[22] 11 U.S.C. § 707(b)(2)(A)(ii)(I).
[23] Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

to modify. For loans that currently have LTVs above 100%, government participation in loss sharing decreases as the LTV increases, such that first liens with over 150% LTV are not eligible for government loss sharing. Modifications that do not lower monthly payments by at least ten percent are also excluded from the loss sharing guarantee. Here is a link to the FDIC proposal: http://www.fdic.gov/consumers/loans/loanmod/.

6) **How does our proposal compare to the Hope for Homeowners Act?**

The Hope for Homeowners Act allows borrowers to refinance into 30-year fixed rate, federally insured mortgages. In exchange for the federal insurance guarantee, the lender must voluntarily reduce the outstanding loan balance on the existing mortgage to 96.5 percent of the home's current value. Subordinate lienholders are offered an immediate up-front payment for releasing their liens. Lenders are allowed to extend the term lengths of loans. All prepayment penalties and late fees must be waived. Eligible borrowers are restricted to borrowers with no secondary residences and whose monthly payments exceed 31 percent of their gross income. The borrower agrees to pay an upfront insurance fee and a monthly insurance fee. In addition, the borrower must share both the equity created at the beginning of the new mortgage and the equity created from future house price appreciation with the FHA. http://www.hud.gov/hopeforhomeowners/index.cfm

a) Our proposal is more flexible, and less costly to taxpayers. Our proposal imposes no mandatory write-down in loan balances. Servicers are given incentives to choose the optimal form of modification—write-down, adjustment in interest rate, forbearance—that avoids foreclosure at the lowest cost to investors. In addition, Congress authorized the Federal Housing Administration (FHA) to insure up to $300 billion of new loans. Very few loans have been guaranteed to date, suggesting the Hope for Homeowners Act is having little impact.[24] But even if the cost of this program is only 5% of the authorized amount, it will be more costly than our proposal, which may avert nearly 1 million foreclosures at a cost of $9 billion.

[24] "HUD Chief Calls Aid on Mortgages A Failure," *Wash. Post.* A01 (Dec. 17, 2008).

APPENDIX 2: Our Servicing Incentive Fee Proposal and Cost-Benefit Analysis

We believe that servicers need greater resources and stronger incentives to modify loans. Current incentive fees for servicers of securitized loans are simply insufficient (see Appendix 1) to encourage mortgage modifications even if the legal barriers to do so are removed (See Appendix 3).

The Servicing Incentive Fee Proposal

Under our proposal, servicers of securitized loans will be paid a servicing Incentive Fee equal to 10% of monthly mortgage payments, capped at $60 per loan. This additional incentive should remain in place for a period of three years to allow markets to recover. After that time, the bulk of all loans will be performing, and thus require little incentive to re-work, or they will have been modified or gone through foreclosure. The Incentive Fees would apply only to securitized mortgages that were below the conforming loan limit in the year in which those mortgages were originated.

Our estimates, based on industry studies, suggest that this additional Incentive Fee (capped at a maximum of $720 per year per loan) combined with standard servicing fees already in place (0.20 to 0.375 percent of the outstanding balance annually) would provide proper incentives for mortgage modifications. By increasing servicers' fees, we reward successful modifications. Unlike normal servicing fees, which are based on a percentage of outstanding mortgage balances, the Incentive Fees are paid only when servicers obtain payments from borrowers. This program discourages unsuccessful modifications, which result in a quick re-default, because servicers receive no payments when the borrower stops paying. On the other hand, simply paying servicers to pursue modification may create a perverse incentive to reduce future borrower payments to a very low level, harming investors. Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification.

We exclude jumbo mortgages from Incentive Fees because these loans have very high average loan balances, typically exceeding $500,000. The average annual fees generated by these mortgages, typically exceeding $1,250, are more than enough to justify substantial effort by servicers to modify troubled loans. Servicers of jumbo loans would, however, still see substantial legal relief from the next part of our proposal, described in Appendix 3.

Cost-Benefit Analysis

According to Loan Performance, about 2.8 million securitized subprime mortgages were outstanding as of October 2008. We assume 25% of these will default over the course of 2009, then 15% in 2010, and then 10% in 2011, absent substantial changes in mortgage modifications. About 2.2 million securitized Alt-A mortgages were outstanding in October 2008.[25] We assume that about 16 percent of these will go into foreclosure in each of the next three years, if substantial mortgage modifications are not undertaken. Finally, about 1.5 million prime jumbo mortgages are outstanding as of October 2008 according to Braddock Financial data. We assume that about 4% of these will go into foreclosure in each of the next three years. These estimates are consistent with other recent studies of foreclosure likelihoods for these mortgage populations.

[25] *See* Federal Reserve Bank of New York, Credit Conditions in the United States.

For our simulations, we assume that mortgage modifications by servicers under our plan will have the same success rate as mortgage modifications by portfolio lenders. Following Piskorski, Seru, and Vig (2008), this implies a reduced foreclosure rate of between 20-30% for subprime loans, 30-40% for Alt-A loans, and 40-50% for prime, jumbo mortgages.

We begin by examining subprime and Alt-A securitized mortgages, the bulk of which would be eligible for Incentive Fees under our modification program. If we assume an improved modification success rate of 30% for subprime mortgages, the servicing Incentive Fees would total $4.8 billion over three years and would prevent more than 420,000 foreclosures in that same three year period. With an Alt-A success rate of 40%, Incentive Fees would total $4 billion over three years and save 440,000 alt-A foreclosures. So, for the riskiest pools of mortgages, Incentive Fees would total $9 billion and save nearly 900,000 foreclosures, a cost of about $10,000 per foreclosure saved. Assuming a lower modification success rate of 20% and 30% for subprime and Alt-A loans, respectively, 600,000 foreclosures could be prevented at a total cost of around $8.6 billion, a cost of $14,500 per foreclosure saved.

Our plan will also affect the incentives of prime jumbo servicers, even though they will not receive incentive payments. Our plan removes legal barriers that prevent these servicers from pursing modifications. Up to 12 percent of prime jumbo loans could face foreclosure during the next three years. Our plan could avert 72,000 to 90,000 of these foreclosures (a 40-50 percent reduction in foreclosures) by allowing servicers to use the same types of modification programs for securitized loans as are currently being used by portfolio lenders.

Thus, our program could save up to a million foreclosures by addressing incentive problems for securitized loans, a 35 percent reduction.

These calculations are only approximations. We have assumed that the servicing Incentive Fee for every non-delinquent, non-foreclosed loan will equal the maximum possible fee, $720 per loan per year. The actual fee paid will likely be lower. Some modifications will reduce monthly mortgage payments to a level that entitles the servicer to less than the maximum fee. On the other hand, we assume no refinancings or prepayments that would generate a one-time payment equal to 12 times the previous month's Incentive Fee. We expect some refinancings and short sales in the pool. Also some of the loans we consider have balances above the conforming limit; they would not qualify for the program. Nonetheless, the total cost of our Incentive Fee program can be no more than $11 billion, which is the maximum servicing Incentive Fee for 3 years for all currently outstanding non-agency loans in question. Thus, the cost to taxpayers through TARP would be modest.

Our calculations rely on the Piskorski et. al. (2008) study, which uses data ending in March 2008. Without post-2008 data we do not know whether foreclosures that have been prevented thus far might yet occur in the future. This raises the possibility that we have *overestimated* the potential reduction in foreclosures. On the other hand, that study examines a period during which portfolio lenders used a relatively limited set of tools for modifying loans. They rarely relied on forbearance, forgiveness, and other tools that are increasingly used today. This raises the possibility that we have *underestimated* the potential reduction in foreclosures.

APPENDIX 3: Our Legislative Proposal and Constitutional Analysis[26]

Legislators and commentators have assumed that Bankruptcy Code amendments are the only constitutional tools available to Congress as it tries to mitigate the foreclosure crisis. We do not agree. We believe that Congress has authority, under the Commerce and Spending Clauses, to modify the terms of securitization contracts and give mortgage servicers greater discretion to pursue modification in lieu of foreclosure. Using this authority, Congress has the opportunity to craft a far more targeted solution to the current crisis than is possible through Bankruptcy Code amendments.

In 1933, at the height of the Great Depression, Minnesota imposed a moratorium on foreclosures. As long as a homeowner made monthly payments equal to the rental value of the home, a lender was forbidden from forcing a sale of the home. This legislation was temporary, designed to mitigate an economic crisis, and upheld by the United States Supreme Court.[27] Today, in the context of another economic crisis, we propose another temporary program to moderate an avalanche of foreclosures. We propose federal legislation that gives third-party mortgage servicers (a) discretion to choose between loan modification and foreclosure when a mortgage nears or enters default (our legislative proposal) and (b) strong incentives to select modification when it will yield greater recovery to investors, as a group, than foreclosure (our incentive proposal). Our proposals do not impose a significant burden on the U.S. Treasury. Nor do they burden credit markets, as Bankruptcy Code amendments would. Nor do they raise constitutional concerns, as we discuss below.

Appendix 2 discusses our incentive proposal. The constitutionality of this proposal is straightforward. First, the Commerce Clause[28] authorizes Congress to regulate markets that cross state lines or have a significant impact on interstate commerce.[29] The mortgage securitization market, without doubt, satisfies these criteria. Second, the Spending Clause[30] authorizes Congress to allocate federal funds for public purposes and to condition those funds on particular conduct.[31] Our incentive proposal allocates federal TARP funds to servicers if they avoid foreclosure.

Our legislative proposal is somewhat more complex. This Appendix describes the proposal in detail and justifies its constitutionality.

The Legislative Proposal

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[26] This proposal was vetted by constitutional law scholars at Columbia Law School, the University of Chicago Law School, and Yale Law School. We are grateful for their assistance.
[27] *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).
[28] U.S. Const. Art. I, § 8, cl. 3.
[29] *Perez v. United States*, 402 U.S. 146 (1971) ("The Commerce Clause reaches, in the main, three categories of problems. First, the use of channels of interstate or foreign commerce which Congress deems are being misused .... Second, protection of the instrumentalities of interstate commerce .... Third, those activities affecting commerce. It is with this last category that we are here concerned.").
[30] Art. I, § 8, cl. 1.
[31] *Buckley v. Valeo*, 424 U.S. 1, 90-92 (1976); *South Dakota v. Dole*, 483 U.S. 203, 206-07 (1987) ("The Constitution empowers Congress to 'lay and collect Taxes, Duties, Imposts, and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States.' Art. I, § 8, cl. 1. Incident to this power, Congress may attach conditions on the receipt of federal funds, and has repeatedly employed the power 'to further broad policy objectives by conditioning receipt of federal moneys upon compliance by the recipient with federal statutory and administrative directives.'");

Our legislative proposal will modify existing pooling and servicing agreements (PSAs). The proposal has three elements. Specific legislation appears at the end of this Appendix.

First, we propose legislation that *temporarily* suspends PSA clauses that limit loan modification. These clauses include outright prohibitions on modification, caps on the number of mortgages that can be modified (e.g., five percent of the pool), limits on the frequency of modifications (e.g., no more than once during a twelve month period), and limits on the range of permissible modifications (e.g., the modified interest rate cannot fall below a set floor). During the next three years—through calendar year 2011—mortgage servicers will be free to participate in our incentive program and modify mortgages, subject to the litigation safe harbor described below. By the end of 2011, we hope, the U.S. economy will have recovered, making our proposal unnecessary.

