HOME FORECLOSURES: WILL VOLUNTARY MORTGAGE MODIFICATION HELP FAMILIES SAVE THEIR HOMES? (PART I)

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

JULY 9, 2009

Serial No. 111–53

Printed for the use of the Committee on the Judiciary

Available via the World Wide Web: http://judiciary.house.gov

U.S. GOVERNMENT PRINTING OFFICE

50–864 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON THE JUDICIARY

JOHN CONYERS, JR., Michigan, *Chairman*

HOWARD L. BERMAN, California
RICK BOUCHER, Virginia
JERROLD NADLER, New York
ROBERT C. "BOBBY" SCOTT, Virginia
MELVIN L. WATT, North Carolina
ZOE LOFGREN, California
SHEILA JACKSON LEE, Texas
MAXINE WATERS, California
WILLIAM D. DELAHUNT, Massachusetts
ROBERT WEXLER, Florida
STEVE COHEN, Tennessee
HENRY C. "HANK" JOHNSON, JR., Georgia
PEDRO PIERLUISI, Puerto Rico
MIKE QUIGLEY, Illinois
LUIS V. GUTIERREZ, Illinois
BRAD SHERMAN, California
TAMMY BALDWIN, Wisconsin
CHARLES A. GONZALEZ, Texas
ANTHONY D. WEINER, New York
ADAM B. SCHIFF, California
LINDA T. SÁNCHEZ, California
DEBBIE WASSERMAN SCHULTZ, Florida
DANIEL MAFFEI, New York

LAMAR SMITH, Texas
F. JAMES SENSENBRENNER, JR., Wisconsin
HOWARD COBLE, North Carolina
ELTON GALLEGLY, California
BOB GOODLATTE, Virginia
DANIEL E. LUNGREN, California
DARRELL E. ISSA, California
J. RANDY FORBES, Virginia
STEVE KING, Iowa
TRENT FRANKS, Arizona
LOUIE GOHMERT, Texas
JIM JORDAN, Ohio
TED POE, Texas
JASON CHAFFETZ, Utah
TOM ROONEY, Florida
GREGG HARPER, Mississippi

PERRY APELBAUM, *Majority Staff Director and Chief Counsel*
SEAN MCLAUGHLIN, *Minority Chief of Staff and General Counsel*

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

STEVE COHEN, Tennessee, *Chairman*

WILLIAM D. DELAHUNT, Massachusetts
MELVIN L. WATT, North Carolina
BRAD SHERMAN, California
DANIEL MAFFEI, New York
ZOE LOFGREN, California
HENRY C. "HANK" JOHNSON, JR., Georgia
ROBERT C. "BOBBY" SCOTT, Virginia
JOHN CONYERS, JR., Michigan

TRENT FRANKS, Arizona
JIM JORDAN, Ohio
HOWARD COBLE, North Carolina
DARRELL E. ISSA, California
J. RANDY FORBES, Virginia
STEVE KING, Iowa

MICHONE JOHNSON, *Chief Counsel*
DANIEL FLORES, *Minority Counsel*

CONTENTS

JULY 9, 2009

HOME FORECLOSURES: WILL VOLUNTARY MORTGAGE MODIFICATION HELP FAMILIES SAVE THEIR HOMES? (PART I)

THURSDAY, JULY 9, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 1:06 p.m., in room 2237, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Lofgren, and Franks.

Staff Present: James Park, Majority Counsel; Daniel Flores, Minority Counsel; and Adam Russell, Majority Professional Staff Member.

Mr. COHEN. This hearing of the Committee on the Judiciary, the Subcommittee on Commercial and Administrative Law, will now come to order.

Without objection, the Chair will be authorized to prepare a recess to the hearing. I will now recognize myself for a short statement.

Today's hearing gives us an opportunity to revisit the roots of the mortgage foreclosure crisis and its continuing effects on our economy. We will examine the effectiveness of government initiatives, principally the Treasury Department's Home Affordable Modification Program, in addressing that crisis.

This Subcommittee and the full Judiciary Committee have been examining the foreclosure crisis since 2007, holding four hearings on the issue and two markups of legislation to address this crisis. The mortgage foreclosure crisis triggered a broader economic crisis that the Nation finds itself in today. Unfortunately, home foreclosures continue to rise precipitously nationwide, notwithstanding the efforts by the Congress and the previous Administration and this Administration to stem that tide of foreclosures.

For me, the foreclosure crisis hits home almost literally. In a survey of the top 100 metro areas nationwide, my hometown of Memphis, Tennessee is ranked 18th in the number of foreclosures, according to data collected by Realtytrac.com. In a similar comparison of States, the State of Tennessee, my home State, ranked 12th in the number of foreclosures. The extent of the foreclosure crisis is such that all socioeconomic classes are affected by growing foreclosure numbers.

So far, the government's efforts at helping families avoid losing their homes appear not to be working effectively. Some of my colleagues and I suspect this is because the government's efforts have focused almost exclusively on the voluntary modification of the mortgage terms for distressed borrowers. The evidence tends to suggest that encouraging voluntary modifications alone is, at best, minimally effective in helping financially struggling borrowers stay in their homes.

I recognize that the current Treasury Department program is still relatively new, having been instituted only in March. Therefore, we have to reserve final judgment on its effectiveness. Nonetheless, media reports suggest that this current effort may need to be enhanced.

Earlier this year in the 111th Congress, I cosponsored and helped champion Chairman Conyers' bill, H.R. 1106, the Helping Families Save Their Homes Act of 2009, which, among other things, would have given authority to bankruptcy judges to modify debtors' mortgage terms in bankruptcies, including a reduction of the mortgage principal amount. In my view, this provision would have substantially and effectively reduced the number of foreclosures. Unfortunately, this provision was never signed into law. Adopting this provision would help strengthen any program and would encourage voluntary mortgage modifications by loan servicers.

I thank the witnesses for appearing today, and I look forward to their testimony.

I now recognize my colleague, Mr. Franks, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. FRANKS. Well, thank you, Mr. Chairman.

Mr. Chairman, today, we revisit the important question of mortgage foreclosures. Now, probably very few Members know better than I do how important this question is to individuals in congressional districts across this country, especially those that have had high foreclosure rates, as mine has.

I have to say, however, that I am puzzled by today's hearing. The only foreclosure-related measure I know of that is within this Subcommittee's jurisdiction is the mortgage cramdown legislation we considered earlier this year. That proposal was deeply defective. It promised to help virtually no one while inflicting unnecessary damage on the home lending market and the rule of contract. It was precisely the opposite of what we needed to consider. It therefore died a quick and deserved death in the Senate. Any attempt to revive it now is a pointless distraction from our need to arrive at a genuine solution to our constituents' problems.

But that, Mr. Chairman, is not the only thing that puzzles me, troubles me or disturbs me—I do not know which is the best term—about today's hearing. I need only to consider the title of today's hearing to be concerned, "Will Voluntary Mortgage Modification Help Families Save Their Homes?" The implications of that topic, or that question, cannot really be missed.

Someone thinks that voluntary modifications will not help families stay in their homes. Someone, whether by cramdown or otherwise, wants government to mandate mortgage modifications to keep families in their homes, and someone must want government to inflict that financial sacrifice on lenders and not on borrowers. Why? No one mandated borrowers to enter into mortgage contracts. The question has to be asked if anyone is to be held accountable in America anymore for entering into a contract.

Why are we still trying to get out of the historic credit crisis in this country?

The last I heard, it was still a problem. Confiscating contract rights of lenders will freeze credit. It will not free it up. If neither borrowers nor lenders are voluntarily modifying their contracts, why on Earth should the government be forcing them do so?

Is the era of freedom of contract over in this country? I hope it is not. In fact, under both HOPE NOW and the Obama administration's voluntary mortgage modification programs, freedom of contract is still at work. Many lenders and homeowners are voluntarily modifying their mortgages.

What these programs need is not to be replaced by a government program that is mandating modifications. What they need is more time to work, Mr. Chairman. The Obama administration program is barely a few months old. It has just been modified. There has not been enough time for it to produce results allowing us to even judge it one way or the other. Congress dedicated $75 billion to the Obama administration program earlier this year, and I wonder if my colleagues across the aisle have already concluded that the money was ill-spent, as was the $787 billion they spent in the stimulus bill. Speaking, Mr. Chairman, of the stimulus bill, it takes me to my last point.

Evidence shows that an overwhelming number of foreclosures we face are due to unemployment and falling home values. How many of these foreclosures could have been avoided completely if this Congress had just passed a responsible and effective stimulus bill? How many real jobs would we have "saved or created"? How many individuals would have been better able to bid on homes in the housing market, helping to stabilize falling home values? How much good could we truly have done?

Mr. Chairman, this Congress has already committed too many grievous and profoundly dangerous economic mistakes in the long run in this term alone. Let us not add fuel to that unfortunate fire by reconsidering mortgage cramdown, proposing government-mandated modifications, or otherwise spending a single minute on anything other than considering and passing a genuine job-producing, growth-creating piece of legislation.

With that, Mr. Chairman, I appreciate your indulgence, and I yield back.

Mr. COHEN. I thank the gentleman for his statement.

I will now recognize Members on this side if they would like to make opening statements.

Would the distinguished Vice Chair and the former great prosecutor and current great Congressman like to make a statement?

Mr. DELAHUNT. Do you have any more adjectives?

Mr. COHEN. Dashing. Handsome.

Mr. DELAHUNT. I can stay here all day if you want to just keep going.

Mr. COHEN. No more.

Mr. FRANKS. Aging.

Mr. COHEN. Mr. Franks, the "aging" part will not be mentioned.

Mr. FRANKS. I am sorry.

Mr. DELAHUNT. The problem is I had premature white hair, but the real problem is that my face is now catching up with my hair.

You know, I will be very brief. I heard the Ranking Member speak of the sanctity of contract. I would just, you know, make a point that bankruptcy, an opportunity to start afresh, has been a concept that has been embraced in American jurisprudence for years, as long as the sanctity of contract. So let's not pretend that this idea or the concept of cramdown is breaking new ground. That is simply inaccurate. It is inaccurate. We have crammed down and have provided benefits for those who own boats and cars and rental property, so the idea of the cramming down principal for people who are about to lose their homes is not Earth-shattering. It is not an aberration of American jurisprudence by any stretch of the imagination.

My friend from Arizona then goes on to talk about, you know, what this Administration has promised for 5 months. Let me respond with a partisan comment. What we have got on our plate is the product of 8 years of economic policies that were formulated by the previous Administration, along with the Republican Congress that held the majority on both sides for some 6 years.

With that, I yield back.

Mr. COHEN. Thank you, sir.

Does the distinguished Ranking Member, Mr. Smith, desire to make an opening statement?

Mr. SMITH. I do, Mr. Chairman.

Mr. COHEN. And I should say some nice things about you to equal those things I said about the Vice Chairman, but we will take judicial notice.

Mr. SMITH. You know, I would not mind hearing those adjectives repeated, if you wanted to go that far, but if not——

Mr. COHEN. I will incorporate by reference.

Mr. SMITH. Okay. Thank you, Mr. Chairman.

As we again consider mortgage foreclosures and mortgage modification programs, we should remember two fundamental principles.

First, we in Congress should not take actions that undermine personal accountability. In recent years, an unusual number of people took on mortgages they could not afford. The vast majority of Americans, however, did not. They took on loans for which they assumed responsibility, and they continue to pay their mortgages on time. I continue to believe that Americans do not want so-called "solutions" that absolve borrowers of personal responsibility.

Second, we should aim to supplement, not threaten, the loan modification programs that lenders and the government are implementing. The mortgage bankruptcy legislation we considered earlier this year failed to honor both of these principles as well as a host of others. As a result, it rightly met its demise in the Senate. By all appearances, what lies most behind foreclosure rates today, July 2009, are two basic facts:

First, unemployment is spiraling upward. Second, housing prices and the housing market have not stabilized. Rising unemployment is due to the failure to adopt economic policies that will genuinely stimulate the economy.

When Congress considered the stimulus bill, Republicans proposed an alternative that would have put money into the hands of individuals and small businesses. It would have promoted real job growth. It would have avoided thousands of the unemployment-related foreclosures we are now witnessing.

The stimulus bill did not give us unemployment rates below 8 percent as President Obama promised. On the contrary, unemployment is approaching 10 percent, and it may rise higher still. As a result, we have a whole new wave of unemployment-related foreclosures. Nothing we can do to revise the Bankruptcy Code will help an unemployed person pay off a mortgage. Only real jobs and economic growth will do that.

What about stabilizing home prices in the housing market? The Responsible Homeowners Act of 2009, introduced this April, would honor personal responsibility in the mortgage market while providing home purchase incentives that can actually help to stabilize that market.

The already rejected mortgage bankruptcy ideas would destabilize the housing market and housing prices by tightening mortgage credit. How do we know that? Because that kind of destabilization has happened before. When chapter 12 of the Bankruptcy Code was modified to allow cramdowns for family farms, interest rates for farm mortgages went up. Rising mortgage interest rates under the fundamental laws of economics can mean only one thing: fewer buyers able to bid on homes, coupled with our continuing excess housing inventory that is guaranteed to produce new declines in home prices.

Under normal conditions, a decline in housing prices could stimulate housing sales, but with the continued increase in unemployment rates and the sputtering economy, we would not see any such increase today. Furthermore, additional declines in home prices are likely to push more mortgages under water. That will trigger still more foreclosures, deepening the problem, not solving it. Our housing markets are beginning to show signs of recovery, so we should not now—not ever—enact legislation that will be a drag on a housing recovery.

Thank you, Mr. Chairman. I yield back.

Mr. COHEN. I thank the Ranking Member of the full Committee.

I now recognize the Chair of the Immigration Subcommittee and another cosponsor and true champion of the Helping Families Save Their Homes Act of 2009, Ms. Lofgren of California.

Ms. LOFGREN. Thank you, Mr. Chairman. Thank you for convening a hearing on this crucial issue because we are in a continuing crisis of home foreclosures in this country.