This legislation abrogates the terms of PSAs in order to facilitate loan modification and thereby increase payments to investors as a group. Most investors, therefore, will be benefited—not harmed—relative to their expected payoff from foreclosure. Some junior-tranche investors could be harmed, because they can expect coupon payments during a lengthy foreclosure process. Modification may eliminate these expected cash flow rights.

Although this effect raises no constitutional problems, and although policymakers could ignore the effect, our proposed legislation would provide compensation for aggrieved investors. This would be accomplished by empowering a federal agency—such as the Federal Housing Authority (FHA)—to administer a compensation program for aggrieved investors. After modification occurs, investors could file compensation claims with the agency. The investors would bear the burden of proof. The agency could accept, contest, or deny the claim, subject to judicial review. The agency's budget would be drawn from TARP funds.

It is important to emphasize, however, that an investor would be entitled to compensation only under three conditions: (i) legislation abrogated PSA provisions that explicitly limited loan modification, (ii) had these provisions not been abrogated, the loan would have gone to foreclosure, and (iii) the investor would have received greater cash flow from foreclosure than modification. Most PSAs do not include explicit limits on modification. Even when they do, the limits do not prevent all modifications. A servicer might implement the same modification whether or not legislation abrogates limits in the PSA. Thus, the FHA (or another agency) will likely make compensatory payments in a small minority of modifications.

Vesting a federal agency with authority to compensate aggrieved investors is attractive for two reasons. First, it ensures that our proposal does not systematically disadvantage any particular class of investors. Second, it places no burdens on servicers to estimate the losses to particular investors from modification. It would be complicated to assess these losses, and this complexity could greatly slow the process of resolving foreclosures. We believe that quick action to stop foreclosures would benefit the public interest.

Second, we propose a "litigation safe harbor" for servicers who participate in our program and modify mortgages. Currently, significant litigation risk attends any modification because the terms of PSAs are imprecise and subject to conflicting interpretations. It is unclear, for example, when a modification serves the "best interests" of the trust and whether the servicer must repurchase every mortgage that is modified.[32] Our proposal eliminates this uncertainty: A

[32] This latter issue is the subject of the Countrywide litigation. *See* Paul Jackson, "A Tale of Two Loan Modifications, As Investors Sue Countrywide," *Housing Wire* (Dec. 2, 2008).

servicer will avoid liability to investors if, at the time it performed the loan modification, it reasonably and in good faith believed that modification would increase the returns to investors as a group.

Investors will need information to assess whether a servicer's decisions are consistent with a reasonable, good-faith belief in the merits of modification. We therefore propose that servicers publish detailed, loan-level data on modifications and post-modification payments.

Third, we believe that costs of litigation should, in appropriate cases, be shifted to aggrieved investors. If an investor brings suit after a modification, but the participating servicer successfully invokes the modification safe harbor, the investor will bear all of the servicer's legal costs (including reasonable attorney fees and fees for expert witnesses). In this way, servicers can be confident that good-faith modifications will not increase the risk of costly litigation. This safe harbor will also be temporary and apply only to participating mortgage servicers who conduct modifications during the next three years (through the end of 2011).

Constitutional Analysis

Our legislative proposal uses federal legislation to regulate mortgage securitization contracts. Because the securitization market crosses state lines and, without doubt, has a major impact on interstate commerce, Congress has authority under the Commerce Clause to enact the proposed legislation. But because the legislation alters the terms of existing contracts (the PSAs), it raises other constitutional concerns. The most important is that our proposal violates the Takings[33] and Due Process[34] clauses of the Fifth Amendment, because it abrogates vested contractual rights.

The Takings Clause prohibits the federal government from taking private property for public use without just compensation. The Clause "is designed not to limit the governmental interference with property rights *per se*, but rather to secure *compensation* in the event of otherwise proper interference amounting to a taking."[35] Even assuming our legislative proposal amounts to a takings, it is not an unconstitutional takings because investors are compensated, in kind, for the legislative interference. Servicers will be given discretion to modify loans and incentive to do so only when it *improves* payments to investors as a group. Relative to foreclosure, modification will only increase expected returns to investors. Supreme Court cases make clear that no takings occurs when a government policy causes no monetary loss.[36] That will be the case for most investors here. Put differently, our Legislative Proposal makes securitized mortgages more valuable to investors. Although it impairs property rights, it impairs rights that are—in the current environment—*destroying* value.

To be sure, some investors may suffer a reduction in expected payoffs. This is most likely to be true for junior-tranche investors, who are often be entitled to a share of coupon payments during the foreclosure process, which can last eighteen months. Because it avoids the lengthy foreclosure process, loan modification will eliminate the investors' rights to coupon payments.

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[33] U.S. Const. Am. V ("... nor shall private property be taken for public use, without just compensation... .").
[34] U.S. Const. Am. V ("No person shall be ... deprived of ... property, without due process of law ... .").
[35] *Lingle v. Chevron U.S.A., Inc.*, 544 U.S. 528, 536-537 (2005), quoting *First English Evangelical Lutheran Church of Glendale v. County of Los Angeles*, 482 U.S. 304, 315 (1987)
[36] *Brown v. Legal Found. of Washington*, 538 US 216 (2003).

This deprivation, however, is not an unconstitutional takings. Investors are losing contractual rights—a share of coupon payments, set by contract—not real property rights. Different rules ("regulatory takings") apply to the former rights. Most importantly, with respect to our proposal, the Supreme Court has emphasized repeatedly that the subject matter of almost every contract is susceptible to government regulation. Therefore, any party to a contract is or should be aware that future government regulation could reduce the value of contractual rights.[37] Here, the securitization contracts give investors interests in mortgages. The market for mortgage loans, as noted above, is one that Congress can regulate. If the government uses regulation to take contractual rights for its own benefit, a taking issue could arise.[38] But that is not the case here: our proposal nullifies some contractual rights in order to avert premature foreclosures. The direct beneficiaries are homeowners, investors, and servicers, not the federal government.[39] Nonetheless, we propose compensation to aggrieved investors—with compensation delivered by an administrative agency—to eliminate lingering constitutional doubts, smooth the modification process, and ensure a quick resolution of the crisis.

For similar reasons, there is no violation of the Due Process Clause. The standard test for assessing the constitutionality of economic and social legislation—that it must bear a "rational relationship" to a legitimate governmental objective[40]—is notoriously lenient[41] and easily met here.[42] First, our proposal serves a legitimate state interest—minimizing the foreclosure crisis. Second, it is rational response to the crisis. Our proposal offers a temporary, incentive-based

[37] *See, e.g., Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1027-1028 (1992) ("And in the case of personal property, by reason of the State's traditionally high degree of control over commercial dealings, [the property owner] ought to be aware of the possibility that new regulation might even render his property economically worthless (at least if the property's only economically productive use is sale or manufacture for sale)."); *Connolly v. Pension Ben. Guar. Corp.*, 475 U.S. 211, 223-24 (1986), quoting *Norman v. Baltimore & Ohio R. Co.*, 294 U.S. 240, 307-308 (1935) ("Contracts, however express, cannot fetter the constitutional authority of Congress. Contracts may create rights of property, but when contracts deal with a subject matter which lies within the control of Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them.")

[38] *Connolly*, 475 U.S. at 224.

[39] Additionally, our legislative proposal would abrogate a relatively minor provision (the right to coupon payments during the foreclosure process) in contracts between securitization trusts and junior-tranche investors. Because our proposal does not destroy all of the investors' contractual rights, it is unlikely to be viewed as a taking. *See, e.g., Andrus v. Allard* 444 U.S. 51, 65-66 (1979) ("[T]he denial of one traditional property right does not always amount to a taking. At least where an owner possesses a full 'bundle' of property rights, the destruction of one 'strand' of the bundle is not a taking, because the aggregate must be viewed in its entirety."); *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 131 (1978) ("'Taking' jurisprudence does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated. In deciding whether a particular governmental action has effected a taking, this Court focuses rather both on the character of the action and on the nature and extent of the interference with rights in the parcel as a whole. . . .").

[40] *Village of Belle Terre v. Boraas*, 416 U.S. 1, 8 (1974). *See also General Motors Corp. v. Romein*, 503 U.S. 181, 191 (1992); *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 124-125 (1978).

[41] *Williamson v. Lee Optical*, 348 US 483, 487-88 (1955) ("It is enough that there is an evil at hand for correction, and that it might be thought that the particular legislative measure was a rational way to correct it.").

[42] *See also Lingle v. Chevron U.S.A., Inc.*, 544 U.S. at 542 ("[A] regulation that fails to serve any legitimate governmental objective may be so arbitrary or irrational that it runs afoul of the Due Process Clause," even if it survives scrutiny under the Takings Clause.).

program that encourages modifications that serve the best interests of investors. Although contract rights are curtailed, most investors will benefit. If they are harmed, our program offers compensation.

Finally, the Supreme Court has upheld various state statutes that have impaired existing contractual rights. Although these cases apply the Contracts Clause[43], which is inapplicable to federal legislation[44], they provide useful guidance. The Contracts Clause imposes more restrictive[45] constraints on state law than the Due Process Clause imposes on federal action. If our proposal would survive scrutiny under the Contract Clause, then, it raises no due process concerns.

In Contracts Clause cases, the Supreme Court has asked whether state legislation (i) surprises contractual parties, who reasonably expected to avoid state interference with their contractual rights, (ii) "rests on, and is prompted by, significant and legitimate state interests", and (iii) uses rational means to address the state interest.[46] Our proposal satisfies these inquiries. To be sure, when they agreed to the PSAs, investors probably did not anticipate the kind of legal intervention that we propose here. At the same time, however, they did not expect to avoid *any* legal intervention. The investors purchased securities, regulated by federal securities laws, which change frequently.

Even if legislation defeats the reasonable investment-backed expectations of investors, the Supreme Court has made clear that the legislation does not violate the Contracts Clause if it is motivated by "an important general social problem."[47] The interest here—avoiding a foreclosure crisis that threatens the nation's housing market—is undoubtedly a compelling social problem. And our proposal is a narrowly tailored program for mitigating that crisis. Limits on modification will be lifted, to permit modification; a litigation safe harbor will be available for good faith, reasonable modifications.

Indeed, our proposal is no more burdensome than the Minnesota foreclosure moratorium, which was challenged before the Supreme Court and withstood scrutiny under the Contracts Clause.[48] Like that moratorium, our proposal is a temporary measure to address a major economic crisis. That program applied to all homeowners and cut back the foreclosure rights of lenders for two years. Although lenders could reassert their rights after that period ended, the moratorium itself caused permanent injury to lenders. This effect was acknowledged by dissenting justices when the moratorium was reviewed by the Supreme Court: "[I]t cannot be foreseen what will happen to the property during that long period of time. The buildings may deteriorate in quality; the value of the property may fall to a sum far below the purchase price."[49]

[43] U.S. Const. Art. I, s 10, cl. 1 ("No State shall ... pass any ... Law impairing the Obligation of Contracts ....")

[44] *National R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe R.R.*, 470 U.S. 451, 472 (1985).

[45] *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733 (1984) ("We have never held, however, that the principles embodied in the Fifth Amendment's Due Process Clause are coextensive with prohibitions existing against state impairments of pre-existing contracts. ... Indeed, to the extent that recent decisions of the Court have addressed the issue, we have contrasted the limitations imposed on States by the Contract Clause with the less searching standards imposed on economic legislation by the Due Process Clauses.").

[46] *Energy Reserves Group v. Kansas Power & Light Co.*, 459 U.S. 400 (1983).

[47] *Id.*, at 412 n. 13.

[48] *Blaisdell*, 290 U.S. 398.

[49] *Id.*, at 481-82 (Sutherland, J., dissenting) ("Moreover, it cannot be foreseen what will happen to the

This permanent injury did not undermine the constitutional status of the moratorium because, according to a majority of the Supreme Court, the Minnesota statute was motivated by an economic emergency, designed to "protect the vital interests of the community"[50], and reasonably tailored (in duration and scope) to "the exigency which called it forth"[51], particularly because investors received some compensation (payments equal to the rental value of the home) during the moratorium.

Our proposal shares features in common with the Minnesota statute. Ours is motivated by an economic emergency—the same emergency motivating other historic legislation, such as the Emergency Economic Stabilization Act of 2008,[52] which created the TARP. Our proposal is designed to protect the "vital interests of the community." The current foreclosure crisis is destructive to communities, homeowners, and investors. And our proposal is tailored to "the exigency which called it forth." It is temporary: it creates a limited period (through 2011) during which mortgage servicers are given discretion to modify troubled mortgages and protected by a litigation safe harbor. Like the Minnesota statute, our proposal effectively compensates lenders for the abrogation of their contractual rights. While the Minnesota statute compensated lenders explicitly, our proposal offers in-kind compensation: Servicers will modify loans only when modification *improves* payoffs to investors as a group. They will not enjoy the protection of our safe harbor if they pursue modification without a reasonable, good-faith belief that modification will benefit investors. Although our proposal will permanently impair the rights of investors—because it allows servicers to modify loans even when PSAs would prohibit or limit it—this does not necessarily distinguish it from the Minnesota moratorium, which permanently impaired the rights of lenders.

Proposed Legislation

The elements of our legislative proposal could be implemented by an Act along the following lines. This draft legislation does not include provisions that establish a compensation fund for aggrieved investors. We anticipate that these provisions would be modeled on existing federal laws.[53]

1. **Definitions.**

(a) "Securitized Mortgages" means residential mortgages that have been pooled by a Securitization Vehicle.

(b) "Securitization Vehicle" means a trust, corporation, partnership, limited liability entity, special purpose entity, or other structure that—

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property during that long period of time. The buildings may deteriorate in quality; the value of the property may fall to a sum far below the purchase price; the financial needs of appellant may become so pressing as to render it urgently necessary that the property shall be sold for whatever it may bring.

"However these or other supposable contingencies may be, the statute denies appellant for a period of two years the ownership and possession of the property—an asset which, in any event, is of substantial character, and which possibly may turn out to be of great value. The statute, therefore, is not merely a modification of the remedy; it effects a material and injurious change in the obligation.").

[50] *Id.*, at 444.

[51] *Id.*, at 447.

[52] Pub. L. No. 110-343 (2008).

[53] *See, e.g.*, The Cerro Grande Fire Assistance Act, Pub. L. No. 106-246 § 101, 114 Stat. 511, 583-590 (2000).

(i) is the issuer, or is created by the issuer, of mortgage pass-through certificates, participation certificates, mortgage-backed securities, or other similar securities backed by a pool of assets that includes residential mortgage loans;

(ii) holds such loans; and

(iii) has not issued securities that are guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation Fannie Mae, or the Government National Mortgage Association.[54]

(c) "Servicer" means a servicer of Securitized Mortgages.

(d) "Eligible Servicer" means a servicer of pooled and securitized residential mortgages, all of which are eligible mortgages.

(e) "Eligible Mortgage" means a residential mortgage, the principal amount of which did not exceed the conforming loan size that was in existence at the time of origination for a comparable dwelling as established by the federal national mortgage association.

(f) ''Secretary'' means the Secretary of the Treasury.

(g) ''TARP Funds'' means funds authorized for payment pursuant to the Troubled Asset Relief Program of the Emergency Economic Stabilization Act of 2008.

(h) "Effective Term of the Act" means the period beginning on the effective date of this Act and ending on December 21, 2008.

(i) "Incentive Fee" means the monthly payment to Eligible Servicers as determined in Section 3(a).

(j) "Prepayment Fee" means the payment to Eligible Servicers as determined in Section 3(b).

2. **Authority**. The Secretary is authorized to use TARP Funds to make payments to Eligible Servicers on the terms and conditions set out in Section 3.

3. **Fees Paid to Eligible Servicers**. During the Effective Term of the Act, Eligible Servicers are entitled to monthly fee payments consistent with the following terms and conditions:

(a) For every mortgage that was not prepaid during a month, Eligible Servicers are entitled to an Incentive Fee equal to ten percent of mortgage payments received during that month, provided that the Incentive Fee does not exceed $60 per loan.

(b) For every mortgage that was prepaid during a month, Eligible Servicers will receive a one-time Prepayment Fee equal to 12 times the previous month's Incentive Fee.

4. **Safe Harbor.** Notwithstanding any other provision of law, and notwithstanding any investment contract between a Servicer and a Securitization Vehicle, a Servicer –

[54] With the exception of Section 1(b)(iii), our definition of "securitization vehicle" is borrowed from Senate Bill S. 2801, The Mortgage Enhancement and Modification Act of 2008 (April 2, 2008), and House Bill H.R. 5857, the Homeownership Protection and Housing Market Stabilization Act of 2008 (April 22, 2008).

(a) owes any duty to maximize the net present value of the pooled mortgages in the Securitization Vehicle to all investors and parties having a direct or indirect interest in such Vehicle, not to any individual party or group of parties; and

(b) shall be deemed to act in the best interests of all such investors and parties if the servicer agrees to or implements a modification, workout, or other loss mitigation plan for a residential mortgage or a class of residential mortgages that constitute a part or all of the pooled mortgages in such Securitization Vehicle, provided that any mortgage so modified meets the following criteria:

(i) Default on the payment of such mortgage has occurred or is reasonably foreseeable.

(ii) The property securing such mortgage is occupied by the mortgagor of such mortgage.

(iii) The servicer reasonably and in good faith believes that the anticipated recovery on the principal outstanding obligation of the mortgage under the modification or workout plan exceeds, on a net present value basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure.[55]

(c) shall not be obligated to repurchase loans from or otherwise make payments to the Securitization Vehicle on account of a modification, workout, or other loss mitigation plan that satisfies the conditions of Subsection 4(b).

(d) if it acts in a manner consistent with the duty set forth in subsections (a) and (b), shall not be liable for entering into a modification or workout plan to

(i) any person, based on that person's ownership of a residential mortgage loan or any interest in a pool of residential mortgage loans or in securities that distribute payments out of the principal, interest and other payments in loans on the pool;

(ii) any person who is obligated to make payments determined in reference to any loan or any interest referred to in paragraph (i); or

(iii) any person that insures any loan or any interest referred to in paragraph (i) under any law or regulation of the United States or any law or regulation of any State or political subdivision of any State.[56]

5. **Legal costs**. If an unsuccessful suit is brought by a person listed in Subsection 4(d), that person will bear the servicer's actual legal costs, including reasonable attorney fees and expert witness fees, incurred in good faith.

6. **Reporting requirements**.[57] Every Servicer shall report regularly, but not less frequently than monthly, to the Secretary on the extent and scope of the loss

[55] Sections 4(a) and 4(b) parallel the standard approved by Congress in the Hope for Homeowners Act of 2008, 15 U.S.C. § 1639.

[56] Section 4(d) draws on the safe harbor proposed by House Bill H.R. 5857, The Homeownership Protection and Housing Market Stabilization Act of 2008 (April 22, 2008).

[57] This section draws on reporting requirements proposed by Senate Bill S. 3686, The Foreclosure Diversion and Residential Mortgage Loan Modification Act (Sep. 17, 2008).

mitigation activities of the mortgage owner.

(a) The reports shall include—

(i) the number of residential mortgage loans receiving loss mitigation that have become performing loans;

(ii) the number of residential mortgage loans receiving loss mitigation that have proceeded to foreclosure;

(iii) the total number of foreclosures initiated during the reporting period;

(iv) data on loss mitigation activities disaggregated to reflect whether the loss mitigation was—

(I) waiver of any late payment charge, penalty interest, or any other fees or charges, or any combination thereof;

(II) establishment of a repayment plan under which the homeowner resumes regularly scheduled payments and pays additional amounts at scheduled intervals to cure the delinquency;

(III) forbearance under the loan that provides for a temporary reduction in or cessation of monthly payments followed by a reamortization of the amounts due under the loan, including arrearage, and a new schedule of repayment amounts;

(IV) waiver, modification, or variation of any material term of the loan, including short-term, long-term, or life-of-loan modification that changes the interest rate, forgives the payment of principal or interest, or extends the final maturity date of the loan;

(V) short refinancing of the loan consisting of acceptance of payment from or on behalf of the homeowner of an amount less than the amount alleged to be due and owing under the loan, including principal, interest, and fees, in full satisfaction of the obligation under such loan and as part of a refinance transaction in which the property is intended to remain the principal residence of the homeowner;

(VI) acquisition of the property by the owner or servicer by deed in lieu of foreclosure;

(VII) short sale of the principal residence that is subject to the lien securing the loan;

(VIII) assumption of the homeowner's obligation under the loan by a third party;

(IX) cancellation or postponement of a foreclosure sale to allow the homeowner additional time to sell the property; or

(X) any other loss mitigation activity not covered; and

(v) such other information as the Secretary determines to be relevant.

(b) After removing information that would compromise the privacy interests of mortgagors, the Secretary make public the reports required by this Section.

7. **Sunset**. This Act shall sunset December 31, 2011.

APPENDIX 4: Cost of Potential Compensation to Junior Investors

Our proposal includes compensation for investors who (a) are parties to PSAs that explicitly limit modification and (b) suffer losses, relative to foreclosure, as a result of modifications that are permitted by our Legislative Proposal but barred by the original terms of the PSAs. The compensation, we believe, should be paid using TARP funds. The aggregate cost of compensation can be estimated as follows.

As of October 2008, there were about $1.52 trillion worth of outstanding privately securitized mortgages of which about $900 billion were subprime and alt-A and $620 billion were prime/jumbo mortgages. Among these securitized mortgages, about one third of the PSAs include explicit limits on modification.[58] The average interest rate on these mortgages, we assume, is about 7 percent for subprime and alt-A and 6 percent for prime. We assume that modification will affect junior investors who are, on average, entitled to 5 percent of interest payments from the subprime and alt-A mortgage pools and up to 1 percent from prime pools. We believe these numbers are reasonable in light of initial subordination levels and the recent wave of foreclosures, which has eliminated many junior positions. The smaller impact of mortgage modifications on junior positions in prime pools is motivated by the much lower subordination levels for these mortgages and smaller number of potential modifications. Loan modification will prevent these investors from receiving their respective percent share of up to 18 months of interest payments, which they would have received if the loan had gone through foreclosure.

Based on these assumptions, the total cost of compensating junior investors is $1.7 billion (equal to 0.011% of $1.5 trillion). These calculations may well overstate the actual cost because it assumes that junior investors lose 18 months of cash flow, but the number of months will be much smaller in many jurisdictions. Additionally, some securities might be pass through, eliminating the need to compensate junior holders, and the limits in some PSAs may not prevent optimal modification, in which case modification will not harm junior investors (relative to what they expected under the terms of the contract).