We saw record number of foreclosures in June, nearly 300,000 according to the figures I have seen, and it is very clear to me that the voluntary modifications are not working. Several million homes have been foreclosed on. Several hundred thousand new homes are going into foreclosure every month, and the total number of voluntary modifications has been very few. We will get the exact numbers, but it looks like a few hundred thousand at most, in the face of millions in need.

This mismatch means real trauma for individuals, but it also means a disaster for the American economy, not only for those going into foreclosure but for their neighbors. As we know, for every home in foreclosure, the average decline in value for the innocent bystanders, the neighbors, is about 7 percent. If you go into some towns in California and you see the amount of foreclosures, you can see that the value of homes is just collapsing, which is feeding into the spiraling down of our American economy. The voluntary program is not working.

Today, in the *San Jose Mercury News,* there is a headline: "Loan Pleas Swamp Banks." If you read the article, it talks about individuals who have tried in vain over a period of months to get information for voluntary modification with their banks. I will just mention one individual, my constituent Angelo Gallo, 46, of San Jose, who has been working since January with his bank. He has sent, numerous times, information which is always lost by his bank. Now he has been notified here in July that they are going to go into foreclosure except, oops, they are eligible for the Obama plan modification. This is a disaster.

I want to note with great disappointment that the Treasury Department was too busy to come to this hearing today. I think it is shameful that the Treasury Department is too busy to deal with the Congress with regard to the collapse of the housing market in America. We passed a very good bill in the House that allowed for the Obama plan to work, but failing that, made sure that the bankruptcy laws are available for those who are eligible to readjust the principal or interest of their mortgages.

I note that this is not a new concept. Article I, section 8 of the Constitution, which has been with us since 1789, indicates that the Congress should establish a uniform law on the subject of bankruptcies throughout the United States.

Certainly, as my colleague Mr. Delahunt has mentioned, second homes and certain other properties are available for modification. We are also, I think, led by the decline in individual home mortgages and are about to see an absolute avalanche of commercial real estate bankruptcies. Those will all be eligible for modification in the Bankruptcy Court, unlike the hapless poor individual homeowner.

I am just tremendously frustrated that we have provided funding for banks around the country, and yet they are stiffing the homeowners of the United States. The Congress has failed to act. The Administration has failed to act. I think it is up to us to step forward once again and not to give up on this, Mr. Chairman, because I think it is not yet too late to enact this reform and to stem this collapse of the housing market in the United States.

I yield back.

Mr. COHEN. Thank you. I thank the gentlewoman for her statement.

We don't have any other Members here, and I am now pleased to introduce our first witness. I want to thank all of the witnesses for participating in today's hearing. Without objection, your written statements will be placed into the record, and we would ask you limit your oral remarks to 5 minutes. There is a system we have here that shows a green light, which shows you have got between 1 and 5 minutes left. At the 4-minute time, it turns yellow, or the yellow light comes up, and the green light goes off. Then after that minute, the red light comes on, and at that time, you should have finished or should be prepared to quickly finish your remarks. After each witness has presented his or her testimony—"his" in this case—Subcommittee Members will be permitted to ask questions, again, subject to the 5-minute rule.

Our first witness is Alan White, a professor at the Valparaiso University School of Law, the former home of Gene Bartow. He has been there since 2007, teaching consumer law, commercial law and contracts. He is a nationally recognized expert on the credit regulation of the mortgage market, and is quoted frequently in the national media, including in The Wall Street Journal, *The Washington Post* and *The New York Times,* in connection with his research on this particular issue.

He has published a number of research papers and articles on housing, credit and consumer law issues, and has testified before Congress and other agencies on the foreclosure crisis, bankruptcy reform and predatory mortgage lending.

Mr. COHEN. Thank you, Professor White. Will you begin your testimony?

TESTIMONY OF ALAN M. WHITE, ASSISTANT PROFESSOR OF LAW, VALPARAISO UNIVERSITY SCHOOL OF LAW, VALPARAISO, IN

Mr. WHITE. Thank you.

Mr. Chairman and Members of the Committee, thank you for inviting me to testify about this very important issue. I have indeed been following, specifically, mortgage modification and foreclosure activity very closely for the last 24 months, and I have tried as much as possible to gather the available facts and data about what is actually happening in the real world in the markets, and it is based on that information and that data that I want to offer my remarks today.

One comment I would like to make about information is that we need more of it. I have said this before, but the Treasury Department now has access to very detailed information from mortgage companies that will tell us how many homes are being foreclosed every month, how many mortgages are being renegotiated and under what terms. It is really vital that that information be made public and be in as much detail and in as timely a fashion as possible so that all of the questions that are going to be considered today can be evaluated with accurate information. The information I rely on is mostly mortgage information reported to investors in mortgage-backed securities. It is somewhat helpful, but it does not cover the entire market. It does tell us, I think, a few important things about what is going on out there.

First, clearly, we have a massive failure of contracts. And I certainly would associate myself with a comment that adherence to contracts is a very important principle, and I teach contract law. We have, in particular, subprime mortgages that are failing at a rate of greater than 50 percent, so we are looking at a situation where lenders and servicers need to administer contracts that are going to default or that are already in default. The question is what to do with those contracts.

There are now 2.5 million American homeowners with mortgages in foreclosure. There are considerably more than that who are delinquent. Every month, another quarter of a million is added to that number, so any program which modifies 10,000 or 20,000 or 50,000 mortgages is only making a very small dent in a very large problem.

I suppose the good news is, currently, about 125,000 mortgages are being modified every month. That is prior to the implementation of the Administration's new program. What is disappointing about the Home Affordable program is that the announced goals in terms of the number of renegotiations are extremely modest, and they are talking about numbers of modifications that would not make any significant increase, that probably would be less than what the industry has been doing voluntarily up until now.

In addition to the fact that modifications are consistently lagging behind foreclosures, the number of foreclosures is still increasing. We have not reached the peak of the crisis and started to taper off, and that is very troubling.

The third fact that is very troubling is the levels of losses that are being inflicted on investors, banks and ultimately, perhaps, on the taxpayers. Each month when a home is foreclosed and sold, the investor is losing more money than the last month. Of the June data that I have, the loss severities are running at about 65 percent, meaning that if a $100,000 mortgage is foreclosed, the investor is recovering $35,000. That is not a very good return. It also suggests that if there is some way to renegotiate the loan and successfully get a borrower to pay 70 or 80 percent rather than 35 percent, everyone would be better off.

Now, I want to address briefly a paper that was just released earlier this week, written by some economists at the Boston Federal Reserve, which kind of takes issue with the simple proposition that if we could reduce and renegotiate mortgages to a more affordable level, everybody would be better off, not only the homeowners and their communities but also the investors.

In this paper—and I have had some correspondence with its author—it contends that, really, servicers are acting quite rationally because, in fact, they make more money in foreclosing than in renegotiating loans. The difficulty with this paper—and I make some reference to it in my written testimony—is that it makes a bunch of assumptions which, I think, are just not based on what is happening out in the real world market today.

They assume, for example, that large numbers of homeowners who are behind on their mortgages can get caught up and pay their loans in full. So, of course, the investors will lose money if we allow bankruptcy courts to voluntarily reduce their debts by 10 or 20 percent, because if we just left everything alone, they would have paid 100 percent. I looked at the data that I am getting from the investor reports. The cure rates for defaulted mortgages are less than 10 percent. The chances that somebody who is behind now is going to be able to refinance or to catch up are slim to none.

They also talk about the fact that many modifications fail. We have this problem of re-defaults, and that is certainly true as 30 or 40 percent, maybe 50 percent, of modified loans have not succeeded. I think that is partly because the modifications have not been very well designed.

I think it is also important to stress that even with a 50 percent failure rate, you can develop numbers to show that if you succeed with half of your modifications, you are saving investors money as well as obviously saving half of the homes that otherwise would have been foreclosed.

So I will stop there since my time is up. I will be happy to answer any questions you may have. Thank you.

Mr. COHEN. Thank you, Professor White. I thank you for your testimony and for being cognizant of the lighting system and of the time requirements.

[The prepared statement of Mr. White follows:]

PREPARED STATEMENT OF ALAN M. WHITE

Testimony of Alan M. White

Valparaiso University School of Law

Before the House Subcommittee on Commercial and Administrative Law

Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes?

July 9, 2009

Chairman Cohen, Ranking Member Franks and members of the Committee, thank you for this opportunity to testify concerning the vital questions of how we are responding and should respond to the foreclosure crisis. I have studied the subprime mortgage industry for the past ten years, and I am conducting ongoing research on mortgage defaults, foreclosures, workouts and modification agreements. I testified in September of last year before the House Financial Services Committee about the inadequacy of voluntary action by mortgage servicers, and unfortunately the foreclosure crisis has grown dramatically worse since then. Month after month up to and including June 2009 foreclosures continue to increase, and voluntary modifications have failed to keep pace with foreclosures, much less to turn the tide.

The Administration's Home Affordable program, offering incentives to mortgage servicers to increase voluntary modifications, has not been in effect long enough to evaluate. It is clear, however, that this new voluntary, incentives-based program will not and cannot achieve the necessary degree of foreclosure prevention and mortgage debt reduction that are the essential prerequisites to an economic recovery.

Today I will summarize my findings on foreclosures and mortgage modifications during the last twenty-four months. I want to emphasize two key points. First, foreclosures and the economic waste associated with them continue to increase month after month. Second, voluntary mortgage modifications are increasing, not decreasing, total mortgage debt, in a manner that will only prolong the crisis.

Month after month we have seen an increase in new foreclosure filings, from about 125,000 in July 2007 to a high of 290,000 in March 2009. There was a temporary slowdown in the fourth quarter of 2008, as Fannie Mae and several major banks, as well as a number of states, instituted temporary foreclosure freezes, but the steady rise in foreclosures has now resumed, so that we are not even at the peak of the crisis yet.

The losses on foreclosures also continue to rise. Mortgage investors lost an appalling 56% of the total mortgage debt on foreclosures in November 2008, and an even more appalling 65% in June 2009. In the pool of subprime and alt-A mortgages that I follow, there was about 100 times as much money lost on foreclosure sales in June as there was in writing off interest and principal for modified mortgages. There were about ten times as many liquidated foreclosures as there were modifications with debt reduction, and the foreclosure losses on each mortgage were about ten times the amounts of the write-offs on modifications.

While mortgage servicers steadily increased loan modification numbers from July 2007 through February 2009, modifications have tapered off and declined since then. One possible explanation is that the Administration's Home Affordable program requires that homeowners enter a 3-month temporary trial payment period before their loans are permanently modified, and the Home Affordable contracts were not completed until April, so perhaps we will see increased modification activity in August and September. On the other hand, the Treasury Department has set very modest goals for the program, announcing that they expect 50,000 modifications to be completed in the initial phase. Given that HOPE NOW reported about 125,000 voluntary modifications each month through March, 2009, and that there are close to 2 million homes in foreclosure now, the Administration's numbers are not nearly ambitious enough.

Voluntary mortgage modifications continue to increase overall mortgage debt, not reduce it. There are still fewer than 10% of modifications that involve any forgiveness of interest or principal (in June 2009), and fewer than 2% of modifications actually reduce the principal loan balance. Meanwhile, the most common voluntary modification involves *adding* unpaid interest and fees to the balance, so that the homeowner owes more, not less, than before the modification. As a result, more and more Americans owe more than their home is worth. In the long run, these homeowners will have no incentive to continue struggling to make payments, and they will face a crushing debt burden for years to come.

Mortgage modifications in 2007 and early 2008 frequently did not even reduce monthly payment burdens. Things have improved somewhat on this front, and now about 60% of modifications do result, at least temporarily, in reduced monthly payments. This is usually achieved by temporary reductions in interest rates, or by extending 30-year mortgages to 40 years, or both.

Many voluntary mortgage modifications reduce interest and payments only for a three- to five-year period, and are thus kicking the can down the road. Homeowners with modified loans thus will face interest rate and payment increases in 2012, 2013 or 2014, similar to the payment shocks that resulted from subprime adjustable-rate mortgages in the first place. Moreover, many modifications result in large balloon payments that come due when the mortgage matures.

The Boston Federal Reserve Bank recently released a discussion paper whose central argument is that mortgage servicers have rational economic reasons for not modifying mortgages.[1] In particular, they argue that because modified loans redefault at a high rate, and unmodified loans in default are sometimes cured and paid in full, voluntary modifications could result in overall losses, so mortgage servicers are acting rationally by foreclosing, not modifying.

[1] Manuel Adelino, Kristopher Gerardi & Paul Willen, Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization (Boston Federal Reserve Bank Public Policy Discussion Paper 09-4, July 6, 2009).

There are two problems with this argument. First, the authors use a theoretical model to compare foreclosures with modifications, and the outcome of the model depends entirely on the assumptions made about redefault, cure and loss severity rates. If losses on foreclosures are high, mortgages in default have a low probability of getting caught up or paid in full, and modifications can result in on-time payment in a majority of cases, then modifications will indeed save servicers and investors money. The second problem is that the need to prevent foreclosures and reduce mortgage debt goes beyond the need of the mortgage company to maximize return on a particular loan. Every additional foreclosure sale reduces the value of surrounding properties and also reduces the value of mortgages held by other investors and financial institutions. The cost of losing a home for the family affected is incalculable, and is also not borne by the mortgage holder.

These externalities fully justify intervention to reduce foreclosures and encourage modifications, and more specifically to reduce existing mortgage balances to bring them into line with home values, while allowing families to remain in their homes and preventing the emptying and devastation of neighborhoods. The simplest way to achieve the deleveraging of American homeowners is to allow bankruptcy judges to reduce mortgages to the value of the property for those homeowners who choose to go through the rigors of Chapter 13, including devoting all their available income to debt repayment. Mortgage reduction in bankruptcy is an essential complement to the voluntary mortgage modification programs that so far have not gotten to the heart of the problem.

Detailed summaries of the mortgage foreclosure and modification data I am following are available on my web page at:

http://www.valpo.edu/law/faculty/awhite/data/index.php

In addition I have written two papers summarizing the limitations of voluntary mortgage modifications in 2007 and 2008, which are available at:

http://ssrn.com/abstract=1325534 and http://ssrn.com/abstract=1259538.