Our compensation amounts are low because the alternative that investors face is foreclosure. Some investors are claiming much higher levels of compensation than a few billion dollars. How do they get those much higher damage amounts? One argument made by investors is that there are clauses in the PSAs that require loans to be bought out of the trusts at par if they are modified. However, without this legislation, the value of those loans is not par, but it is the value of the loans in a foreclosure because servicers would not choose to modify mortgages under the existing PSAs. Thus our view is that compensation should be based on the entirety of our proposal, versus what would happen without our proposal (status quo).

For the 1/3 of PSAs that place appreciable limits on modifications, our proposal would eliminate those limits. However, at most, compensation would only be due to investors whose economic interests were harmed. The proposal gives a safe harbor for modifications that increase returns to investors as a group. The only investors who would be harmed is a small group of mezzanine investors who might lose some cash flow they would otherwise have received during the foreclosure process before their tranches were wiped out altogether. We propose to compensate those investors whose economic interests have been harmed with TARP money.

[58] *See, e.g.*, Credit Suisse, "The Day After Tomorrow: Payment Shock and Loan Modifications" (2007).

However, that compensation amounts to less than $2 billion, a relatively small sum given the large number of foreclosures prevented.

For the roughly 2/3 of PSAs that suggest that servicers operate "in the best interests of the trust," our proposal really just clarifies that the interpretation of that clause should refer to investors as a group. For those trusts, we do not see compensation as being necessary. The modifications allowed would increase returns to the trust as a whole. However, even if we did provide compensation for these trusts as well, the amount involved would be small—probably 2 times our estimate above, or $4 billion.

Adding the $1.7 billion cost of this adjustment, our proposal will cost around $10.7 billion and prevent nearly one million foreclosures.

Draft 3: January 25, 2009

A New Proposal to Compensate Second Lien Holders
by Christopher Mayer, Edward Morrison, and Tomasz Piskorski*

Second liens can be a barrier to successful modifications of first mortgages. Modification of the first mortgage might yield greater recovery to first mortgage lenders than a foreclosure. But there is little incentive to modify the first mortgage unless second lien lenders agree to relinquish their claims. Otherwise, a modification of the first mortgage will just allow the borrower to allocate more of her income to the second lien.

Even if the first mortgage exceeds the home's expected foreclosure value—implying zero recovery to the second lien lenders in foreclosure—the second lien servicer has little incentive to agree to a modification that extinguishes the second lien. As long as there is some uncertainty surrounding foreclosure value, no matter how small, the servicer will prefer foreclosure to loan modification. The former offers a slight chance of recovery to second lien lenders; the latter offers no recovery. Additionally, terms of pooling and servicing agreements might prevent the second lien servicer from agreeing to any modification that extinguishes the lien. As well, by delaying and appearing obstinate, the second lien lender might convince the first mortgage servicer to "buy out" the second lien at a price above its true value. This is often called a "hold-up" problem.

We propose that Congress create incentives for second lien servicers to cooperate with first mortgage servicers. Our proposal has two elements—(1) an Incentive Fee and (2) a Legislative Proposal.

Incentive Fee. We propose compensating second lien lenders who voluntarily surrender their mortgages in order to permit modification by first mortgage servicers. If a first mortgage servicer proposes a loan modification and, in response, the second lien servicer relinquishes its claims against the home and the borrower, the second lien lender will receive payment equal to five percent of the outstanding second lien balance, with payment not to exceed $1,500 per property. If multiple second liens exist, this payment will be split between the liens. This compensation can be paid using TARP funds.

In order to limit taxpayer costs, and focus primarily on foreclosure prevention, the Incentive Fee will be available only to a second lien lender that relinquishes its claims in response to a decision by a first mortgage servicer to conduct a significant modification of the primary mortgage. By significant, we mean a modification that reduces the borrower's monthly payments by at least 10 percent. This program will only apply to primary residences. As well, compensation will be available only when the first and

* Mayer- Senior Vice Dean and Paul Milstein Professor of Real Estate, Columbia Business School; Morrison- Professor of Law, Columbia Law School; Piskorski- Assistant Professor, Columbia Business School. Rembrandt Koning, Benjamin Lockwood, Bryan McArdle, Ira Yeung and Michael Tannenbaum for excellent research assistance. The authors alone take responsibility for this proposal and any errors or omissions therein.

second liens are held by different lenders. Finally, our proposal will apply to all second liens, because the hold-up problem applies beyond just privately securitized mortgages.

The cost of the Incentive Fee will be approximately $1.65 billion. As with our other proposal, the cost of this plan is quite moderate compared to the possible expenditure of $50 to $100 billion to reduce foreclosures. We compute the cost of compensation as follows. Using deeds records, we estimate that about 13.3 million homes are subject to both first mortgages and second liens as of October 2008. Among these homes, 8.9 million homes have loan-to-value ratios exceeding 92 percent. (In our calculations, we assume a loan-to-value ratio equal to 92 percent; this allows for future house price declines of 8 percent or more.) When the loan-to-value ratio is only 92 percent, a second lien lender is unlikely to agree to relinquish its claim, for obvious reasons. We assume that around one-quarter of these mortgages are at risk of foreclosure. Among those, modification might make sense half of the time. Thus about 1.1 million second lien mortgages might require compensation for the relinquishment of their rights. If all second lien holders agree to relinquish their rights, the total cost of compensating them will be no more than $1.65 billon.

Legislative Proposal. Our proposal gives second lien servicers sole authority to decide whether to surrender the lien in exchange for the Incentive Fee. Because this authority may be inconsistent with the terms of pooling and servicing agreements (PSAs), we propose that Congress enact a "litigation safe harbor" that insulates servicers from litigation, provided they surrender second liens only when they have a reasonable, good faith belief that the Incentive Fee will increase the recovery to investors, as a group, relative to foreclosure. This safe harbor will be an affirmative defense, which servicers can assert in the event of litigation, regardless of the actual terms of the PSAs. Judges will evaluate whether the servicer held a reasonable, good faith belief that the Incentive Fee would increase recoveries to investors, not on evidence that investors were in fact made better off. If investors bring suit, but a servicer successfully invokes the safe harbor, the plaintiff investors will pay the servicer's actual legal costs, including attorney and expert-witness fees.

This Legislative Proposal is constitutional for the same reasons that our Loan Modification Proposal is constitutional (see Appendix 3 of that proposal). Central to our constitutional analysis is the observation that, although our proposal abrogates terms of existing contracts, it does so in order to *improve* investor recoveries.

Additionally, the Incentive Fee and Legislative Proposal should be temporary measures to address the current foreclosure crisis. We propose that Congress terminate these measures at the end of calendar year 2011, by which time the current crisis should have moderated.

Together, the Incentive Fee and Legislative Proposal will help align the interests of first and second lien lenders. The Incentive Fee gives second lien lenders a financial incentive to cooperate with first mortgage servicers when they pursue loan modification. Because second lien lenders are widely dispersed and face barriers to cooperation, the Legislative Proposal empowers second lien servicers to act on their behalf. These servicers will respond to financial incentive created by the Incentive Fee only when it is in the best interests of second lien investors.

Draft 3: January 25, 2009

The Legislative Proposal could be implemented by legislation along the following lines:

1. **Definitions.**

(a) "First Mortgage" means a first-priority, senior mortgage on owner-occupied housing.

(b) "Subordinate Lien" means a subordinate lien on owner-occupied housing.

(c) "Modification" means a permanent change to the terms of a First Mortgage—including reduction in interest rates and fees, term or amortization extensions, forbearance or forgiveness of principal, or other similar changes—that reduces the borrower's monthly payments by at least ten percent.

(d) "Securitized First Mortgages" means First Mortgages that have been pooled by a Securitization Vehicle.

(e) "Securitized Subordinate Liens" means Subordinate Liens that have been pooled by a Securitization Vehicle.

(f) "Securitization Vehicle" means a trust, corporation, partnership, limited liability entity, special purpose entity, or other structure that—

(i) is the issuer, or is created by the issuer, of mortgage pass-through certificates, participation certificates, mortgage-backed securities, or other similar securities backed by a pool of assets that includes residential mortgage loans;

(ii) holds such loans; and

(iii) has not issued securities that are guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation Fannie Mae, or the Government National Mortgage Association.

(g) "First Lien Servicer" means a servicer of First Mortgages, including Securitized First Mortgages.

(h) "Subordinate Lien Servicer" means a servicer of Subordinate Liens, including Securitized Subordinate Liens.

(i) "Incentive Fee" means payment equal to five percent of the outstanding balance of a Subordinate Lien that is surrendered to the mortgagor pursuant to the Incentive Fee Program, defined in Section 3.

(j) ''Secretary'' means the Secretary of the Treasury.

(k) ''TARP Funds'' means funds authorized for payment pursuant to the Troubled Asset Relief Program of the Emergency Economic Stabilization Act of 2008.

(l) "Effective Term of the Act" means the period beginning on the effective date of this Act and ending on December 31, 2011.

2. **Authority**. The Secretary is authorized to use TARP Funds to make payments to Eligible Servicers on the terms and conditions set out in Section 3.

3. **Incentive Fee Program**. During the Effective Term of the Act, a

Subordinate Lien Servicer is entitled to the Incentive Fee, not to exceed $1,500, for every Subordinate Lien that is surrendered to the mortgagor, provided that

(a) the borrower's personal liability under the Subordinate Lien is extinguished,

(b) the Subordinate Lien Servicer submits proof that the First Mortgage underwent Modification immediately before or after the Subordinate Lien was surrendered, and

(c) the Second Lien Servicer is a different entity from the First Mortgage Servicer.

4. **Multiple Subordinate Liens**. If more than one Subordinate Lien encumbers the same property, each Subordinate Lien Servicer may participate in the Incentive Fee Program, but total payments to the Subordinate Lien Servicers may not exceed $1,500.

5. **Safe Harbor.** Notwithstanding any other provision of law, and notwithstanding any investment contract between a Subordinate Lien Servicer and a Securitization Vehicle, a Subordinate Lien Servicer –

(a) owes any duty to maximize the net present value of the pooled mortgages in the Securitization Vehicle to all investors and parties having a direct or indirect interest in such Vehicle, not to any individual party or group of parties; and

(b) shall be deemed to act in the best interests of all such investors and parties if the Subordinate Lien Servicer participates in the Incentive Fee Program, provided the Subordinate Lien Servicer reasonably and in good faith believes that the anticipated recovery under the Incentive Fee Program exceeds, on a net present value basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure.

(c) if it acts in a manner consistent with the duty set forth in subsections (a) and (b), shall not be liable for entering into a modification or workout plan to

(i) any person, based on that person's ownership of a residential mortgage loan or any interest in a pool of residential mortgage loans or in securities that distribute payments out of the principal, interest and other payments in loans on the pool;

(ii) any person who is obligated to make payments determined in reference to any loan or any interest referred to in paragraph (i); or

(iii) any person that insures any loan or any interest referred to in paragraph (i) under any law or regulation of the United States or any law or regulation of any State or political subdivision of any State.

6. **Legal costs**. If an unsuccessful suit is brought by a person listed in Subsection 4(c), that person will bear the servicer's actual legal costs, including reasonable attorney fees and expert witness fees, incurred in good faith.