I would be happy to answer any questions, and to respond to any specific queries from you or your staff regarding the available foreclosure and modification data.

1. Comparison of Foreclosure Losses and Modification Write-Downs:

May 26, 2009 Columbia Collateral file (subprime and alt-A)					
	Numbe r	**Avg Loss**	**Avg Original Balance**	**Loss severity**	**Total Losses**
Liquidated Foreclosures	32,267	$141,953	$219,677	64.62%	$4,580,416,861
Loan Modifications with write-offs	2,343	$13,077	$221,199	5.91%	$30,638,804
Ratio of Foreclosure losses to Modifications write-downs:					149.50

June 25, 2009 Columbia Collateral file (subprime and alt-A)					
	Numbe r	**Avg Loss**	**Avg Original Balance**	**Loss severity**	**Total Losses**
Liquidated Foreclosures	31,856	$143,987	$222,714	64.65%	$4,586,843,026
Loan Modifications with write-offs	3,135	$14,353	$223,162	6.43%	$44,996,967
Ratio of Foreclosure losses to Modifications write-downs:					101.94

Mr. COHEN. Our second witness is Mr. Jim Carr. He is Chief Operating Officer for the National Community Reinvestment Coalition. He is an associate of 600 local development organizations across the Nation that are dedicated to improving the flow of capital to communities and to promoting economic mobility. He is a visiting professor at Columbia University. Prior to his appointment, he served as Senior Vice President for Financial Innovation, Planning and Research for the Fannie Mae Foundation, and he was Vice President of Housing Research at Fannie Mae. He has held posts as Assistant Director for Tax Policy for the U.S. Senate Budget Committee and as research associate at the Center for Urban Policy research at Rutgers.

Mr. Carr, you may begin your testimony.

TESTIMONY OF JAMES H. CARR, CHIEF OPERATING OFFICER, NATIONAL COMMUNITY REINVESTMENT COALITION, WASHINGTON, DC

Mr. CARR. Good afternoon.

[Technical difficulties.]

Mr. COHEN. Who is our expert on this? There you go. We have had some bad luck with Rutgers in this hearing and on this Committee. Go ahead.

Mr. CARR. Okay. That seems to have done it. Thank you very much.

Chairman Cohen and other distinguished Members of the Committee, on behalf of the National Community Reinvestment Coalition, we are honored to have an opportunity to share our thoughts with you today. I would like to say that NCRC is also pleased to be a member of a new coalition of more than 200 consumer, civic, labor, and civil rights organizations, called Americans for Financial Reform, which is working to cultivate integrity and accountability within the financial system.

Members of the Committee, the U.S. economy is mired in the worst economic crisis in more than half a century, and while few would conclude the current economic environment is comparable to the Great Depression, we could certainly conclude it is the Great Recession. Although we have suffered much already, the worst remains ahead of us.

Unlike the foreclosures of 2007 and 2008 that were driven by the toxic and unaffordable mortgage products, the current wave of foreclosures is largely the result of unemployment and/or loss of income. The more than 3 million jobs that have been lost since the start of this year, for example, translate into possibly 1.2 million more foreclosures. In fact, we are now experiencing a self-perpetuating cycle whereby foreclosures create a drag on the economy that leads to more foreclosures and to further economic distress. The bottom line of this is that it seems difficult to understand how we will enter a meaningful economic recovery as long as the foreclosure crisis continues to grow.

It is important to recognize that this is not an equal opportunity recession. Although the national unemployment rate is an uncomfortable 9½ percent as of June, that rate for African Americans already exceeds 15 percent, and for Latinos it is approaching 13 percent. This is compared to a rate of just under 9 percent for non-Hispanic White households. Because African Americans and Latinos have comparatively few savings, they are poorly positioned to survive a lengthy battle of unemployment. As a result, potentially millions of African Americans and Latinos stand the prospect of falling out of the middle class by the time the economy recovers. Moreover, African Americans and Latinos were targeted disproportionately for deceptive loan products. As a result, Blacks and

Latinos are overrepresented in the foreclosure statistics. African Americans, for example, have experienced a decline of 3 percentage points in home ownership rate since the crisis began.

In response to the magnitude and complexity of the current crisis, a threefold response is necessary. First, we need to stem the tide of foreclosures. The new Home Affordable Modification Program is the most comprehensive plan that has been put forward to date, but the program is off to a slow start for a variety of program design and administrative reasons.

In response, the Administration has been aggressive about addressing the weaknesses in the program, but to date they estimate that 50,000 loans have been modified since the program was launched. This compares to an estimated 7 million foreclosures now predicted this year and next by Moodys.com. So it appears that there is a mismatch.

What we believe is needed is a new vintage Great Depression-era Homeowners Loan Corporation or type of operation within the Federal Government which would effectively reach out and purchase toxic assets. This was proposed last year, and we believe it should have been done; but they should buy them, using exceptional powers of the Federal Government, at a discount between the current market and the face value of those loans. That discount would be applied to modifying the loans to make them long-term affordable.

We also believe that some type of supernormal entity is needed because of the unique nature of the foreclosures now which are driven by unemployment. There is no program in place right now that currently can deal with homes going into foreclosure for which the consumer has no effective income.

The reform of the Bankruptcy Code is something that we also believe is warranted. It was proposed as part of the President's Home Affordable Modification Program, and we believe it should be reintroduced and passed into law. As has been stated already, currently, bankruptcy courts can modify repayment terms on outstanding debts of luxury yachts, investment properties and other assets, except if it is the family home. We believe that there is no public purpose served in this treatment.

Further, expanded bankruptcy protection could address a major share of loans going into foreclosure, and it could act as an incentive for servicers to be more responsive to the Federal Government's public policy goals of loan modifications.

Second, we believe that certain communities which have borne disproportionate shares of the damage should actually receive disproportionate shares of assistance to help us out of this crisis. We believe that those neighborhoods that have a convergence of three factors—significantly high unemployment rates, high concentrations of foreclosures and historically underfunded or poorly maintained infrastructure—should receive priority treatment.

Channeling dollars to individuals and communities that need them the most will actually, most immediately, stimulate the economy and will create jobs. The reason for this is that families who live on the edge of survival will pour those recovery dollars immediately back into the economy, spending it on groceries, medicine, clothing, child care, energy, transportation, and on other basic necessities.

In conclusion, let me say that the final piece of what is needed is to put into place financial system reforms that make sure that the current crisis we are experiencing never happens again. That would include addressing unfair and deceptive lending practices, expanding laws that improve access to capital, such as the Community Reinvestment Act, and also enacting, we believe, a consumer financial protection agency that can more proactively address fraud, misbehavior and abuse before it works its way into the system.

Thank you very much.

Mr. COHEN. Thank you, Mr. Carr. I appreciate your testimony as well.

[The prepared statement of Mr. Carr follows:]

PREPARED STATEMENT OF JAMES H. CARR

INTRODUCTION

Good afternoon Mr. Chairman and other distinguished Members of the Committee. My name is James H. Carr and I am the Chief Operating Officer for the National Community Reinvestment Coalition. On behalf of our coalition, I am honored to speak with you today.

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. NCRC is also pleased to be a member of a new coalition of more than 200 consumer, civic, labor, and civil rights organizations—Americans for Financial Reform—that is working to cultivate integrity and accountability within the US financial system.

THE FORECLOSURE AND ECONOMIC CRISES

Members of the Committee, the U.S. economy is mired in the worst economic crisis in more than a half century. And while few would conclude the current economic environment is comparable to the Great Depression, today's economy has earned its moniker, the Great Recession. Although we have suffered much already, the worst remains ahead of us.

The most dispiriting aspect of the current crisis is that we have yet to meaningfully address foreclosure crisis, the core problem that caused the financial system to implode and drove the economy into a ditch.

The current wave of foreclosures is largely rooted in toxic mortgage products originated between 2007 and 2008. This wave is being driven by rising unemployment and reduction in workers' hours. The more than 3 million jobs that have been lost since the start of this year, for example, translate into potentially 1.2 million additional foreclosures.

In fact, we are now experiencing a self-perpetuating cycle wherein (1) foreclosures drive down home values; (2) sinking home values erode bank assets and household wealth; (3) loss of wealth leads to lower consumer spending and less lending activity by banks; (4) this, in turn, leads to lower productivity; (5) decreased productivity creates more unemployment; and (6) more foreclosures. At this point the cycle is complete and self-reinforcing, as newly unemployed and under-employed homeowners face foreclosure when they cannot make mortgage payments.

The reality of this self-reinforcing and economically destructive cycle raises questions about the validity of many recent economic projections that suggest the economy is recovering. The financial services industry, for example, remains on life support despite recent positive earnings news.

A close look at the fine print and footnotes in the positive earnings reports of many large financial firms, for example, reveals that creative accounting has replaced innovative finance as a primary source of profits within the banking industry. Few of the reported earnings are a result of lending for and investments in tangible products and services for the American economy.

NOT AN EQUAL OPPORTUNITY CRISIS

This is not an equal opportunity recession. Although the national unemployment rate is an uncomfortable 9.5 percent as of June, that rate for African Americans exceeds 15 percent, and for Latinos unemployment is approaching 13 percent. The unemployment rate for non-Hispanic whites, by comparison, remains under 9 percent.

Because African Americans and Latinos comparatively few savings, they are poorly positioned to survive a lengthy bout of unemployment. As a result, potentially millions of African-Americans and Latino households could find themselves falling out of the middle class by the time the economy recovers.

Moreover, African Americans and Latinos were targeted disproportionately for deceptive high cost loans. According to a study by the U.S. Department of Housing and Urban Development, subprime loans are five times more likely in African American communities than in white neighborhoods, and homeowners in high-income black areas are twice as likely as borrowers in lower-income white communities to have subprime loans.

The result is that blacks and Latinos are over-represented in the foreclosure statistics. African Americans, for example, have experienced a full three-percentage point drop in their homeownership rate since the crisis began.

Research by the National Community Reinvestment Coalition found that predatory lenders aimed their toxic products heavily at women of color. Because African-American children are more likely to reside in female-headed households, black children are also disproportionately harmed as a result of the foreclosure crisis and its attendant stresses.

Finally, in a separate NCRC study (The Broken Credit System, 2004), we found that after controlling for risk and housing market conditions, the portion of subprime refinance lending increased when the number of residents over the age of 65 increased in a neighborhood. If a borrower were a person of color, female, and a senior, she was the "perfect catch" for a predatory lender.

FIXING THE PROBLEMS

In response to the magnitude and complexity of the current crisis, a three-fold response is essential.

1. Stem the Rising Tide of Foreclosures

The new "Home Affordable Modification Program" (or HAMP) is the most comprehensive plan to date to address the foreclosure crisis.

Features that make the President's plan *superior to any similar programs to date include:*

(1) The government shares the cost of writing down loans to be affordable for borrowers;

(2) Loan modifications are designed to make loans affordable over the long-term;

(3) Borrowers do not have to become delinquent in order to receive assistance;

(4) Second liens can also be modified as part of the plan (more than half subprime loans); and

(5) Servicers are provided financial incentives to encourage their participation; and (bankruptcy protection is proposed as a stick to encourage participation.

These are key and critical program elements missing from previous efforts. But there remain challenges.

Challenges with the program include:

(1) Principal balances on loans that are severely underwater are not bought down or eliminated to improve loan affordability. Forbearance of principal, accompanied with balloon payments due on sale of transfer of property, codifies predatory or discriminatory loan features. This is a critical weakness in HAMP because many loans have experienced negative amortization since they were originated, because they were originated at grossly inflated prices. Loans that are deeply upside down are more at risk of foreclosure even if the payments are made affordable.

(2) The program is voluntary for some institutions, and for all, is administratively cumbersome, time-consuming, and inconsistently administered (including failure to fully appraise consumers' financial situations to ensure the modifications is sustainable from borrower's financial perspective; and

(3) Unemployment-induced foreclosures are not adequately addressed. Borrowers facing a loss of income before or after a modification are not fully

protected and foreclosure needlessly continues to be the trigger for costly evictions. This latter practice of evicting borrowers who have been foreclosed upon further drives down home prices for neighboring homeowners and positions additional properties for foreclosure.

Finally, the program would benefit greatly from more transparent data on loan modification outcomes so as to allow for a more immediate analysis of the program's performance and the need for possible further refinements.

The Administration has thus far been aggressive about responding to program weaknesses and tightening guidelines to improve performance. But as HAMP's performance thus far bears out, the program remains far from meeting the foreclosure prevention needs demanded by the magnitude of the crisis. The best estimates to date are that 50,000 loans have been modified since the program was launched earlier this year. This compares with an estimated 7 million foreclosures predicted for this year and next by Moody's Economy.com.

It is clear that a more robust response is needed.

A "new" vintage Great Depression era Homeowners Loan Corporation (HOLC) is warranted. The new entity would more aggressively pursue loan modifications using exceptional powers, such as eminent domain, to secure toxic loan products from investors and modify as many loans as possible to make them affordable and sustainable. Loans would be purchased at a reasonable discount (between current market value and face value). Discounts secured through the purchase process would be applied to modify the loans. This process would greatly reduce the cost to taxpayers of loan modification.

The new HOLC could also be useful to address unemployment-driven foreclosures. HOLC could take possession of properties and structure foreclosure moratoria based on workers' unemployment benefits. During that period, mortgage payments could be greatly reduced.

Under certain circumstances, borrowers might be allowed to remain in their homes at no cost (for a limited time. This arrangement in many instances would benefit the borrower, their community and investor since vacant and abandoned properties harm all parties and do not benefit anyone. The foreclosure loss severity rate on homes financed with subprime loans is now approaching 65 percent.

Reform of the bankruptcy code is also warranted. It was proposed as part of the President's Home Affordable Modification Program and should be reintroduced and passed into law.

Currently, bankruptcy courts can modify repayment terms on the outstanding debt on a luxury yacht or investment property, but not the family home. This disparity in treatment is unfair, inequitable, and serves no legitimate public policy goal. Furthermore, expanded bankruptcy protection could address as much as 30 percent of loans heading to foreclosure and at no cost to the American taxpayer.

2. Rebuild Communities Harmed by the Crisis

Certain communities have borne a disproportionate share of the damage and pain wrought by the foreclosure and economic crises, and should therefore be targeted for priority allocation of economic recovery funding. These acutely suffering communities are characterized by a convergence of three factors:

1. Significantly higher levels of unemployment;
2. Significantly greater concentrations of foreclosures; and
3. Historically under-funded, inferior, or poorly maintained infrastructure.

Channeling dollars to the individuals and communities that need them most will immediately stimulate the economy and save and create jobs. Families that live on the edge of survival will pour these recovery dollars immediately back into the economy through spending on groceries, medicine, clothing, child care, energy, transportation, and other basic necessities. Prioritizing areas hardest hit by widespread unemployment and mounting foreclosures would more directly help stabilize the housing market and steady falling home prices that continue to undermine the strength of US financial institutions. Finally, investing in areas most in need of infrastructure improvements would provide a needed enhancement of the quality of life in communities long-neglected.

3. Refocus Financial System Regulation on the Interests of Consumers

Many blame the foreclosure crisis on a claim that financial institutions sought to improve homeownership among unqualified low- and moderate-income, and minority households. This assertion has no basis in fact or logic.

According to the Federal Reserve Board, only 6 percent of high-cost subprime loans to low- and moderate-income households were covered by CRA regulation.

And, the Center for Responsible Lending finds that less than 10 percent of subprime loans were for first-time homeownership.

In fact, it was failure to regulate adequately the U.S. mortgage markets that allowed deceptive, reckless, and irresponsible lending to grow unchecked until eventually it overwhelmed the financial system.

Almost every institutional actor in home mortgage finance process played a role. Comprehensive anti-predatory lending legislation should be enacted immediately. Such legislation should apply mortgage-related consumer protections to all of the institutional players in the mortgage market including banks, brokers, mortgage companies, appraisers, servicers, investment banks, credit rating agencies, hedge funds, and other financial entities.

Expansion of the Community Reinvestment Act (CRA) is also essential to bringing safe and sound lending to struggling families and communities.

Inasmuch as nearly 95 percent of problematic subprime loans were originated by non-CRA covered institutions, the time to bring more financial firms under the regulatory umbrella of CRA.

Moreover, today roughly 97 percent of banks pass their CRA exams. Yet, more than 40 million households are only marginally connected to mainstream financial institutions and more than 9 million are completely unbanked. The time has also come to increase enforcement of CRA on existing covered institutions, including eliminating the loopholes, exceptions, and special preferences that allow banks to exclude major shares of their business operations from coverage.

The CRA ratings system is also in need of refinement to provide more meaningful CRA grades, and improve data collection and analysis, and inclusion of race as an explicit factor in CRA exams are also long overdue.

A final component of comprehensive financial regulatory reform is the establishment of a Consumer Financial Protection Agency. President Obama's regulator reform proposal calls for the creation of such an agency, and Congress should pass that into law. The imperative is clear for a regulatory body that puts consumers ahead of special banking interests. The reality of the mortgage market is that as soon as one predatory practice is eliminated, another takes its place.

Today, for example, the Mortgage Asset Research Institute estimates that mortgage-related fraud is more prevalent now than it was at the height of the lending boom. The proposed Consumer Financial Protection Agency would have the authority to investigate and take action against existing and future unfair and irresponsible lending practices as they evolve. And it would create rules that make financially predatory practices harder to introduce in the markets.

CONCLUSION

In the words of Nobel Prize-winning economist Joseph Stiglitz, the financial system discovered there was money at the bottom of the wealth pyramid and it did everything it could to ensure that it did not remain there. Stated otherwise, the business model for many financial institutions was to strip consumers of their wealth rather than build and improve their financial security.

Ironically, most solutions to date have focused on rewarding the financial firms (and their executives) that created this crisis. But in spite of more than $12.8 trillion of financial support in the form of loans, investment, and guarantees, this approach is not working because consumers continue to struggle in a virtual sea of deceptive mortgage debt and a financial system that remains unaccountable to the American public.

Now is the time to shift the focus away from Wall Street and onto Main Street by addressing, in a broader manner, the growing foreclosure crisis and its contagion effects on national home prices and the overall economy. This includes introducing a more robust foreclosure mitigation program, focusing recovery dollars on the communities most negatively impacted by the crisis, and enacting strong consumer protections against deceptive and reckless lending practices.

Mr. COHEN. Our third witness is Mark Calabria. Dr. Calabria is the Director of Financial Regulation Studies at the Cato Institute. Before joining Cato, he spent 6 years as the senior professional staff member for the U.S. Senate Committee on Banking, Housing, and Urban Affairs. In that position, he handled issues relating to housing and mortgage finance, banking and insurance for the Ranking Member, Mr. Shelby of Alabama. Prior to his service on

Capitol Hill, Dr. Calabria served as Deputy Assistant Secretary for Regulatory Affairs at the U.S. Department of Housing and Urban Development, and he held a variety of positions at Harvard's Joint Center for Housing Studies, at the National Association of Home Builders and at the National Association of Realtors. He has also been a research associate at the U.S. Census Bureau Center for Economic Studies.

Thank you. We welcome your testimony.

TESTIMONY OF MARK A. CALABRIA, Ph.D., DIRECTOR OF FINANCIAL REGULATION STUDIES, CATO INSTITUTE, WASHINGTON, DC

Mr. CALABRIA. Thank you, Chairman.

My testimony today will address two specific questions. The first is: Why have the Obama and Bush administrations' efforts along with those of the mortgage industry's to reduce foreclosures had so little impact on the overall foreclosure numbers?

The second question is: Given what we know about why previous efforts have had such little impact, what are our policy options?

The short answer to why previous Federal efforts to stem the current tide of foreclosures have largely failed is that such efforts have grossly misdiagnosed the causes of mortgage defaults. An implicit assumption behind HOPE NOW—FDIC's IndyMac model—and the Obama administration's current foreclosure efforts is that the current wave of foreclosures is almost exclusively the result of predatory lending practices and exploding adjustable rate mortgages where large payment shocks upon the rate reset cause mortgage payments to become unaffordable.

The simple truth is that the vast majority of mortgage defaults are being driven by the same factors that have always driven mortgage defaults: generally, a negative equity position on the part of a homeowner, coupled with a life event that results in a substantial shock to his income, most often a job loss or a reduction in earnings. Until both of these components—negative equity and a negative income shock—are addressed, foreclosures will remain at highly elevated levels.

If payment shock alone were the dominant driver of defaults, then we would observe most defaults occurring around the time of reset, specifically just after the reset. Yet this is not what has been observed. Of loans with reset features that have defaulted, the vast majority of defaults occurred long before the reset.

Additionally, if payment shock were the driver of default, the fixed rate mortgages without any payment shocks would display default patterns significantly below that of adjustable rate mortgages. When one controls for owner equity and credit score, the differences in performance between these different mortgage products largely disappear.

To illustrate, consider that those mortgages generally considered among the safest—mortgages insured by the Federal Housing Administration, the FHA, which are almost exclusively fixed rate with no prepayment penalties and substantial borrower protections—perform on an apples-to-apples basis as badly as the subprime market in terms of delinquencies.

The important shared characteristic of FHA and most of the subprime market is the widespread presence of zero or very little equity in the mortgage at origination. The characteristics of zero or negative equity also explain the poor performance of most subprime adjustable rate mortgages. Many of these loans also had little or no equity upon origination, providing the borrower with little equity cushion when prices fell.

Central to the arguments calling for greater government intervention in the mortgage market is that many, if not most, of the foreclosures being witnessed are unnecessary or avoidable. Generally, it is argued that investors and loan servicers do not face the same incentives and that, in many cases, it would be better for the investor if the loan were modified rather than taken to foreclosure, but still the servicer takes the loan to foreclosure.

The principal flaw in this argument is it ignores the costs to the lender of modifying loans that would have continued paying otherwise. Ex ante, a lender has no way of separating the truly troubled borrowers who would default from those who would take advantage of the system if they knew they could get a modification just by calling. As long as potentially defaulting borrowers remain a low percentage of all borrowers, as they are today, it is in the interest of the investor to reject many modifications that might make sense ex post.

The high level of foreclosures has left many policymakers understandably frustrated and searching for answers. One solution that has been regularly presented is to allow bankruptcy judges to reduce the principal balance of a mortgage loan to reflect the reduced value of the home, the so-called "cramdown." I believe allowing cramdowns would have adverse market consequences while also providing little real relief to borrowers.

Given the unemployment-driven nature of most foreclosures and the inability of unemployed individuals to put forth a repayment plan under chapter 13 of the Bankruptcy Code, it appears that cramdowns would do nothing for those most in need—the unemployed.

As proponents of cramdowns point out, vacation and investment properties can currently be subjected to cramdown. This raises the question, why aren't the significant numbers of foreclosures involving investment properties being resolved via bankruptcy rather than by the foreclosure process?

The most likely reason is that property speculators realize that even a reduced mortgage value is likely to exceed the home value in the near future. With home prices still declining, a crammed-down mortgage would be underwater in a few months. The incentive facing most speculators is often to simply walk away and to let the home fall into foreclosure. This would not be a significant problem if investment properties did not constitute approximately 40 percent of current foreclosures.

At this point, it is worth reflecting on these two points. Cramdowns do little or nothing to help the unemployed, and speculators can already pursue that route but largely choose not to, as it is not in their economic interest. With speculators making up about 40 percent of foreclosures and the unemployed likely making up to around 50 percent, it becomes apparent that, at minimum, cramdowns will do little to help at least 90 percent of borrowers currently in foreclosure.

In concluding my testimony, I again wish to strongly state that the current foreclosure relief efforts have largely been unsuccessful because they have misidentified the underlying causes of mortgage default. It is not exploding ARMs or predatory lending that drives the current wave of foreclosures but negative equity driven by house prices declines, coupled with adverse income shocks, that are the main drivers of defaults on primary residences. Defaults on speculative properties continue to represent a large share of foreclosures. Accordingly, for any plan to be successful, it must address both negative equity and reductions in earnings. Cramdown fails on both accounts.

I thank you for your attention and welcome your questions.

Mr. COHEN. Thank you, sir. I appreciate it, Dr. Calabria.

[The prepared statement of Mr. Calabria follows:]

PREPARED STATEMENT OF MARK A. CALABRIA

Chairman Conyers, Ranking Member Smith, Subcommittee Chairman Cohen, Ranking Member Franks, and distinguished members of the Subcommittee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen and a taxpayer, I have no direct financial interest in the subject matter before the subcommittee today, nor do I represent any entities that do.

My testimony today will address two specific questions. The first is: why have the Obama and Bush Administration efforts, along with those of the mortgage industry, to reduce foreclosures had so little impact on the overall foreclosure numbers?

The second question is: given what we know about why previous efforts have had such little impact, what are our policy options?

In answering both these questions, I rely on an extensive body of academic literature, the vast majority of which has been subjected to peer review, which has examined the determinates of mortgage delinquency and default. Foremost among this literature is a series of recent papers written by economists at the Federal Reserve Banks of Boston and Atlanta, in particular the work of Paul Willen, Christopher Foote and Kristopher Gerardi. My testimony owes a considerable intellectual debt to this research.

WHY HAVEN'T PREVIOUS EFFORTS STEMMED THE FORECLOSURE TIDE?

The short answer to why previous federal efforts to stem the current tide of foreclosures have largely failed is that such efforts have grossly misdiagnosed the causes of mortgage defaults. An implicit assumption behind former Treasury Secretary Paulson's HOPE NOW, FDIC Chair Sheila Bair's IndyMac model, and the Obama Administration's current foreclosure efforts is that the current wave of foreclosures is almost exclusively the result of predatory lending practices and "exploding" adjustable rate mortgages, where large payment shocks upon the rate re-set cause mortgage payment to become "unaffordable."

The simple truth is that the vast majority of mortgage defaults are being driven by the same factors that have always driven mortgage defaults: generally a negative equity position on the part of the homeowner coupled with a life event that results in a substantial shock to their income, most often a job loss or reduction in earnings. Until both of these components, negative equity and a negative income shock are addressed, foreclosures will remain at highly elevated levels.

Given that I am challenging the dominant narrative of the mortgage crisis, it is reasonable to ask for more than mere assertions. First, if payment shock alone were the dominate driver of defaults then we would observe most defaults occurring around the time of re-set, specifically just after the re-set. Yet this is not what has been observed. Analysis by several researchers has found that on loans with re-set features that have defaulted, the vast majority of defaults occurred long before the re-set. Of course some will argue that this is due to such loans being "unaffordable" from the time of origination. Yet according to statistical analysis done at the Boston Federal Reserve, the borrower's initial debt-to-income (DTI) had almost no predictive power in terms of forecasting subsequent default.

Additionally if payment shock was the driver of default, the fixed rate mortgages without any payment shocks would display default patterns significantly below that of adjustable rate mortgages. When one controls for owner equity and credit score, the differences in performance between these different mortgage products largely disappears. To further illustrate this point, consider that those mortgages generally considered among the "safest"—mortgages insured by the Federal Housing Administration (FHA), which are almost exclusively fixed rate with no-prepayment penalties and substantial borrower protections, perform, on an apples to apples basis, as badly as the subprime market in terms of delinquencies.

The important shared characteristic of FHA and most of the subprime market is the widespread presence of zero or very little equity in the mortgage at origination. The characteristics of zero or negative equity also explain the poor performance of most subprime adjustable rate mortgages. Many of these loans also had little or no equity upon origination, providing the borrower with little equity cushion when prices fell. Recognizing the critical role of negative equity of course raises the difficult question as to what exactly it is that homeowners are losing in the event of a foreclosure.