7. **Sunset**. This Act shall sunset December 31, 2011.

Testimony of Robin P. Staudt

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I appreciate the opportunity to testify before you today. I am Robin P. Staudt currently residing in Orange County, NC. This region is farm country on the edge of what used to be small town America but now abuts the Raleigh, Durham, Chapel Hill Triangle. I was raised near Pittsburgh, Pa so I have a bit of a city perspective as well.

As a private citizen I am honored to have this opportunity to speak to this committee. I'm a homeowner, that is the bank along with my husband and my self own my home. I'm a mortgage holder in good standing and working hard to pay down my debt. My family is, as are many other families are experiencing the pressures of this economic crisis and we are radically altering our lives and lifestyles.

Due to this present economic crisis I am currently unemployed; laid off because of the housing construction downturn. With hope for a brighter future quickly fading I desire to see the government get out of the way and let the market work. As you know small businesses employ the majority of this nation's work force. Without drastic tax relief as well as some economic stimulation I fear that this government is selling our children's and grand-children's future to the altar of comfort and expediency.

Please indulge an average American citizen as I must clarify my remarks. I'm a second generation American whose grandmother taught her of the marvels of freedom and all the opportunities it brings. As well my mother and father taught me the value of hard work, honesty, and integrity with the reminder that pride goes before a fall. The constant lesson was that in America you can become anything you want because the government won't stand in your way. I believe that is no longer the case. Those lessons were learned before social engineers gained enough power to skew the outcome of society.

There was a time when having saved money and accrued interest over time one could contract with a local bank for a mortgage on a home helping to grow the neighboring economy. Generally a free market playing field, whether mortgage rates were high or low, the local bank had requirements for all borrowers which protected everyone's interest. The bank wanted to insure the client's ability to repay his debts and proving responsibility was necessary before entering into a contract. That was a somewhat level playing field even if more difficult to achieve the American dream of home ownership. It certainly was a more stable lending environment.

Recent history belies that stability. Government subsidies that "help" anyone and everyone gain entry into the housing market have certainly destabilized that market and hampered the "helping" hand. We now have skewed housing values that no longer represent real values within the housing industry allowing speculators to run artificially inflated housing values wherever possible. It seems the banks along with speculators were drunk with possible runaway profits. Now that the bubble has "burst" they're crying a different tune.

My family, as well as some of our friends have struggled to cope with high rents while trying to save for a home and having now purchased said home are dealing with almost yearly property tax increases, new zoning restrictions, and ever increasing insurance rates. But this was our choice, worked out responsibly with the bank that holds our mortgage.

My family taught me to save.... Just in case. You don't know what tomorrow may bring and you need to be prepared was the lesson. Frugality is NOT a dirty word. So we lived within our means and saved and now we're using that savings as sparingly as possible to stem the tide of this economic difficulty. We are being responsible.

I understand and empathize with those angry over the bailout, and the artificially inflated housing markets. To get an idea of what I mean it's easiest to visit the www.angryrenter.com website. It expresses many a struggling taxpayers' sentiments.

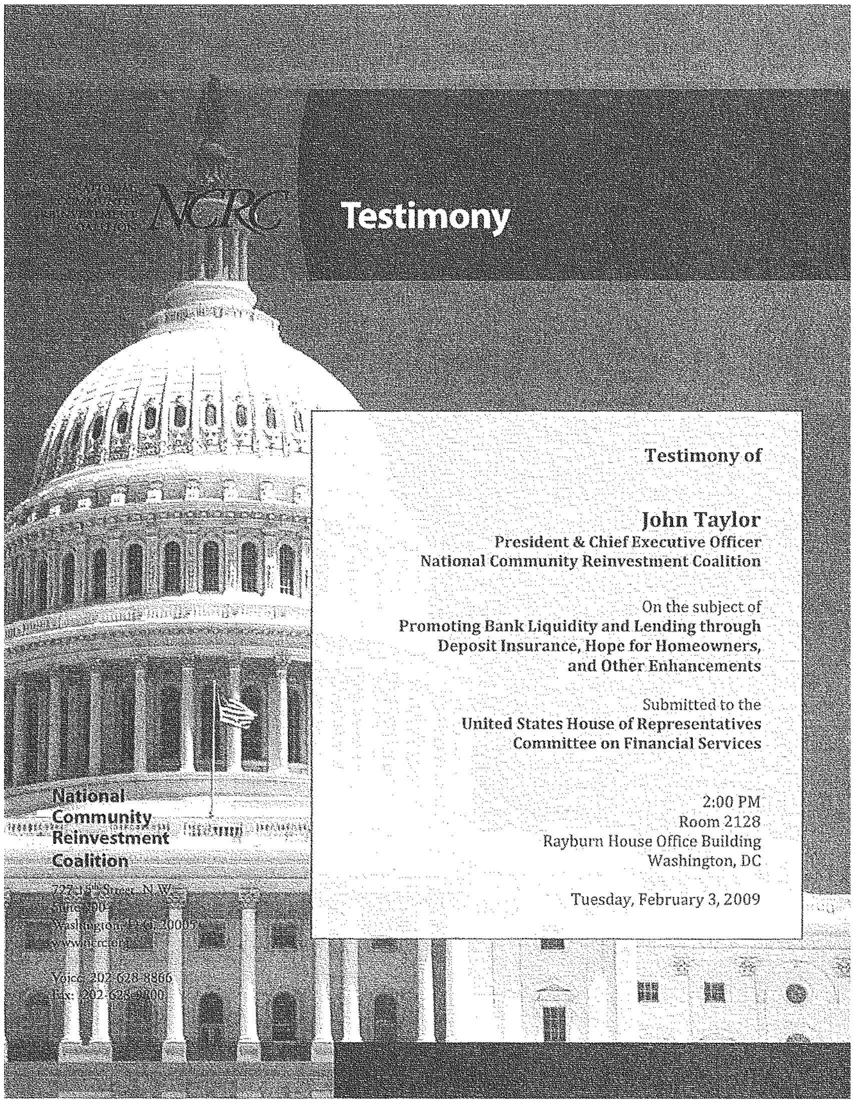
To speak to the failed bail-outs, instead of banks using bail-out money to infuse the country with economic help and stemming the tide of the mortgage crisis they've utilized these funds, our money, that is taxpayer's money to buy each other out. At the heart of our financial crisis is greed and it's greed on every level. Not only the purview of the rich, the poor are just as complicit in this whole debacle. Where is the responsibility and accountability? It's on the backs of the taxpayers, many of whom are not responsible for this bad behavior.

So now that we've radically altered our political climate ushering in an era of "change", what are we doing? How many times do we have to change a mortgage program that has helped less than thirty borrowers? In the 2008 presidential campaign, President Obama promised "to eliminate government programs that are not performing." Under his criteria HOPE for Homeowners should qualify as a program to be cut. Changes to Hope for Homeowners proposed in H.R.703 (if I understand it correctly) attempts to make H4H more attractive to borrowers and lenders. But it drops safeguards that were designed to protect taxpayers. H.R.703 strikes the payment of upfront premiums to FHA, reduces the annual premium, increases the ban-to-value ratios and (this really amazes me) it cancels the government's share of profits in case of long-term home price appreciation.

I certainly claim no expertise with any of the proposals before the committee. I bring only "common sense" and life experience to the table. In I Timothy 6:9-10 (NIV) People who want to get rich fall into temptation and a trap and into many foolish and harmful desires that plunge men into ruin and destruction. For the love of money is a root of all kids of evil,
In this country I often read and hear about the "greedy" big corporations and greedy rich people. There are just two things to say to this: 1) When did a poor person ever give a fulltime job to someone else? 2) Poor people can be just as greedy, if not more so, than rich people.

I believe, as well as others do, from a "common sense" perspective, CUT the capital gains tax to stimulate the economy; it has worked before; CUT spending and eliminate the waste and pandering, it has worked before; CUT the taxes of taxpayers so there is immediate monies to invest in market forces it has worked before. There's a saying that many of you serving on this committee may well be aware of: (paraphrased), The definition of insanity is to keep repeating the same behavior and expecting a different result.

I thank you all for your service to this committee and I most appreciate your time and hearing of an average taxpayer's testimony.


NCRC
Testimony
Testimony of
John Taylor
President & Chief Executive Officer
National Community Reinvestment Coalition
On the subject of
Promoting Bank Liquidity and Lending through
Deposit Insurance, Hope for Homeowners,
and Other Enhancements
Submitted to the
United States House of Representatives
Committee on Financial Services
2:00 PM
Room 2128
Rayburn House Office Building
Washington, DC
Tuesday, February 3, 2009
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I. Introduction

Good afternoon, Chairman Frank, ranking member Bachus, and other distinguished members of the Committee:

I am John Taylor, the president and chief executive officer at the National Community Reinvestment Coalition (NCRC). NCRC is an association of more than 600 community-based organizations that promotes access to basic banking services, including credit and savings, to create and sustain affordable housing, job development, and vibrant communities for America's working families.

I am honored to testify today on behalf of NCRC before the United States House of Representatives Committee on Financial Services regarding promoting bank liquidity and lending through deposit insurance, Hope for Homeowners, and other enhancements. Chairman Frank and members of the Committee, NCRC supports the introduction of H.R. 703. This legislation is a much-needed step in the right direction toward stemming the foreclosure crisis, stabilizing the financial system, and strengthening the overall economy.

II. The Foreclosure Cycle

Inadequate consumer protection, failed regulation, and lax oversight are the initial causes of the foreclosure crisis and allowed the introduction of predatory products and abusive practices in the credit and housing markets, especially pronounced in communities of color. The foreclosures that arose from predatory lending have not only severely undermined the financial stability of working families and communities but also are now weakening the credit markets and diminishing overall economic activity and performance. Massive foreclosures are spurring a self-reinforcing cycle of defaults, declines in home values, and rising unemployment. Widespread unemployment is accelerating the economic crisis, as evidenced in a recent report published by Credit Suisse. The study projects nine million foreclosures over the next four years, assuming an eight percent unemployment rate. Given the current unemployment rate of 7.5%, with a full 140,000 jobs lost last week alone, it seems certain that the US is on track for an eight percent unemployment rate.[1] While predatory and abusive lending drove foreclosures in the past, absent intervention, unemployment-driven foreclosures will be the catalyst spurring an economic crisis in the future larger in scale and magnitude than the current one.

III. Analysis of H.R. 703

The new and amended provisions in H.R. 703 are important measures toward stemming the foreclosure crisis, restoring bank liquidity, and rebuilding consumer confidence in the financial system and US economy.

i. Amendments to FDIC Insurance Provisions

The increase in FDIC insurance coverage from $100,000 to $250,000 will help stabilize banks by reducing the likelihood of a run on deposits. In addition, the increase in the FDIC borrowing authority from $30 billion to $100 billion will provide liquidity for the banking system and reassure investors that expanded FDIC insurance provisions will protect consumer investments and help prop up banks. These insurance provisions are particularly important in this market climate because deposits are now more valuable than in decades past. The "old fashioned bank" is now the model of choice.