"Unnecessary" foreclosures

Central to the arguments calling for greater government invention in the mortgage market is that many, if not most, of the foreclosures being witnessed are "unnecessary" or avoidable. Generally it is argued that investors and loan servicers do not face the same incentives and that in many cases in would be better for the investor if the loan were modified, rather than taken to foreclosure, but still the servicer takes the loan to foreclosure.

The principal flaw in this argument is it ignores the costs to the lender of modifying loans that would have continued paying otherwise. Ex Ante, a lender has no way of separating the truly troubled borrowers, who would default, from those that would take advantage of the system, if they knew they could get a modification just by calling. As long as potentially defaulting borrowers remain a low percentage of all borrowers, as they are today, it is in the best interest of the investor to reject many modifications that might make sense ex post. In addition, lenders may institute various mechanisms to help distinguish troubled borrowers from those looking to game the system.

It is also claimed that the process of securization has driven a wedge between the interests of investors and servicers, with the implication that servicers would be happy to modify, and investors would prefer modifications, but that the pooling and servicing agreements preclude modifications or that servicers fear being sued by investors. The first fact that should question this assumption is the finding by Boston Fed researchers that there is little difference in modification rates between loans held in portfolio versus those held in securitized pools. There is also little evidence that pooling and servicing agreements preclude positive value modifications. According to recent Credit Suisse report, less than 10 percent of agreements disallowed any modifications. While the Congressional Oversight Panel for the TARP has been critical of industry efforts, even that Panel has found that among the sample of pools it examined with a 5-percent cap on the number of modifications, none of the pools examined had actually reached that cap. If few pools have reached the cap, it would seem obvious that the 5 percent cap is not a binding constraint on modifications. In many instances the pooling agreements also require the servicer to act as if the servicer held the whole loan in its portfolio, raising substantial doubts as the validity of the "tranche warfare" theory of modifications.

A careful review of the evidence provides little support for the notion that high transaction costs or a misalignment of incentives is driving lenders to make foreclosures that are not in their economic interest. Since lenders have no way to separate troubled borrowers from those gaming the system, some positive level of negative value foreclosures will be profit-maximizing in the aggregate.

Is cramdown the answer?

The high level of foreclosures has left many policymakers and much of the public understandably frustrated and searching for answers. One "solution" that has been regularly presented is to allow bankruptcy judges to reduce the principle balance of a mortgage loan to reflect the reduced value of the home, the so-called "cramdown." For a variety of reasons, I believe allowing cramdowns would have adverse market consequences while also providing little real relief to borrowers.

Given the unemployment-driven nature of most foreclosures, and the inability of unemployed individuals to put forth a repayment plan under Chapter 13 of the bankruptcy code, it appears that cramdowns would do nothing for those most in need, the unemployed.

As proponents of cramdowns point out, vacation and investment properties can currently be subjected to cramdown. This raises the question: why aren't the significant number of foreclosures involving investment properties being resolved via bankruptcy rather than the foreclosure process? The most likely reason is that property speculators realize that even a reduced mortgage value is likely to exceed the home value in the near future. With home prices still declining, a crammed down mortgage would be underwater in few months. The incentive facing most speculators is often to simply walk away and let the home fall into foreclosure. This would not be a significant problem if investment properties did not constitute approximately 40 percent of current foreclosures.

At this point, it is worth reflecting on these two points: cramdowns do little or nothing to help the unemployed and speculators can already pursue that route, but largely choose not to, as it isn't in their economic interest. With speculators making up about 40 percent of foreclosures, and the unemployed likely making up to around 50 percent, it becomes apparent that at minimum cramdowns will do little to help at least 90 percent of borrowers currently in foreclosure.

The main function of a cramdown would be to serve as reduction in outstanding principle, thereby lowering the monthly payment. Even significant payment reductions may not offer long-term solutions. According to the most recent OTS/OCC mortgage metrics report, of those delinquent borrowers seeing a payment reduction of 20 percent or more 37.6 percent were again delinquent twelve months later. Continuingly re-modifying the same loan is not a solution for the borrower, investor, or lender.

We often use the term "speculator" to refer to purchasers that do not intend to live in the home and often quickly "flip" the home to make a quick profit. That definition is useful, but far too narrow. Many borrowers purchasing a home for occupancy did not do so solely for the consumption benefits of homeownership, but also for the investment returns. They were both consumers and speculators. As these speculators were generally not offering to share potential gains with their lenders, it is not clear why they should be allowed to share their losses.

Of the remaining borrowers, who were neither pure speculators nor unemployed, many of these borrowers invested little of their own cash in the home purchase. Once again, the empirical evidence demonstrates that minimal or zero downpayments on the part of borrowers are the leading mortgage characteristic in terms of predicting default. If borrowers, who have placed no money of their own at risk, are allowed to reduce their losses via cramdown, while also reaping any future appreciation, we are only encouraging future speculation in our housing markets. We should not act surprised if the next housing cycle of bubble and bust is even worst than the most recent.

Proponents of cramdown have also misrepresented the treatment of vacation homes and investor properties during a Chapter 13 bankruptcy. While the current Bankruptcy Code does allows secured debts other than those secured by a principal residence to be crammed down; if they are crammed down, the debtor is required to pay off the entire amount of the secured claim within the three-to-five year duration of the Chapter 13 plan. The debtor does not have 30 years to pay off a modified mortgage as the original loan term may provide. The borrower in these instances is required to pay the entire amount of the secured mortgage by the end of their payment plan. This is one of the reasons many owners of investment choose to walk way rather than seek bankruptcy protection.

Cramdown is often presented as simply a way to put pressure on lenders to negotiate, or to "bring them to the table." It is no more appropriate, in a free society, to use the coercive stick of the state to bring lenders to the table, than it would be to use that stick to bring borrowers to the table. A government focused on the common good, the general welfare, does not choose sides in private disputes.

Less tangible, but perhaps more important in the cramdown debate is the message it sends to market participants, particularly investors. It has long been established in law, and in common sense for that matter, that the body of law relevant to and existing at the time of a contract enters into and comprises part of that contract. To change by legislative fiat the terms of contracts that have already been agreed to is to change the contract itself. I fear if the cramdown were to become law, we send a signal that any private agreement is subject to being re-written depending on which way the political winds are blowing. This is a sure recipe to reduce investment and the overall reliance of market participants on contract. In order to rebuild public trust in both our markets and our government, I believe Congress should affirm its own trust in the voluntary decisions of private parties. To do otherwise is to weaken the very bonds that make a free and civilized society possible.

In speaking of investors, it is also important to remember that cramdown is not simply an issue of taking from lenders and giving to borrowers. As bad as that would be, it is made all the worse as the ultimate investors in mortgage related assets that will suffer losses rather than the largest banks. As the largest banks are mostly just servicers and not the ultimate investor, they will pass along any losses from cramdown to investors. As we have seen in the recent auto restructuring, often these investors are not large corporations or wealthy individuals; they are pension funds representing the retirement savings of millions, usually retired state and local government employees. I have yet to hear a compelling reason why retired teachers and firefighters should be forced to bear the burden of irresponsible borrowing and lending.

NON-COERCIVE SOLUTIONS

I am concerned that inherent in the title of this afternoon's hearing is the assumption that if voluntary modifications are not working, we must look to coercive solutions. The force of the State must be applied to those unwilling to see the light. This assumption should trouble anyone who values a free society. I urge Congress to look for only those solutions that are voluntary.

Some voluntary alternatives to consider: encouraging bank regulators to give lenders more flexibility to lease out foreclosed homes to the current residents. Typically banks come under considerable pressure from their regulators not to engage in long term property leasing or management, as that activity is not considered a core function of banks. I believe we can avoid the larger debate of banks being property managers by giving banks greater flexibility in retaining properties with nonperforming mortgages as rentals, preferably to current residents.

In order to separate out deserving borrowers, who are trying to get back on their feet, from those simply walking away from a bad investment, Federal lending entities, such as FHA and the GSEs, should engage in aggressive recourse against delinquent borrowers who have the ability to pay, but simply choose not too. We should make every effort to turn away from becoming a society where legally incurred debts are no longer obligations to be honored but simply options to be exercised.

CONCLUSIONS

In concluding my testimony, I again wish to strongly state: the current foreclosure relief efforts have largely been unsuccessful because they have misidentified the underlying causes of mortgage default. It is not exploding ARMs or predatory lending that drives the current wave of foreclosures, but negative equity driven by house prices declines coupled with adverse income shocks that are the main driver of defaults on primary residences. Defaults on speculative properties continue to represent a large share of foreclosures. Accordingly for any plan to be successful it must address both negative equity and reductions in earnings. Cramdown fails on both accounts. I thank you for your attention and welcome your questions.

Primary References:

Foote, Gerardi, Goette and Willen (2009) "Reducing Foreclosures: No Easy Answers," National Bureau of Economic Research working paper 15063.

Cordell, L., K. Dynan, A. Lehnert, N. Liang, and E. Mauskopf (2008). The Incentives of Mortgage Servicers: Myths and Realities. Finance and Economics Discussion Series, Federal Reserve Board 46.

Foote, C., K. Gerardi, L. Goette, and P. S. Willen (2008). Just the facts: An initial analysis of subprime's role in the housing crisis. *Journal of Housing Economics* 17 (4).

Foote, C., K. Gerardi, and P. Willen (2008). Negative equity and foreclosure: Theory and evidence. *Journal of Urban Economics* 6 (2), 234–245.

Gerardi, K., A. Shapiro, and P. Willen (2007). Subprime outcomes: Risky mortgages, homeownership experiences, and foreclosures. Federal Reserve Bank of Boston Working Paper 07–15.

Hunt, J. (2009). What do subprime securitization contracts actually say about loan modification. Berkeley Center for Law, Business and the Economy.

Kau, J. B., D. C. Keenan, and T. Kim (1994). Default probabilities for mortgages. Journal of Urban Economics 35 (3), 278–296.

Sherlund, S. (2008). The past, present, and future of subprime mortgages. Finance and Economics Discussion Series 2008–63, Federal Reserve Board.

Mr. COHEN. Our final witness is Irwin Trauss. For the past 10 years, he has worked for the Philadelphia Legal Assistance, providing free legal services to low-income Philadelphians. As supervisor of the Consumer Housing Unit there, he works with Community Legal Services to provide legal services to an eligible low-income population of approximately 400,000 in Philadelphia. For the 20 years preceding his time there, he worked for Community Legal Services in Philadelphia where he co-managed the law center in the Northeast. For a time, he was also chief of the law center's Consumer Housing Unit.

Thank you, Mr. Trauss, and I appreciate your testimony.

TESTIMONY OF IRWIN TRAUSS, MANAGER, ATTORNEY FOR THE CONSUMER HOUSING UNIT, PHILADELPHIA LEGAL ASSISTANCE, PHILADELPHIA, PA

Mr. TRAUSS. Thank you, Mr. Chairman and Members of the Committee for the invitation to appear this afternoon to describe our experience with voluntary mortgage modifications, particularly since the Making Homes Affordable plan came into effect on March 4 of this year.

In addition to supervising the Consumer Housing Unit of Philadelphia Legal Assistance, I also am primarily responsible for running the Save Your Home Philly Hotline, which over the past 15 months, as part of the Philadelphia Court of Common Pleas Mortgage Foreclosure Diversion Pilot Program, has handled about 10,000 calls from Philadelphia homeowners facing the loss of their homes to foreclosure. Also, for the past 32 years, it has been my primary practice, legal practice, to represent low-income homeowners in bank foreclosures. I have done that by litigating in State, Federal and bankruptcy courts.

Before I go on with some of the comments that I have prepared to answer the question that I think I was asked to address, I just want to make a comment about Dr. Calabria's testimony about cramdowns. I just want to make two quick points about that.

One, in the Third Circuit, except as a result of some changes in the law, cramdowns were largely available in the Third Circuit—and still are—with respect to mortgages in certain circumstances since 1978. They were largely available in the Third Circuit due to Vanguard's allowing cramdowns, and they had no effect—no effect—either on the pricing or on the availability of mortgages.

Secondly, the notion that comparing the experience of speculators, with respect to bankruptcy, to the experience of homeowners is completely inappropriate. In my personal experience of representing homeowners, as I say, for my long career, the availability of cramdowns, particularly for low-income homeowners with low-value homes, is extremely helpful in the ability for them to save their homes.

At one point in my practice, a large majority of the chapter 13 cases that I filed for low-income homeowners in Philadelphia involved cramdowns of mortgages, which indeed helped them save their homes.

I think the reason that I was asked to testify was to broaden the perspective as somebody who day-to-day represents homeowners attempting to save their homes. From that perspective, the question that underlies this hearing is that voluntary modifications will not help homeowners save their homes in the numbers required to significantly stem the tide of foreclosures that has been alluded to.

Substantive changes in the law, such as proposed amendments to the Bankruptcy Code, that require loans to be modified to make them affordable are needed to prevent foreclosures in the numbers necessary to prevent the erosion that is occurring in our communities and the erosion of our economy. Unless homeowners have leverage to force a favorable result, lenders will continue to avoid meaningful modifications.

While Making Homes Affordable has made a significant difference in a small percentage of the cases that we have seen in Philadelphia, which is reflective of the nationwide percentage, I believe, it has not resulted in a significantly greater willingness on the part of the servicers to enter into modifications that meaningfully reduce mortgages. It has not resulted in the willingness of lenders to reduce principal, and it has not even resulted in a willingness of lenders to reduce the amount of principal that is subject to interest.

I say this based not only on my personal experience but also on my position as a supervisor of the Hotline and from my involvement in the creation and operation of the Diversion Program that is being run in the courts in Philadelphia.

The Diversion Program, which is described at length in my written testimony, is a program that requires conciliation prior to a loan being foreclosed and prior to a foreclosure sale being able to take place. The lender and the borrower are required to sit down with a JPT who is available to try to work out an alternative resolution. This program is primarily voluntary, and it cannot impose a resolution on an unwilling mortgagee.

It has been my experience that, absent some leverage that can be applied by the homeowner to the lenders, the lenders are ordinarily unwilling to significantly compromise mortgages to make them affordable for the long run. They usually do so when they are forced to, either by aggressive advocacy, by the prospect of litigation, by litigation that actually frustrates their ability to foreclosure, or, in some cases, by pressure that is applied directly or indirectly by the court through the Diversion Program.

The implementation of the Making Homes Affordable Program has resulted in some wholesale delays in foreclosures, which has been helpful to homeowners, but it has not meaningfully affected this dynamic. It is clear that with or without Making Homes Affordable, homeowners represented by knowledgeable advocates, and who are backed up by counsel who are prepared to litigate, get resolutions that are simply not available to homeowners who are not so represented, but resolutions are available if pressed.

The arrival of Making Homes Affordable has not significantly affected the way servicers and their counsel operate. For example, Bank of America has signed a Servicer Participation Agreement, which requires it to make Making Homes Affordable available to homeowners in non-GSE circumstances. Despite this, they have refused to do so, and they inform homeowners that it is only available if they have a GSE loan. Thus, properties that should be protected by this program are not being. This is not an isolated event and we have lots of examples, which are in my testimony, regarding the missed application of the program.

In closing, let me just say that absent significant leverage on the part of homeowners to force a change in the behavior of the majority of servicers, they will continue to avoid meaningful modification, and that contrary to what has been expressed here, the existence of the availability of the cramdown actually will complement—as the Obama administration, I think, has recognized—the voluntary efforts by creating the leverage that is necessary to get lenders to modify loans and to prevent foreclosures at the rates that we need them prevented.

Mr. COHEN. Thank you, Mr. Trauss.

[The prepared statement of Mr. Trauss follows:]

PREPARED STATEMENT OF IRWIN TRAUSS

TESTIMONY OF IRWIN TRAUSS, ESQUIRE

SUPERVISING ATTORNEY
CONSUMER HOUSING UNIT
PHILADELPHIA LEGAL ASSISTANCE

HOME FORECLOSURES: WILL VOLUNTARY MORTGAGE MODIFICATION HELP FAMILIES SAVE THEIR HOMES?

BEFORE THE
SUBCOMMITTEE ON ADMINISTRATIVE AND COMMERCIAL LAW
HOUSE OF REPRESENTATIVES JUDICIARY COMMITTEE

JULY 9. 2009

Mr. Chairman, members of the subcommittee, I would like to thank you for the invitation to appear this afternoon to describe our experience with voluntary mortgage modifications particularly since the Making Homes Affordable plan ("MHAP") came into effect on March 4 of this year.

My name is Irwin Trauss, I am an attorney. I supervise the Consumer Housing Unit of Philadelphia Legal Assistance (PLA), an LSC funded program in Philadelphia, Pennsylvania. I have had this position at PLA for the past 13 years. For the previous 20 years I worked for Community Legal Services (CLS) in Philadelphia in a similar capacity. For almost thirty three years I have primarily represented low income homeowners faced with the loss of their homes through mortgage foreclosure, litigating as necessary in state, federal and bankruptcy court. In addition, I have overall responsibility for the operation of the Save Your Home Philly Hotline which over the past 15 months, as part of the Philadelphia Court of Common Pleas Mortgage Foreclosure Diversion Pilot Program, has handled about 10,000 calls from Philadelphia homeowners facing the loss of their homes to foreclosure.[1] Since April of 2008 every person faced with the imminent loss of his or her home through foreclosure has been referred by the

[1] Since May of 2008, the Hotline has received an average of between 600 and 700 calls a month. Paralegals who work under the supervision of attorneys whom I supervise take the calls. The paralegals on the Hotline triage the calls. They explain the diversion program; make appointments for the callers with housing counselors; and provide information and advice to housing counselors. In appropriate cases they refer the homeowners to the legal services attorneys at PLA or CLS for representation. In a small number of cases they make referrals to private attorneys. The Hotline staff also monitors the operation of the Diversion Program and provides feedback to the Court on behalf of homeowners for whom the Diversion Program has not worked as intended. I and attorneys I supervise, or attorneys from CLS with whom we work closely, help train the volunteer attorneys and the housing counselors. At least one attorney from my unit is present in court every day on which conciliation conferences are scheduled to take place to mentor pro bono attorneys and as a resource for the housing counselors. Finally, I and the attorneys and substantive paralegals in my unit undertake extended representation, which can include litigation, in about 200 new cases a year.

Court to the Hotline. As a result we have an intimate sense of what is happening with foreclosures in Philadelphia.

I understand I have been invited to testify to provide the perspective of someone who day in and day out represents homeowners attempting to stay in their homes. From that perspective, the answer to the question that underlies this hearing is that voluntary modifications will not help families save their homes in the numbers required to significantly stem the tide of foreclosures. Voluntary modifications will only help at the margins. Substantive changes in the law, such as the proposed amendments to the Bankruptcy Code that require loans to be modified to make them affordable, are needed to prevent foreclosures in the numbers necessary to prevent the further erosion of our communities. Unless homeowners have leverage to force favorable results, lenders will continue to avoid the meaningful modifications that are necessary to keep folks in their homes.

While Making Homes Affordable (MHAP) has made a significant difference in a small percentage of the cases that we have seen in Philadelphia, it has not resulted in a significantly greater willingness on the part of servicers to enter into modifications that meaningfully reduce monthly payments. It has also not resulted in a willingness of lenders to reduce the principal due or even to reduce the amount of principal subject to interest.

I say this based not only on my personal experience, but based on the information I glean in my role as the supervisor of the Hotline and from my involvement in the creation and operation of the Diversion Program.

The Hotline is run by Philadelphia Legal Assistance with funding primarily from the Philadelphia Office of Housing and Community Development. The Hotline is an instrumental part of the Philadelphia Court of Common Pleas Mortgage Foreclosure Diversion Pilot Program

- a program designed to reduce the number of homes lost to foreclosure by requiring lenders to meet with homeowners to explore alternatives before a judgment can be entered and before a sheriff sale of the property can take place. You may have heard of this program as it has received a great deal of media attention and has been touted as a solution to the foreclosure epidemic[2].

Under the Philadelphia Diversion Program, in each foreclosure case a conciliation date is scheduled. The court provides notice to the homeowner of the date along with a notice to contact the Hotline. As part of the program the homeowners are referred to housing counselors who help them put together affordable proposals that will enable them to stay in their homes. The proposals are submitted to the mortgage servicer and to the attorney representing the servicer, who are supposed to respond with a counter proposal. If there is a gap between the proposal and the counter proposal, the homeowner can appear on the date set for the conciliation conference and take advantage of available volunteer "judges pro tem" appointed by the Court to assist the parties in reaching an affordable sustainable agreement by bridging the gap between the respective proposals. Under the program the housing counselor is expected to accompany the homeowner to the conciliation conference and pro bono attorneys are supposed to be available to represent the homeowners at the conferences.

At bottom, though, this process is voluntary and a resolution cannot be imposed upon an unwilling mortgagee. It is has been my experience that, absent external pressure, i.e. absent

---

[2] Legislation has been introduced in the Senate (Residential Diversion and Mortgage Loan Modification Act of 2008) to encourage duplication of the program nationwide. I believe this legislation, while well intended, is a distraction from the more pressing need for changes in substantive law that would require mortgage holders to modify mortgages when necessary to make them affordable

some leverage that can be applied by the homeowners or on the homeowners' behalf, lenders are not ordinarily willing to significantly compromise the mortgages to make them affordable over the long run. They usually do so when they are forced to, either by an aggressive advocate, by the prospect of litigation, by litigation that frustrates their attempts to foreclose or by pressure applied directly or indirectly, often discretely, by the Court or the judges pro tem through the Diversion Program.

The implementation of MHAP has resulted in some delays in foreclosures that have been helpful to homeowners, but it has not meaningfully affected this dynamic. It is clear that with or without MHAP homeowners represented by knowledgeable advocates backed up by counsel prepared to litigate get resolutions that are simply not available to a homeowner who is not so represented.

In the Diversion Program when servicers, through their attorneys, make loan modification proposals, it is not unusual for the proposal to contain provisions that may deprive the homeowner of rights they are entitled to under applicable law and that increase the overall obligation, at the same time the proposal might lower the monthly payment. For example, I have seen servicers repeatedly offer modifications of FHA loans with interest rates that are in excess of the maximum rate permitted by the FHA for a modification. And I have seen new loan balances that include fees and costs in excess of the amount permitted by the mortgage document itself and by the FHA regulations.

The arrival of MHAP has not significantly affected the way the mortgage servicers and their counsel operate. It is but one more program with which servicers and their attorneys have to be forced to comply. And with which they will refuse to comply if it suits their purpose to do so.

For example, though the Servicer Participation Agreement (SPA) Bank of America (BoA) has signed with FNMA requires it to participate in the Home Affordable Modification Program (HAMP), callers to the Hotline report that Bank of America refuses to send them HAMP applications when their loans are not owned by FNMA and FHLMC. Hotline paralegals, calling on behalf of clients, have been told repeatedly by BoA loss mitigation employees that only GSE-owned loans are eligible for HAMP. Bank of America is openly violating the terms of the contract it signed with FNMA, foreclosing on homeowners entitled to the benefits of HAMP as if the program did not exist.

Mortgage servicers such as Saxon Mortgage, after an initial moratorium on the foreclosure sale of homes brought about by its signing the SPA, simply reject homeowners for consideration under HAMP, for no reason that is in any way connected with the program requirements, with no notice of any kind to the homeowner or to her counsel. I recently had a case in which Saxon's attorney advised me that my client would not be considered under HAMP because she "did not meet the debt to income ratios of the program." My request for further explanation, of which "ratios" the attorney was referring to, went unanswered. Because HAMP is not transparent, particularly in the application of the Net Present Value Test (NPV), and appears to require no notice to a homeowner who is turned down, it is difficult if not impossible to challenge a lender's refusal to agree to a modification. The forum in which the challenge can be mounted is not clear and it is certainly not clear that a foreclosure sale can be prevented while the challenge is brought.

It is not unusual for the homeowner to get no notice that the servicer has concluded that HAMP is unavailable other than to learn that the house is back on the sheriff sale list, which is what happened in my case.

The whimsical nature of the lender's decision to refuse to engage in a HAMP modification is also brought home by a recent case handled by an attorney whom I supervise, which involved Wells Fargo. The homeowner's request to be considered under HAMP was denied because according to Wells Fargo "[h]er debt to income ratio for the mortgage alone is over 70%. Her monthly mortgage payment cannot be lowered to bring it within HAMP guidelines and still payoff the mortgage debt." There was no suggestion that the NPV test was implicated or that the NPV test was even done. The reason given for the denial was nonsensical in light of the HAMP requirement that anyone with a mortgage payment exceeding 31% of gross income is eligible for consideration for a reduction of the mortgage payment to 31% and for the subsequent application of the NPV test. Nonetheless, Wells Fargo only relented from its position that HAMP was unavailable and the house would be sold, when it was embarrassed into doing so when we brought its position to the attention of a representative of FNMA during a fortuitous fact finding trip he was making to Philadelphia. Wells Fargo reversed itself, decided the client is eligible for HAMP, postponed the sheriff sale and is redoing its calculations. Had the homeowner been without counsel, as most are, her home would have gone to foreclosure sale earlier this week.

Arbitrarily, servicers exclude whole classes of homeowners from consideration under HAMP.[3] Thus many servicers refuse to consider modifying the loans of folks who have

[3]HAMP by its express terms excludes a large class of folks who are most in need of help. It does little for a person at 200% of poverty whose mortgage payments may be less than 31% of her income, but are still unaffordable because the remaining 69% of income is insufficient to cover the cost of food, clothing, transportation, utilities and other minimum basic necessities of life. HAMP also is of little help to someone who is back to work after building up a large arrearage because of a disruption in income resulting from illness or unemployment, but because of the resumption in income cannot meet the 31% of income test.

inherited their homes or obtained them as the result of property settlements resulting from divorce. The servicers take this position because in such a case the owner of the property is not a party to the underlying note, even if she has been paying it for years. HAMP permits no such exclusion.

Absent significant leverage on the part of homeowners to force a change in behavior, the majority of servicers will continue to find ways to avoid meaningful modifications despite HAMP. The only way to change their behavior to the extent required to make meaningful modifications common is to provide the homeowner with leverage over the servicer, such as the threat of a bankruptcy judge imposing a modification. The availability of such an option for homeowners would likely complement voluntary programs such as HAMP and the Diversion Program and substantially increase the chances that meaningful long-lasting modifications will result.

In closing I'd like to thank you again for the invitation to share my experience with you. I would be happy in the future to provide any information which might be of assistance to this subcommittee in its attempt to pass legislation that will stem the steadily rising tide of foreclosures that is causing so much harm to our nation.

-7-

Mr. COHEN. Now we will begin our series of questioning, and I will start the questioning. The first question I have is for Dr. Calabria.

In your testimony, you mentioned that of the vacation and investment properties, in grouping them together, 40 percent of current foreclosures fall into that class. In your testimony you say this would not be a significant problem if investment properties did not constitute approximately 40 percent of current foreclosures.

First, I would like to know the source of your numbers and also your numbers where you suggest that speculators make up about 40 percent of foreclosures and that the unemployed likely—likely—make up around 50 percent. Where do you get those numbers?

Mr. CALABRIA. The 40 percent is from Freddie Mac. The close to 50 percent is a variety of sources in the mortgage industry. A lot have come from the mortgage and bankruptcy associations. Others have come from other sources. I would be happy to kind of get you actual citations on that. There have been a variety of services that have looked at the causes of mortgage default. So the employment part, that is where I have gotten those surveys from.

I also think, if you look at—and I did not bring the data with me. If you take a map and look at where initial unemployment claims are, and you map that to where initial foreclosures are, you will see a huge overlay. So it should not be surprising to anybody that where you have had a complete jump in unemployment, you also see a very large jump in foreclosures. They very much match each other in terms of geography.

Mr. COHEN. Thank you, sir.

In your written testimony, you say that borrowers purchasing a home for occupancy did not do so solely for the consumption benefits of home ownership but also for investment returns. They were both consumers and speculators.

Under your definition, what homeowners are not speculators?