[1] Credit Suisse. "*Foreclosure Update: over 8 million foreclosures expected.*" December 4, 2008.

ii. Amendments to the Hope for Homeowners Program

Amendments to the Hope for Homeowners (H4H) program will improve upon an initiative that is not reaching its intended goals. These amendments will make the program more attractive to consumers and increase its overall effectiveness as a meaningful foreclosure prevention program. The current H4H program is intended to assist distressed borrowers who face the prospect of defaulting on unaffordable mortgages. Under H4H, distressed borrowers can refinance into a home loan insured by the Federal Housing Administration (FHA). Initially, the Congressional Budget Office projected that the H4H program would assist up to 400,000 borrowers. However, since the program's inception last October, only 357 applications have been submitted.[2]

The proposed amendments in H.R. 703 will increase consumer demand for H4H by reducing its cost to consumers. In order to finance insurance, FHA charges H4H consumers an upfront premium (three percent) and an annual premium (1.5 percent of the remaining loan balance). When premiums become unaffordable, consumers are deterred from accepting FHA loans, which decreases the likelihood that lenders will offer FHA products. The proposed amendments would eliminate the upfront premium and reduce the annual premium to between .55 and .75 percent of the remaining loan balance. Moreover, the amendments would allow FHA to eliminate H4H annual premium payments once the borrower's equity reached levels consistent with standard FHA underwriting practices and products.

[2] Michael Corkery. "Mortgage 'Cram-Downs' Loom as Foreclosures Mount." *Wall Street Journal*. December 31, 2008.

Reduced equity-sharing with the federal government is another welcomed enhancement to H4H. Under the current program and depending on the circumstances, either all or half of the equity created as a result of a refinance into an H4H loan must be shared with the federal government. And, when a home purchased through an H4H loan is sold or the loan is refinanced, 50 percent of any future appreciation must be shared with the federal government. H.R. 703 would eliminate the future appreciation-sharing requirement and would preserve significant wealth-building opportunities for borrowers.

For example, if a house is currently appraised at $100,000 and a distressed borrower refinances into an H4H loan of $93,000, this refinance would result in a 93 percent loan-to-value ratio with a $7,000 gain in home equity, as provided by the H4H amendment in H.R. 703. If the borrower were to sell this house within one year, the borrower would have to pay the federal government the entire equity gain of $7,000 (since the federal government effectively paid the $7,000 down-payment for the borrower). Each year thereafter, the payment to the federal government would decline until year five, when the borrower would owe the federal government $3,500 or 50 percent of the $7,000 effective down-payment provided by the federal government for which the borrower would now be able to repay.

If in year five the house has appreciated to $135,000 and the borrower decides to sell the house, under the current H4H program, the borrower would have to share 50 percent ($17,500) of the future appreciation gain ($35,000) with the federal government. Under the proposed changes in H.R. 703, the borrower would not have to share any of the future appreciation gain.

iii. Safe Harbor Provision for Servicers

The safe harbor provision for servicers will increase the likelihood of meaningful loan modifications that will safeguard against lawsuits for servicers and offer monetary incentives. A current disincentive for servicers is that they are often more assured of payments if they proceed to foreclosure than if they modify loans.[3] HR 703 provides that a servicer would be protected from investor lawsuits if the servicer reasonably and in good faith believes that its loan modifications will exceed, on a net present value basis, the anticipated recovery of loan principal than can be achieved through foreclosure.[4] FDIC suggests that in many instances the net present value of loan modifications will exceed the value that can be recouped in foreclosure.[5] H.R. 703 provides servicers with a legal foundation and economic justification for enacting loan modifications, and also empowers the H4H program to offer payments to servicers for modifying loans.

IV. Broad-Scale Loan Modification Program Needed Now

While H.R. 703 is a step in the right direction, NCRC urges the Committee to consider a broad-scale loan modification program to supplement and expand the objectives of HR 703.

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[3] Alan White. "Paying (but not overpaying) the Servicers, memo appearing on Public Citizen's Consumer Law and Policy Blog." http://pubcit.typepad.com/clpblog/2008/11/paying-but-not.html. November 17, 2008.

[4] H.R. 703 also provides legal protection for servicers from consumer lawsuits contesting loan modifications. As we read the bill, NCRC interprets this provision as not providing legal protection for servicers for any abusive servicing practices prior to loan modifications nor any legal immunity for originators for abusive lending practices. This distinction should remain if H.R. 703 is enacted.

[5] http://www.fdic.gov/consumers/loans/loanmod/ and see Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Oversight of Implementation of the *Emergency Economic Stabilization Act of 2008* and of Government Lending and Insurance Facilities. U.S. House of Representatives Committee on Financial Services; Room 2128, Rayburn House Office Building, November 18, 2008. http://www.fdic.gov/news/news/speeches/chairman/spnov1808.html.

i. Homeowners Emergency Loan Program (HELP Now)

In January 2008, NCRC proposed the establishment of the broad-scale loan modification program Homeowners Emergency Loan Program (HELP Now). This program would authorize the Treasury Department to buy troubled loans at steep discounts (equivalent to roughly the current market value) from securitized pools. This would result in a relatively low cost to taxpayers. The government would then arrange for these loans to be modified through existing entities such as Fannie Mae and Freddie Mac, and then sell the modified loans back to the private market.

ii. Use the Authority of the Federal Government to Purchase Troubled Assets

Just a couple of weeks ago, I testified before you all and discussed how using the power of eminent domain would be an effective measure to require financial institutions to sell large volumes of distressed mortgages to the federal government under a program such as HELP Now. During that hearing, the point was raised that the federal government would need to preempt state law to accomplish this and that using the power of eminent domain posed a problem.

There are other approaches: For example, the federal government has the legal authority to alter and rewrite Mortgage Backed Securities (MBS) and other secondary market structures to accomplish meaningful loan modifications. Three Columbia University professors have recently asserted that the "Commerce Clause" and the "Spending Clause" of the Constitution allows the government to regulate interstate financial markets and spend federal funds for the public purpose of loan modifications. In addition, the professors maintain that the "Takings Clause" is not violated if investors and other financial institutions are compensated—as they would be under HELP Now, since the value of selling discounted loans to the federal government would exceed the value of foreclosure). Finally, the "Due Process Clause" is not violated if the government action has a legitimate objective, such as foreclosure prevention and a strengthened economy. To justify their approach, the professors cite the US Supreme Court's decision to uphold a foreclosure moratorium in Minnesota during the Great Depression and ruled that the state's action protected the vital interests of the community.[6]

Consistent with the views of the Columbia University professors, the *Emergency Economic Stabilization Act of 2008* (EESA) codifies the authority of the federal government to purchase and/or alter the terms and conditions of lending instruments. Title I of EESA authorizes the Treasury Secretary "to establish the Troubled Asset Relief Program (TARP) to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, *on such terms and conditions as are determined by the Secretary*, and in accordance with this Act and the policies and procedures developed and published by the Secretary."

While a broad-scale loan modification program and H.R. 703 will stem foreclosures, NCRC recommends that the Committee address the failed regulation, lax oversight, and lack of consumer protections that contributed to the current economic crisis.

NCRC urges the Committee to preserve, expand, and vigorously enforce the *Community Reinvestment Act* (CRA). CRA establishes an obligation for banks to serve the needs of all communities, particularly low- to moderate-income neighborhoods, consistent with safety and soundness. In order to build upon CRA's benefits and increase the safety and soundness of credit and capital, NCRC urges Congress to pass CRA modernization legislation—similar to the *CRA Modernization Act of 2007*—and the planned reintroduction of the *CRA Modernization Act*

[6] Christopher Mayer, Edward Morrison, and Tomasz Piskorski, *A New Proposal for Loan Modifications*, January 7, 2009, and see Testimony of Dr. Christopher J. Mayer before the House Committee on Financial Services Hearing: Priorities for the Next Administration: Use of TARP Funds under EESA January 13, 2009. http://www.house.gov/apps/list/hearing/financialsvcs_dem/mayer011309.pdf

of 2009 (to be sponsored by Representatives Eddie Bernice Johnson and Luis Gutierrez). The *CRA Modernization Act of 2009* would apply CRA to non-bank financial institutions, including mainstream credit unions, insurance companies, independent mortgage companies, and investment banks. Moreover, this legislation would strengthen CRA as applied to banks by enhancing publicly available data on lending activity, requiring CRA exams to consider lending to minorities, and ensuring that the great majority of bank lending activity is scrutinized.

NCRC also supports the enactment of comprehensive anti-predatory lending legislation that eliminates predatory and abusive lending practices. Hundreds of studies, legislative testimony, and print news stories document the predatory and abusive lending practices that led to millions of foreclosures across the country, but to date, nothing has been done to purge these practices from the housing and credit markets. H.R. 703 should be enacted with provisions for a broad-scale loan modification program, and comprehensive anti-predatory lending legislation that includes modernizing CRA and strengthening the safety and soundness requirements imposed by CRA to prevent another foreclosure crisis in the future.

V. Conclusion

H.R. 703 is a necessary measure to stem foreclosures and stabilize the financial markets. Failed regulation, lax oversight, and predatory lending led to millions of foreclosures that formed the epicenter of the current economic crisis. However, a broad-scale loan modification program such as HELP Now, regulatory reform to enhance consumer protection, and comprehensive anti-predatory lending legislation such as CRA modernization are also needed to break the cycle of foreclosures and mitigate its devastating contagion effects in working communities. The communities that suffer most are those that can afford it least. Communities hardest hit by the foreclosure crisis and widespread unemployment are communities that were especially vulnerable to predatory lending and market misbehavior. Therefore, we must restore the strength and stability of the US markets by restoring trust and integrity to the financial system. We can accomplish this by forever purging predatory and abusive practices in lending and promoting fairness and equality in the housing and credit markets. The markets are not self-correcting, and until integrity is restored and consumer confidence is reestablished, the national economy will become increasingly unhinged absent immediate intervention.

Thank you.

Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Committee on Financial Services

United States House of Representatives

AMERICAN
BANKERS
ASSOCIATION ®

Testimony of Edward L. Yingling

On Behalf of the American Bankers Association

Before the

Committee on Financial Services

United States House of Representatives

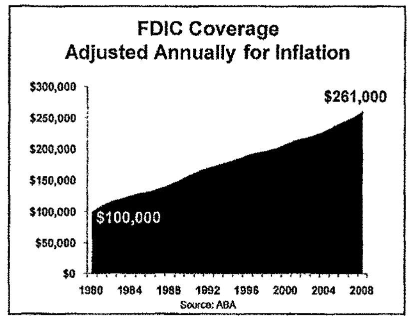
February 3, 2009

Chairman Frank and members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (ABA). ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.6 trillion in assets and employ over 2 million men and women.

We appreciate the opportunity to testify on H.R. 703, which is designed to promote bank liquidity and lending through changes to the deposit insurance coverage, improvements in the HOPE for Homeowners Program, and prompt availability of capital through the TARP's Capital Purchase Program for small community banks. ABA supports this bill and believes that it provides important improvements that will help enhance liquidity and capital in the banking industry and make the HOPE for Homeowners a more viable option to assist troubled borrowers. Let me address each of the major elements of H.R. 703.

I. Changes to Deposit Insurance Levels, Borrowing Authority and Systemic Risk Assessments

Deposit Insurance Levels: ABA supports making permanent the $250,000 deposit insurance limit that was set on a temporary basis in the Emergency Economic Stabilization Act (EESA). This increase, from $100,000, helped heighten consumer and small business confidence and also resulted in some additional funding for banks. However, this increase expires at the end of 2009. It is important that this issue be addressed by Congress as quickly as possible. As a practical matter, with each passing month, it becomes more difficult for banks to effectively offer certificates of deposit (CDs) over $100,000 with longer maturities because the expiration date on the insurance increase is moving closer. For example, by June, banks will only be able to offer six-month CDs in the $100,000 to $250,000 range that are fully insured. This limitation may create a large funding problem at year-end as CDs are being written to correspond to the expiration date. Moreover, the limitations on insured CD funding will hurt the ability of banks to fund loans with longer-term deposits. Finally, the expiration date and differing levels of insurance on CDs will be confusing to customers.



Congress, when it made changes to the Federal Deposit Insurance Corporation (FDIC) in 2005, did implement an inflation adjustment to the $100,000 level going forward.[1] This adjustment did not reflect the impact that inflation has had on the $100,000 level since 1980 (when the limit was raised from $40,000). Had the adjustment been made since 1980 (using the consumer price index), the deposit insurance limit today would have been $261,000 (see the chart).[2] Moreover, per capita incomes have risen by more than five times since 1980, lending further support for the increased coverage level.

Increasing the coverage level comes with a significant cost to the banking industry, as it must pay premiums to assure adequate reserves to support these newly insured deposits. The FDIC estimates that the increase in coverage from $100,000 to $250,000 will increase insured deposits by about 15 percent, or $680 billion. This reduces the reserve ratio (which is calculated by taking the Deposit Insurance Fund balance and dividing by insured deposits) by about 10 basis points. To bring the reserve ratio back to the pre-$250,000 range would take a premium payment of $7.8 billion. A one-time charge at this level would significantly impair banks' ability to lend, particularly as it would come on top of high premiums already being assessed to cover current and expected

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1 The first inflation adjustment authorized under the 2005 deposit insurance bill would be effective January 1, 2010, and the level would be adjusted every five years after that.

2 Using the Personal Consumption Expenditure Chain-type Price Index (which is the index used in the law for FDIC coverage), the $100,000 level in 1980 would be equal to $233,000 today.

losses faced by the FDIC.[3] Spreading out this cost by extending the restoration plan period for the reserve ratio to regain the 1.15 percent statutory level – from 5 years to 8 years – is extremely important. ABA supports this important change.

Treasury Borrowing Authority: We also believe that enlarging FDIC's borrowing authority with the Treasury is a reasonable change giving the FDIC more flexibility to manage cash flows related to bank failures and to back-stop the insurance fund should it be necessary. Cash-flow issues occur as the FDIC acquires assets in failures that need to be sold off in an orderly fashion. We would emphasize that this is a line of credit, and any draws on it by the FDIC constitutes a borrowing that ***must be repaid by the banking industry***. Moreover, there has already been a tremendous amount of confusion in the media about Treasury borrowing by FDIC and how the agency uses this line to manage cash flows. Great care must be taken to be sure that the public understands that this provides flexibility to the FDIC and says nothing about the potential losses that FDIC anticipates over the next few years.

Systemic Risk Assessments: The FDIC has used its systemic risk exception authority several times over the last six months in ways that no one could have predicted when this authority was enacted into law in 1991. While a creative approach was certainly required in this difficult environment, the programs announced have taken the FDIC well beyond its chartered responsibilities to protect insured depositors in the event of a bank failure. The FDIC Debt Guarantee Program (under its Temporary Liquidity Guarantee Program) is an example of protection now provided by the FDIC that is not directed at depositors. In fact, bank or financial holding companies are perhaps the most likely institutions to issue guaranteed debt under this program. Moreover, in contrast to reimbursement for insured deposits ***after*** a bank fails, the guarantee provides protection ***without*** the failure of the institution or the FDIC acting as receiver or conservator.

While the FDIC is charging for the guarantee, there is no experience with this type of guarantee or with the other systemic risk exceptions that have been made. In fact, there is no

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[3] The average premium for 2009 is expected to be around 11.6 basis points (doubling the 2008 rates) and will generate approximately $8.7 billion in revenue for the FDIC's Deposit Insurance Fund. Over the current 5-year recapitalization plan, the FDIC will raise about $46.5 billion in premium income, and the fund balance at the end of that period is projected to be approximately $68 billion. When combined with interest income on the fund, the cost of the additional protection from moving from $100,000 to $250,000 is estimated to be about 1.2 basis points per year. Thus, extending the period for recapitalization has a significant positive impact on the cost to the banking industry of such a change in depositor protection.

historical performance that might guide the pricing, exposure, and expected losses – a troubling situation particularly in this difficult economic period where risk and uncertainty have risen significantly. While the expectation of the FDIC is that the pricing will cover the costs of the program, should it not, the entire banking industry must bear the cost under current law. We would note, for example, that while over 3,500 banks – almost half of all banks – opted out of the debt guarantee program, they would ***still bear a share of cost*** if there were a loss from any institutions that had opted-in.[4] Moreover, some holding companies are issuing significant levels of FDIC-guaranteed debt, yet would not necessarily bear an appropriate share of any costs that might occur because the bank is small relative to the parent company. Thus, providing the FDIC flexibility to spread the cost of any systemic risk determination across institutions that benefited the most – including holding companies – is appropriate.

However, the determination about how costs should be fairly distributed will be challenging and subject to significant debate and dispute. It would be appropriate for the FDIC to detail situations where the systemic risk exception might be used – ***and what limitations there are to ensure that such authority is used prudently*** – and how costs might be allocated should there be losses in these different situations. Certainly, while no one expects perfect foresight regarding the next situation that might trigger a systemic risk exception, such detailed scenarios would provide how costs would be allocated.

ABA also believes that any systemic risk ***assessment*** should be clearly and directly associated with the systemic risk determination that created the loss and not be used in any way as an alternative funding mechanism to cover other costs of the FDIC or used to expand the mission of the FDIC beyond what Congress has determined to be appropriate. For example, this authority would not be used to pre-fund assessments to pay for losses that the FDIC contemplates may be incurred as a result of invoking the systemic risk authority; rather, it would be used to recover losses actually incurred. Clarifying language that directly connects the costs to the specific systemic risk determination is needed.

Risk-Based Premium Penalty Rates May Hurt Liquidity: Finally, we would note that while these proposed legislative actions may help promote bank liquidity and lending, the FDIC is proposing changes to its risk-based assessment formula that may have the opposite effect. For

[4] Moreover, many banks opted into the program only to give them the ***option*** to issue guaranteed debt. These banks may never actually issue guaranteed debt but could end up paying the costs of other losses incurred.

example, the FDIC has proposed significant additional costs (i.e., added insurance premiums) for use of Federal Home Loan Bank (FHLB) advances. The threshold proposed by the FDIC would unfairly penalize banks that have relied on these very stable sources of liquidity. Moreover, FHLB advances are a cost-effective way to raise funds, help banks manage interest rate risk by match-funding to the term of the loan, and facilitate community development loans.

In addition, the FDIC proposes to charge higher premiums to banks that use elevated levels of brokered deposits, but the FDIC proposal fails to distinguish among ***different*** types of brokered deposits. This is critical, since some so-called "brokered deposits" – such as reciprocal deposits and sweeps from broker-dealers to affiliated banks – are designed to maintain relationships with customers and provide safe, stable and low-cost funding for banks. ABA supports changing the law governing brokered deposits to explicitly distinguish these and similar types of customer deposits from the more volatile brokered deposits the original law was intended to cover.

II. Improvements Would Make the HOPE for Homeowners Program a More Viable Option to Assist Troubled Borrowers

Mr. Chairman, we reiterate our continued support for the HOPE for Homeowners program and our commitment to working with this committee to further improve HOPE for Homeowners. We believe the changes to the program recently announced by the Department of Housing and Urban Development have the potential to attract many more borrowers and lenders. Additionally, we are pleased to see further changes included in H.R. 703. We would like to comment both on those changes and on other recommendations for improving the program:

- **Streamlining the process.** The current underwriting process for HOPE for Homeowners is complex and confusing, both for borrowers and lenders. Existing technology platforms cannot be used to originate a HOPE for Homeowners loan, and the investment of both time and money to modify or create new platforms is too substantial to be economically feasible, especially when loan origination departments are running above capacity. As a result, HOPE for Homeowners loans all have to be processed ***manually***. This is time-consuming and frustrating for the borrower and lender alike. We encourage FHA to explore the use of the streamlined underwriting process it currently employs for FHA refinances as a model for HOPE for Homeowners originations. Additionally, we urge FHA to relax Direct Endorsement requirements to give servicers (and their contract underwriters) greater flexibility to structure broader home retention solutions for more borrowers.

- **Second lien holders must be given greater incentives to extinguish or subordinate their interests.** Second lien holders present a substantial impediment to refinancing under the HOPE for Homeowners program. Recent changes adopted in law allow for payments to second lien holders as incentives to extinguish or subordinate their interests. FHA should immediately implement a process for providing sufficient cash payments as incentives for second lien holders.

- **Servicers should be incentivized to allow for loan restructurings using HOPE for Homeowners.** The H.R. 703 provides for such incentives. We support this added tool.

- **Lenders and servicers should be provided protection against litigation when acting reasonably and in good faith.** All loan mitigation programs, including HOPE for Homeowners, face the hurdle of litigation risk from investors when loans have been securitized. After the announcement of the HOPE for Homeowners program, at least two mortgage-backed securities (MBS) investors sent letters to their servicers threatening litigation if the servicers were to implement the HOPE for Homeowners program. Investors have been particularly opposed to the principal reductions required by HOPE for Homeowners. Legislation is needed to provide a "safe harbor" for lenders and servicers that implement loss mitigation solutions where it can reasonably be concluded that such a solution is in the general interest of investors through a net present value calculation. Such a safe harbor should explicitly include principal reductions that demonstrably result in a better return for investors than foreclosure. ***We applaud the inclusion of a safe harbor in H.R. 703.*** We would further recommend that the safe harbor also specifically include trustees. We would be pleased to provide a specific proposal to the committee on how to include trustees.

- **Incentives to participate should be provided for borrowers with no equity.** A sad reality is that some borrowers who find themselves with no equity in their homes will choose to simply walk away from the property (and the loan obligations) rather than participate in HOPE for Homeowners. This is largely because the HOPE for Homeowners does not provide them with incentives to keep the property and/or does not provide the borrower with a monthly payment that is affordable. We believe that the equity and appreciation sharing components of HOPE for Homeowners discourage potential borrowers from participating in HOPE for Homeowners. Most homeowners view their home not just as a place to live, but also as an investment. Denying equity or appreciation to borrowers puts them in the position of renters rather than owners, and many borrowers will find it cheaper to simply become a renter after walking away from the property. The equity and appreciation sharing components of the program should be eliminated or significantly reduced.

  Again, ABA supports the provisions in H.R. 703 to scale the equity sharing back to only the equity created as a result of the HOPE for Homeowners refinancing and would further limit the sharing to a period of five years. These changes are logical and represent a fairer balance for the borrower and the government.

- **We agree that the insurance requirement should be reconsidered.** The current structure of the HOPE for Homeowners program requires up front and annual insurance premiums and requires that loans must be structured as 30-year fixed rate loans (40-year loans will be allowed when recent statutory changes are implemented). These requirements limit the affordability of HOPE for Homeowners loans for many borrowers. We concur with the elimination or substantial reduction of the upfront and annual premiums in the early years of the loan and the use of more flexible rate requirements for loss mitigation. For example, we urge the consideration of interest-only features or lower interest rates in the early years of the loan with gradual payment increases to facilitate keeping borrowers in the home now. We support H.R. 703 which reduces the upfront and ongoing premium requirements for borrowers participating in the program.