Mr. CALABRIA. I guess to some extent we all are, but I think that is one of the policy changes that I think we need to change. I mean, one of the things that has gotten us to where we are today is that in the last 10 years, or even further back, we had an attitude in this country that the market for home ownership was just a casino. You know, get in quick; flip it, you know. How many shows did we see come on TV like "Flip This House"?

I think we really need to turn back in terms of a public policy perspective in Washington, where we say home ownership is for stable communities where you put a life investment in, and this is not something that you get into and flip 6 months later. That, to me, has been part of the reason we are where we are today, which is that we have treated homes like they were casinos. I think we really need to move beyond that and change many of the things in our Tax Code, many of the things in our financial services policy that encourage that.

Mr. COHEN. Thank you, sir.

If the current foreclosure crisis were caused by unemployment and other "traditional" factors as you describe them, why did the number of foreclosures increase so dramatically during a good economy?

Mr. CALABRIA. First, we have to keep in mind there is always a steady level of foreclosures during a good economy. The reason that it increased at that time is during a good economy, when you have positive house price appreciation, you do not have to go to foreclosure. Very few people will actually walk away from their homes when there is positive equity. If you have lost your job, you are going to do much better in a short sale, and you will be able to take some of the equity.

So when you have a decline in house prices—and really, the decline in house prices started before we were in the recession. It was 2005-2006 where you had the housing market peak in terms of house price appreciation. So the housing market turned at least a year before the economy actually turned, and it was the negative equity situation. Even in a good economy, people lose jobs all the time. But in a good economy and in an increasing housing market, you have other options to refinance. That went away when the housing market turned down.

Mr. COHEN. Thank you.

Mr. Carr, do you have any thoughts on Dr. Calabria's theory that this was all just normal, like global warming?

Mr. CARR. I have several comments. I am not exactly sure where to start, but I guess I would just say that the truth is, between two sides of the table, usually somewhere in between. So while I can agree with a number of statements that he has made, particularly now about the unemployment-driven aspect of the foreclosure crisis and the significance of loans being upside down, I would offer a slightly different perspective.

That is that this foreclosure crisis began many years ago, first in Black and Latino communities. It was driven by payment shock of the mortgages, combined with things like prepayment penalties, second liens, no escrow set aside to protect borrowers who were entering the market, excessive broker fees, and other predatory features.

I also agree that there were a lot of consumers, including investors and speculators, who were into the market and who did turn it into a casino; but I would say that that is one of the most profoundly positive reasons for putting forward a consumer financial protection agency so as to make sure that consumers cannot treat their homes in such a manner and on such a massive scale that it actually implodes the credit markets and destroys everyone's home ownership values.

The final argument or point I would make is the idea that servicers now are not modifying loans because they cannot identify or understand how to modify a loan. It is an odd statement because nonprofit counselors do that every single day. We at the National Community Reinvestment Coalition engage with servicers every single day. It is not a mystery, and it is not rocket science. It is standard, old-fashioned, good underwriting practices. When you collect the information from consumers—their credit scores, their income and other financial attributes—you know which borrowers are, in fact, solvable in terms of a loan modification and which ones are not.

Then the final point that I would make, even though I have already said this is my final point, is as to the notion of cramdowns. It is just amazing to me the people who say, if you somehow adjust the principal in Bankruptcy Court, you will undermine the credit markets. Those people are not paying attention to the news. Those credit markets have already been destroyed. The most significant thing that we can do for this credit market right now is in this foreclosure crisis. The way we end that foreclosure crisis is, in one way, putting into place a stick.

I think one of the most significant values of bankruptcy reform is not necessarily the people who go through bankruptcy. It is servicers now knowing that the American public expects them to respond to the crisis we are in and to do something about this foreclosure crisis before we see a whole new wave of bank losses that ultimately could potentially cripple the U.S. economy, the Treasury and other major financial institutions.

There is a lot of concern out there despite all of the idea that the economy is recovering. If anyone looks at the footnotes and the small print, you will see that this economy is on life support and so is the banking system.

Mr. CALABRIA. Can I respond a little bit if you don't mind? I know it is your time.

Mr. COHEN. With those encouraging words, I think we could use some response.

Mr. CALABRIA. Thank you.

Let me say I want to clarify, because I think there has been a misunderstanding.

When I am saying lenders do not know, it is they do not know who. If you go and say anybody who calls me gets a 10 percent reduction in their payment, a lot of people are going to call who will never default, so it is very difficult for the lender ahead of time.

I do want to emphasize. One of the problems throughout this mortgage meltdown has been the capacity of the mitigation offices of the lenders. You know, I myself yelled at lenders a year and a half ago. "You guys need to staff up. You are going to get phone calls, and you are not going to be able to handle them."

I actually think one of the problems of the Obama foreclosure plan is you have this whole thing where you refinance Freddie and Fannie loans for people who are not even in any imminent danger of foreclosure, and what that gives the incentive for a lender to do is I am going to refinance this person because, okay, they have got 100 percent equity; but Fannie takes the risk, and I will make origination fees on it, and I will spend my time doing that rather than working with the hard cases.

You know, I have described one of my conversations with the Administration. Their approach is reverse triage: Let us take care of the people who need help the least rather than those the most. I do want to make a——

Mr. COHEN. Let me ask you this, Doctor——

Mr. CALABRIA. Sure.

Mr. COHEN [continuing]. If Mr. Franks will indulge me, because you asked us.

You know, the people who need the help the most seem like they would be the people who are going into bankruptcy. They are willing to go into bankruptcy, take all of their assets and all of their life and throw it up to the court and public eye and say, hey, you take over control of my life for a period of time and tell me what I can spend and what I cannot spend and what I did. And you can only do this every so often.

Doesn't it seem like those people maybe would be the ones that would benefit if they are that much distressed?

Mr. CALABRIA. My concern is that—my understanding of chapter 13 is you need to come up with a repayment plan. If you have lost a job, it is pretty hard to kind of come up with a repayment plan because you do not have the income. That is why, you know, I keep saying that I think we need to find a way—and, you know, one of things that I think we need to think through——

Mr. COHEN. Let us assume that this is not a person who has lost a job. This is a person who has still got a job. Their adjustable rate mortgage went up to a point that they could not afford it, or maybe they took a 10 percent cut, like so many people have at businesses, to continue.

What is the situation with them? Would they not benefit?

Mr. CALABRIA. Potentially.

Let me preface with the reason I talk about the employment, as long as we are going to hear numbers about 2 million foreclosures and such, you know, we need to keep in mind, you know, if this could help 5 percent of the people, then maybe you need to debate it in those terms, and you might even want to do something if it only helps 5 percent of the people; my point being is you need to go ahead of time and be honest that this is not going to help 80 percent of the people, this is going to help 5 percent of the people.

My concern is I do think—and I think there are two different debates between have we learned that this did not work and perhaps we should change it going forward between going backward, because I do think—to me, I think a fundamental principle of law is that—when the law that is outstanding at a time of contract incorporates into that contract, and for me to go back and change it—I think there is a very different argument between saying, okay, we think there should be cramdown for principal residences. You do that going forward for obligations that have not been entered into.

I want to comment a little bit on something that Jim has said and that a lot of people have said, and I think it is important. We quite often have heard sort of we need to put a stick behind the lenders. You know, that kind of concerns me. My vision of government is you look at the common welfare. You do not choose sides. I mean, for instance, we know that a very large impetus for higher foreclosures in California is that if you walk away from a home in California, they cannot come after you for the rest of it. They take the home. They do not become a creditor for the rest of it. In other States—there are about a dozen States like that where you cannot get a deficiency judgment, and that encourages it.

My perspective would be, while I think that law encourages foreclosure, I would not go back and rewrite it. I would not take a stick behind the bar in that case. So I think taking a stick to anybody, you know, I find problematic. I mean we should be trying to come up with consensual, noncoercive solutions here rather than trying to force people.

Mr. COHEN. Thank you, Doctor. I think our time is beyond, but I appreciate the information.

I now would like to recognize for questioning Mr. Franks, the Ranking Member.

Mr. FRANKS. Well, thank you, Mr. Chairman.

Dr. Calabria probably left off where I will start, and that is this notion of retroactive law.

You know, sometimes I think that those colleagues on the left believe that those of us on the right think that only competition is the fundamental drive of economy, and that is really not true. I believe that the fundamental drive of a free market economy is a thing called trust. I believe that the people who have capital trust government to be able to enforce their contracts and to be able to act rationally and not to come back and change the rules in the middle of the game.

Mr. Delahunt mentioned bankruptcy, that it has been a part of our scheme for a long time, and I completely concede that. What is different about this is that it is retroactive. When those bankruptcy laws are already in place, lenders take those things into consideration. They are able to actuarially or they are able to kind of extrapolate what the possible risks are to bankruptcy and take that into consideration, and that is the big challenge that we have here.

If we do things that scare those with capital—I know that capitalists are bad, but we forget that those are all of the people who are the investors in this country. Incidentally, I said that tongue in cheek, of course. The reality is that if we scare the capitalists away, they will take their capital out of the system, and if they do, only government will be left to deal with the result.

I want to thank Mr. Carr for pointing—you know, for perhaps being a little bit different from my perspective, but he did understand that a lot of the present mortgage problem is driven by unemployment, and I appreciate that.

Dr. Calabria, I have to tell you: Your opening statement, rarely have I seen a more out-of-the-park explanation. I think, if all of us could carefully analyze what you said, we probably would all come out on the same page. And I do not know that you and I would have to move at all, but that is just a guess.

Mr. Chairman, under the Community Reinvestment Act, the Clinton administration, Fannie Mae and Freddie Mac leaned on lenders to grant more and riskier mortgages to less creditworthy borrowers. That is an undeniable reality. Bank regulators and HUD even forced banks to meet quotas for these riskier loans or jeopardize their ratings as lenders. To meet these requirements, banks essentially had little choice but to make bad loans.

For example, no-money-down loans became common under the CRA, Community Reinvestment Act, regime because it was often the only way they could make those loans to fit that quota. And of course, not surprisingly, the result was a train wreck for everyone.

What we had was not so much predatory lenders preying on poor borrowers but a predatory government preying on banks to force its political ends and, thereby, many times, destroying poor borrowers. The mortgage cramdown legislation, I believe, threatens the same result.

Now, Dr. Calabria, let me just ask you—and again, I have never seen, since I have been on this Committee, something like the cramdown legislation more thoroughly dismantled by an opening statement, okay?

Mr. CALABRIA. Very kind of you to say.

Mr. FRANKS. So, if we simply, sir, let the natural foreclosure process work, will the housing market, in your opinion, stabilize and the foreclosure wave subside faster than if we intervene as a government? In other words, give me your juxtaposition here.

Mr. CALABRIA. One of the very key factors to keep in mind, both in terms of the lender and the borrower, is not as much the absolute level of house prices but the direction, the incentive. I mean, for instance, one of the incentives for a lender would be, okay, you are going—there might be a redefault. If I take the home today, it might be worth more if I sell it than if I take it 6 months or a year from now.

So in a declining housing market, the incentive for the lender is actually to foreclose as quick as possible; and also for the borrower, if your time horizon—depending on your time horizon, if you are looking at, well, you know, I can sit in this home, but it is going to lose value. That is the one thing about the cramdown. If you take it down to where they have zero equity, as I said in my opening statement, they could in 6 months be underwater. Whereas, if you get to a point in the housing market where the only direction is up, then the incentives of both the lender and the borrower are actually greater to stay in the home.

So my own perspective is that I think we want the housing market to actually hit—and people have talked about the dangers of overshooting, and those are very real dangers, but I actually think the dangers of not overshooting are worse. So the quicker we hit bottom, the quicker we can sort of go back up, and I think that that is a very important part. So I think we need to keep that in mind.

Mr. FRANKS. All right. Let me try to—excellent answer. Let me try to cram in one more question.

Many portray the mortgage cramdown proposal as no cost to consumers, that it will not cost consumers anything.

What are the hidden costs of cramdown for regular people, you know, due to the impact on mom-and-pop investors and the mortgage-backed securities, home mortgage rates, and other factors? What are the hidden costs? Is it at no cost to the average person?

Mr. CALABRIA. Well, let us start with the first direct cost to the taxpayer. We now, via Fannie, Freddie and the Federal Reserve, are the largest single holders of mortgage-backed assets in the world. I have had conversations with folks over at the Federal Reserve. They have factored into their portfolio cost what they think the cramdown will do to them. So they think they are going to lose money.

Freddie Mac announced that their projections were going to be, you know, potentially tens of billions, so all of these—and we were picking it up. The important thing—it would be one thing if Freddie and Fannie were simply private companies. We are Freddie and Fannie, and the taxpayer will back that. So first of all, there are direct taxpayer costs to this.

Second, you know, most of it will probably not be the increase of rate, but it will be the increase of down payments you will see going forward, to sort of modify that effect of cramdown. You can forget getting a zero down payment, and that may or may not be a good thing, but you will definitely see people move toward seeing a 20 percent down payment or something like that. And you even are seeing that in many parts of the market now, and the reason that that is a huge obstacle is we know from a variety of research that the number one obstacle to any anybody achieving home ownership, particularly in minority communities, is coming up with a down payment.

So at some point—and I do think it is important for borrowers to have skin in the game, but at some point you will have such a requirement for down payment that you will have adverse impacts upon home ownership rates. So that is something to kind of keep in mind.

I think the broader picture in this that concerns me is that, is this the end? What are you going to tell investors? Well, we are going to change the terms of the contract because we do not like it, because there is overwhelming public policy in that.

I look at it this way: You know, when we want to build a road, when we take somebody's land for the public good, we compensate them. If you want to take somebody's mortgage rights for the public good, you compensate them. It is a very simple concept, and I think that that is the approach that needs to be taken, if we are going to do that.

I think, you know, if you look at Professor White's work, he makes a lot of strong arguments there. There are externalities there, but if you are going to take those externalities, you need to compensate for it because those costs are going to be shifted to somebody.