III. Fully Fund the Capital Purchase Program as Originally Announced

The ABA strongly supports the provisions in H.R. 703 that direct the Treasury to take all the necessary actions to provide capital under the Capital Purchase Program (CPP) under TARP for community banks and to do so on comparable terms afforded to other CPP recipients. We strongly believe that the current commitment should be fulfilled in order to prevent competitive disparities from occurring and to assure that ***every community*** has the same opportunity for its banks to participate, ***so that increased credit availability will spread across the country.***

By explicitly citing S-corporations, mutually-owned insured depository institutions and privately held (non-stock) institutions, H.R. 703 acknowledges the critical role these community institutions play in meeting the credit needs of cities and towns across America. It also recognizes that the current situation is unfair to many regions of the country and individual communities where S-corporation or mutual institutions are the most prevalent local source of credit. For example, in many New England communities, mutual institutions predominate. Currently those communities do not have the same opportunity for their banks to participate in the CPP. These community banks are particularly important in funding small businesses, which will be the first to generate new jobs as the economy recovers. While they did not cause the current problems in our economy, they stand ready to be a significant part of the solution. Simply put, the CPP should allow all healthy banks, regardless of their corporate structure or charter type, to participate.

Moreover, they should be allowed to participate on comparable terms. While Treasury has worked very hard to offer economically comparable terms to the various types of corporate charters, variations have occurred. For instance, investments in S-corporations that are stand-alone banks will be treated as Tier 2 capital, while investments in other participating institutions will be treated as Tier 1 capital. We urge Congress to direct Treasury to permit such S-corporations to form holding companies, assign the debt to the holding companies, and receive equal treatment under the capital rules.

As these corporate structures may not be fully understood by some policymakers, let me describe briefly the structure of those banks:

- ***S-corporation banks:*** Many community banks are organized under this structure. These banks are subject to many restrictions, including on the number of shareholders (which is limited to 100) and on the type of stock they may issue (S-corporations may only issue a single class of stock). The senior preferred stock investment that Treasury initially proposed would have constituted a second class of stock and, therefore, S-corporations would not have been able to participate. ABA supported a proposal developed by the federal banking regulators that would allow S-corporation banks to issue to Treasury a type of subordinated debt so that the CPP investment would be, as a general matter, on similar economic terms as other participants. On January 14, 2009, Treasury provided such terms, which will allow about 2,500 institutions the option to participate in the program.

- ***Mutual banks:*** There are over 700 banks or bank holding companies organized under mutual ownership. Stand-alone mutual banks cannot issue shares. Some mutual holding companies have issued minority shares, but must retain a majority interest in the hands of the mutual ownership interest if they are to remain mutually owned. Even if they have the capacity to issue additional preferred shares, they may not be able to comply with requirements established by Treasury for exchanged-traded, SEC filing companies. Finally, a majority of mutual holding companies have not been authorized to issue minority shares, and cannot comply with the terms currently available under the CPP. We propose two alternatives. Instead of preferred stock, mutual capital certificates could be used. Mutual capital certificates are subordinate to all deposit accounts and debt obligations, and are entitled to be paid dividends. Alternatively, subordinated debt could be ***used as a replacement*** investment with some type of redemption fee.

Regardless of the corporate structure, all banks provide vital services to their communities and all should be allowed to compete on equal terms. Therefore, it is imperative that Treasury adopt policies that would allow mutual organizations to participate in the CPP and to issue term sheets for these organizations expeditiously.

Conclusion

Mr. Chairman, I appreciate the opportunity to present the views of the American Bankers Association and express our support for H.R. 703. The ABA stands ready to work with this Committee to enact these important changes.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

JAN 13 2009

The Honorable Randy Neugebauer
U.S. House of Representatives
Washington DC 20515-4319

Dear Representative Neugebauer:

Thank you for your letter of January 11, 2009, requesting the Department of Housing and Urban Development's assessment of the impact of proposals to allow bankruptcy judges to modify the terms of mortgages of the Federal Housing Administration (FHA) and Ginnie Mae. This is a critical matter for the Department and I appreciate the opportunity to respond.

The key statutory provision of any legislation allowing bankruptcy judges to modify mortgages that affects FHA, Ginnie Mae, and the entire mortgage market, is removal of the special status now provided for home mortgages under Chapter 13 of the U.S. bankruptcy code. The import of that special status is that the courts may *not* bifurcate mortgage loans into separate secured and unsecured pieces, as is permissible with other debts. That special status was first interpreted by the U.S. Supreme Court in 1993, and was then codified by the Congress in Section 303 of the Bankruptcy Reform Act of 1994.[1]

The Department is concerned about the effects of legislative proposals, such as S. 61 and H.R. 200, that would remove the special status for principal residences that exists under the Bankruptcy Act of 1994. The proposed changes would permit the courts to modify or "cramdown" the principal obligation to an amount equal to the current value of the secured property. The residual amount owed would then be recast into an unsecured debt obligation.
In Chapter 7 liquidation cases, the secured loan has primacy over sale proceeds of the security property, while the unsecured piece is grouped with all other unsecured debt in payment priority. In a Chapter 13 bankruptcy reorganization, payment plans are structured first to cover payments on secured debts. The Court then determines the amounts the household can afford to pay toward monthly debt obligations to satisfy unsecured debts, a portion of which may not receive payment. In either Chapter 7 or Chapter 13 proceedings much or all unsecured debt is not required to be paid by the debtor leaving lenders with no option but to write-off the unpaid amount as an uncollectible debt.[2]

Impacts of Cramdowns on FHA

[1]The Court actually ruled first on Chapter 7 cases in *Dewsnup v. Timm*, 112 S.Ct. 773, 22 BCD 750 (1992), and then on Chapter 13 cases in *Nobelman v. American Savings Bank*, 113 S.Ct. 2106 (1993). Statutory clarfication was in Title III, section 301 of the 1994 Act and can be found at 11 USC 1322.

[2] It is also the case that many Chapter 13 cases progress to Chapter 7 liquidations where the unsecured second mortgage is completely written-off by the lender.

FHA insurance coverage for lenders is only on secured debt. Thus, the immediate effect of a bankruptcy court cramdown would be that the lender has an uninsured loss. This would introduce a new risk to lenders, and create a situation wherein FHA no longer provides 100 percent insurance coverage of the mortgage amount. Such a change would increase the interest rates charged for FHA-insured loans as lenders purchase other guarantees to cover that risk. If such guarantees are not available, or prove to be very expensive, the availability of FHA insurance will be reduced. Because FHA loans have historically had higher default and foreclosure rates than conventional mortgages, the interest rate increase for FHA-insured borrowers would be more substantial than it would be for conventional borrowers.

If S. 61 or H.R. 200 were adopted, every property in jeopardy of foreclosure would also be a potential candidate for a bankruptcy court cramdown. In theory, Chapter 13 cramdowns would be limited to borrowers with commitments to their properties, meaning they have both the willingness and ability to continue to support the mortgage at some level. However, significant percentages of current Chapter 13 repayment plans fail and a property foreclosure ensues.

Having the option of a cramdown would increase the attractiveness of Chapter 13 filings versus working directly with lenders to find an appropriate loss mitigation workout plan. The fundamental difference between a bankruptcy cramdown and loss mitigation is that typical loss mitigation default workouts do not absolve the borrower of any obligation to repay the entire mortgage.

FHA has been very successful with its loss mitigation program. One tool in this program is known as a Partial Claim. Under this program, FHA pays up to 12 months of mortgage payments to the lender, on behalf of a defaulted borrower, to bring the loan current. The borrower, in turn, signs a promissory note to pledge that any future home equity will be used to repay HUD when the property is sold.[3] That promissory note bears no interest and is secured by a property lien. If implemented, S. 61 and H.R. 200 would potentially render these liens to be worthless. Repayment of those liens today contributes to the health and stability of the FHA Mortgage Insurance Fund. As of December 31, 2008, FHA had partial claims that totaled $464 million.

Impact of Mortgage Cramdowns on Lenders, Ginnie Mae and Homeowners

To the extent that S. 61 and H.R. 200 add increased credit risk to FHA-insured loans, financial regulators could choose to implement capital requirements on federally-insured depository institutions that hold such loans on their balance sheets. If FHA loans were considered to have increased credit risk for lenders, then financial regulators could also revisit the rules regarding zero capital requirements on Ginnie Mae's mortgage backed securities (MBS).

Ginnie Mae guarantees MBS investors no disruption in mortgage-payment cash flows with

[3] Many borrowers choose to repay the note when they refinance their properties, prior to moving and selling the home.

its lenders/servicers responsible for making full pass-throughs to the security trustee until the first-lien mortgage is paid off. Pass-through payments are based on the original mortgage and not any new, reduced mortgage created by a bankruptcy court. Thus, even if a borrower is successful in a Chapter 13 reorganization plan, the lender would always have a cash-flow shortfall because of the cramdown. Therefore, lenders will re-purchase Chapter 13 loans out of Ginnie Mae pools and take the immediate write-off of principal, rather than incur this ongoing responsibility to MBS investors. Should the lender experience an increase in borrowers that receive cramdowns, its financial status could be severely impacted. If a lender then has financial difficulties and cannot meet its other pass-through obligations, Ginnie Mae will step in, take over the servicing portfolio, and itself absorb the residual loss created by the cramdown.[4]

There is one additional problem for homeowners who receive court-ordered mortgage cramdowns: property casualty insurers often limit coverage to the principal balance of the mortgage, which is the minimum required for loan approval. If a catastrophic insurable event occurs, homeowners will be exposed to financial loss because a crammed-down mortgage may not fully reflect the replacement cost of a property even if it reflects its current market value. The most likely outcome would be that the lender receives the proceeds of the insurance policy rather than the property being restored. As occurred in areas damaged by Hurricane Katrina, this leads to property abandonment and other problems in those impacted neighborhoods.

Conclusion

Proponents of bankruptcy court cramdowns of mortgage loans likely intend to induce subprime lenders to be more proactive with foreclosure avoidance options. Broad-sweeping measures that affect all home mortgages fundamentally change the expectations of all parties involved in housing finance -- from originating lenders, to loan servicers, to mortgage insurers, and to ultimate investors. Because those parties have outstanding contracts that specify their respective financial responsibilities to one another, many will be immediately liable for additional costs not accounted for in the initial transaction. Future mortgage contracts will reflect increased interest rates to compensate for this increased risk. Interest rates on new loans will increase not only to cover the projected cost on those new loans but to cover the added cost on outstanding loans as well.

It is the Department's conclusion that S. 61 and H.R. 200 create a fundamental change in the quality and value of residential real estate as collateral for a mortgage loan. It is this uncertainty that will lead to higher mortgage costs for most borrowers.

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[4] Ginnie Mae resells these loan-servicing portfolios, but a portfolio with crammed-down mortgages will sell at a discount that reflects the cramdowns.

Thank you again for your correspondence on this important topic, and I trust this information will be useful as Congress contemplates providing bankruptcy judges the authority to modify mortgages.

Sincerely,

Brian D. Montgomery
Assistant Secretary for Housing –
Federal Housing Commissioner

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