Mr. FRANKS. Thank you, Mr. Chairman. Let me just say we learn something every day, and I have just learned that the taxpayers now are the largest mortgage holders in the world. I do not know about you, but that does not encourage me.

Mr. COHEN. Thank you, sir.

Now I would like to recognize Mr. Delahunt.

Mr. DELAHUNT. Thank you, Mr. Chairman.

I think we have a lot more to learn, and I agree with the Ranking Member. I would like to learn about how government created this mess.

Can you help me, Mr. Carr? Particularly CRA. You put some statistics in your testimony that seem to contradict what I just heard, but maybe government is what caused this problem. So maybe you can tell us that your statistics were inaccurate and that you unintentionally misrepresented to the Committee what the real facts are. I thought your testimony, Mr. Carr, was really a home run as well.

Mr. CARR. Thank you.

Mr. DELAHUNT. It was a grand slam. That is what I call it. With that, Mr. Carr, can you tell us about the CRA and about how that has brought forth this economic tsunami that happened to occur during the past 8 years of the Bush administration?

Mr. CARR. Sure. It is actually the Federal Reserve Board statistic that only 6 percent of high-cost loans to low- and moderate-income households were covered under CRA, and so it is just amazing that CRA continues to be the fault of these loans. The reality of it is that consumer groups for years were arguing——

Mr. DELAHUNT. Can you repeat that for me——

Mr. CARR. Sure.

Mr. DELAHUNT [continuing]. Because I think it is important that we all really listen to what the facts are.

Mr. CARR. Six percent of the high-cost loans to low- and moderate-income households were covered under CRA.

Mr. DELAHUNT. So there is only 6 percent?

Mr. FRANKS. Those are the ones that failed. Just kidding.

Mr. DELAHUNT. No. See, but that is his schtick. You know, we continue to hear this because some—you know, it is a philosophical perspective, and that is really what it comes down to.

Mr. CARR. Right.

Mr. DELAHUNT. When you are looking for whipping boys, you know, the CRA is just a prime target.

What you are telling us as to what the facts are, as opposed to just the assertion and the allegation, is that only 6 percent of the— you finish the sentence for me.

Mr. CARR [continuing]. High-cost loans to low- and moderate-income borrowers were covered under CRA.

Mr. DELAHUNT. That is kind of reassuring. So the other 94 percent were not covered by the CRA. Thank you.

Can you proceed? We will get back to you, Mr. Calabria.

Mr. CARR. There are other statistics, such as from the Center for Responsible Lending, that show that less than 10 percent of high-cost subprime loans made between 2008—between 1998 and 2006 were to first-time home buyers. But I think, more importantly, it is that there is just a treasure trove full of research and papers that track all the way back to the mid-1990's that point out these unfair and deceptive lending practices by nonprofit organizations; and I think it is important to remember that the State of North Carolina actually put into place a comprehensive predatory lending law back in 1999, and several other States attempted to protect their residents from these obvious unfair and deceptive practices, again, going back 10 years.

So it was not like it was just predictable; it was predicted. And the nonprofit and the the development community were actively working to strengthen CRA rules specifically so that unfair and deceptive lending would not occur under that act, and we are still working——

Mr. DELAHUNT. Mr. Carr, were they successful in doing that to a better degree than the other non-CRA institutions?

Mr. CARR. Well, most of the lending ultimately went out to non-CRA institutions or to affiliates of CRA-covered institutions that were not counted for CRA purposes.

I think that there are also a couple of other things, I think, to keep in mind about this.

Mr. DELAHUNT. I have got to make—you know, with CRA, we have got to put this to bed one way or another, and I think the members of the panel have to really come together to agree upon what the data shows, whether I am correct or Mr. Franks is correct or whomever is correct.

Compare for us, if you will, the performance of loans that are issued under CRA-regulated institutions and those that are issued under non-CRA institutions or mortgage lenders.

Mr. CARR. Right. Well, Dr. White—I do not want to put him on the spot. He might have more specific statistics. What we know from our research is that, in fact, they perform significantly better. Although in this——

Mr. DELAHUNT. That is what I want to hear.

Mr. CARR. In this environment, however, everyone's loans are going into foreclosure, and so depending on what year you look——

Mr. DELAHUNT. I understand that. In this environment, everybody is going down. You know, we talk about negative equity. Everybody is underwater, it is just not the subprime. But the historical data indicates that the CRA-regulated institutions did better than the non-CRA.

I yield to my friend from Arizona.

Mr. FRANKS. Keep in mind that the 6 percent of those loans that were under CRA, that were extended under CRA, Mr. Delahunt, caused the entire system to change. The government cannot say this is okay for this group and not for the other group, and it became a systemic issue.

Mr. DELAHUNT. Reclaiming my time.

Mr. FRANKS. I hope you will let Dr. Calabria respond.

Mr. COHEN. I am going——

Ms. LOFGREN. Mr. Chairman.

Mr. COHEN [continuing]. To suggest that your time has expired. I am going to recognize Ms. Lofgren for as much time as she may consume before we rush to votes.

Ms. LOFGREN. Thank you, Mr. Chairman. And I will be brief because I know that we have a number of votes, and perhaps we can finish this and not keep our witnesses here.

First I would like to say, once again, how disappointed I am that the Treasury Department was too busy to participate in this hearing, and I would like to suggest, Mr. Chairman, that we prepare a written inquiry to the Department with the questions that we would have asked, and ask them to respond and to get the facts and information to us within the next week, or at most two, so that we can take whatever action is necessary.

Mr. COHEN. I appreciate that. We will do that, and we will also look into the Government Accounting Office study.

Ms. LOFGREN. I would be very happy to work with the Chairman on that point.

I would like to ask Professor White, your testimony about how many modifications actually involved a reduction, I mean so many of the modifications actually involve an increase in the monthly payment. Small wonder that they are not working.

I thought a lot about why is this, why are the banks behaving in this way? In *The New York Times* article, just right after the Fourth of July—and this is a quote. It said: But the most frightening, fascinating and frightening figures in the data that they have looked at from the Wells Fargo Bank detail how much money is lost when foreclosed homes are sold.

In June, the data show almost 32,000 liquidation sales. The average loss on those was 64.7 percent of the original loan balances. So I guess what I am looking at is if you took a look at modifications in Bankruptcy Court, where those are allowable for secondary mortgages, commercial real estate and the like, generally the reduction in principal is nowhere near what the banks are losing in the foreclosure sale. What is motivating, what is going on here?

Why are they operating in manners that seem so adverse to their financial interests?

Mr. WHITE. Well, one of the important things you have to understand is that it is not the investors who are making the decisions. The servicers have their own economic calculations that they make that have nothing to do with ultimately how much is lost on the loan because the servicer, in most cases now, has no skin in the game. They are not the investor and they not affected by whether the foreclosure loss is 10 percent or 90 percent. So long as they can recover the servicing advances, which might be 5 percent of the total amount, they will be made whole in a foreclosure.

In fact, the servicers have every reason to go ahead with foreclosure and every reason not to modify. And some of those incentives, I think, the Administration wisely tried to correct a little bit in the design of the Home Affordable Program. We will see if that works or not. But I think it is also the case that investors and the servicers are in denial. In spite of the fact that they are losing 60 percent every time they foreclose on a home, they believe somehow that if they continue foreclosing and refusing to modify, eventually they will recover closer to 100 percent of these mortgages that are so massively delinquent and in default. And we have right now a huge pipeline. There are a lot of foreclosures that have been started. Fortunately, the completed liquidation sales have been at a fairly—I don't want to say low level, because they are——

Ms. LOFGREN. The States have stopped them in some cases. Now those laws are running.

Mr. WHITE. They are having some moratoria, and even just looking at the data in general, there are a lot more foreclosures coming into the pipeline than are coming out of the sales. There a lot of homeowners who are in foreclosure but haven't lost their house yet, so there is still time to restructure more loans.

Now I have no illusion that 100 percent or 50 percent or any huge percentage of the 2½ million families in foreclosure can successfully renegotiate their loans. But I am quite confident that more can be renegotiated than are being renegotiated now. I mean, I think there are foreclosures happening, there are several data that——

Ms. LOFGREN. Well, clearly, not every person who is in trouble is going to be successful in renegotiating their loan. I think that is clear. On the other hand, I will close now because I know we have a vote outstanding.

As we were coming up to our vote on the bankruptcy provision in the House, I was present at a meeting where Chairman Frank was there; and one of the other Members said, how are we—you know, what about this new Administration program? What do we do with our constituents? And Mr. Frank says, tell them to call their lender today because the program is in effect. And the Member said, well, the banks won't return their calls. I will say the banks won't return my calls on behalf of constituents either. So Mr. Frank said, well, tell them that your constituent is going to go bankrupt, and then they will return the call.

I think that that is an element to this. It is a motivation to actually be accountable and to get serious about this. I think it is tragic that we have not adopted the measure, and I hope that we will yet do so. And I yield back.

Mr. COHEN. I want to thank the lady and thank all the witnesses for their testimony today.

Without objection, Members have 5 legislative days to submit any additional written questions, which we will forward to the witnesses and ask that you answer as promptly as you can and they will be made a part of the record.

Without objection, the record will remain open for 5 legislative days for submission of any additional materials.

Again, I thank everybody for their time and patience. The hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 2:23 p.m., the Subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

At the heart of our Nation's current economic troubles is the endless cycle of home mortgage foreclosures, a cycle that unfortunately appears to be gaining momentum rather than drawing to a close.

In addition to undermining our Nation's economy, these foreclosures devastate families, neighborhoods, and local governments.

In 2008, 1 in 10 American homeowners fell behind in their mortgage payments or were in foreclosure. The Federal Reserve estimates that in 2009, there will be 2.5 million home foreclosures. Others estimate that the number could be as high as 3 million.

Over the next four years, there could be between 8 and 10 million foreclosures. In my hometown of Detroit, 1 out of every 275 housing units faces foreclosure. There are 138 foreclosures a day in Wayne County.

We have not seen foreclosure numbers like these since the Great Depression, and the mortgage foreclosure crisis continues to grow at an alarming rate, with devastating consequences for communities across the Nation.

In March of this year, the Treasury Department instituted its Home Affordable Modification Program with the laudable goal of addressing this crisis by providing financial incentives to servicers to voluntarily modify mortgages headed to foreclosure.

The Program provides servicers economic and other incentives to make mortgage payments for troubled borrowers more affordable. Payments can be reduced to 31% of the borrower's gross monthly income by a reduction in the interest rate or an extension of the mortgage term, or both.

Empirical studies suggest, however, that voluntary modifications continue to be ineffective. The Program appears to be hampered by a series of administrative issues, including adequate staff to handle modification requests, among other deficiencies.

Although there will be an estimated 2.5 million home foreclosures in 2009, there have only been about 240,000 voluntary mortgage modifications since the Program's inception.

Even worse, the number of modifications appears to be *decreasing rather than increasing*. According to Professor Alan White, one of our witnesses today, mortgage modifications peaked in February at 23,749 modified loans. By contrast, there were only 19,041 modified loans in May and 18,179 modified loans in June.

In the meantime, the number of foreclosures continues to rise, going from 242,000 foreclosures in January to 277,847 in May and 281,560 in June.

And, an analysis of many of these so-called "modifications" indicates that they actually may worsen a homeowner's financial predicament.

While I appreciate the Program's well-intentioned attempt to entice loan servicers to voluntarily modify mortgages of financially troubled homeowners, I believe that these efforts do not go far enough to address the foreclosure crisis.

Accordingly, I have three suggestions that may help to enhance any voluntary mortgage modification program, which I hope we will address today.

First, bankruptcy judges must be given the authority to modify mortgages in bankruptcy.

The threat of a mandatory principal reduction in bankruptcy will serve as a healthy incentive to better ensure that more meaningful voluntary modifications will be done outside of court.

In the absence of judicial mortgage modification authority, or some similar threat of mandatory mortgage modification, lenders and servicers simply do not have enough of an incentive to modify mortgages in a meaningful and substantial way.

Just this past Monday, the Federal Reserve Bank of Boston released a study concluding that *only 3 percent of delinquent borrowers who were more than 60 days behind in their payments had their loans modified to reduce monthly payments.* A somewhat greater percentage received modifications that did not even result in lower payments.

According to one of the study's coauthors, lenders will not modify loans voluntarily because *"maximizing profits does not mean modifying loans."*

As many of you know, mortgages on second and third homes and investment properties (such as multi-family homes) can be judicially modified under current law, as can virtually any other secured claim, including claims secured by yachts, airplanes, and commercial real estate worth many millions of dollars.

It is unfathomable to me that no such authority exists for a working family's principal residence.

Judicial modification of primary mortgages would help stop the endless cycle of foreclosures, by allowing homeowners to avoid foreclosure and by keeping more distressed properties from coming into the market.

Second, any mortgage modification program should require—or at least provide strong incentives for—servicers to reduce the principal balance on a mortgage, as studies have shown that the most successful mortgage modifications included principal reductions.

Many have noted that when a homeowner does not have an equity stake in his or her home, he or she is more likely to default on the mortgage loan. The best thing for struggling homeowners is to reduce mortgage principal.

But the Home Affordable Modification Program fails to include any requirement or incentive for principal reductions.

As a result, most loan modifications merely postpone or stretch out the payments and, thus, merely delay the inevitable default and foreclosure. In fact, some studies show that homeowners often wind up deeper in debt as a direct result of these modifications. Not surprisingly, the re-default rate is nearly 50%.

Third, any efforts by Congress or the Administration to address the foreclosure crisis must put distressed homeowners ahead of the interests of financial institutions.

Giving the mortgage lending industry a free hand to pick and choose which mortgages to modify, and under what terms, simply does not work.

Yet most of the government's efforts have centered on encouraging voluntary loan modifications, which unfortunately prioritizes the interests of financial institutions at the expense of the interests of struggling homeowners.

For instance, in a belated response to the mortgage foreclosure crisis, the Bush Administration issued various incentives, brokered with the lending industry, to provide some relief for American homeowners facing foreclosure. Over time, it became apparent that these initiatives were largely ineffective.

Unfortunately, the current Home Affordable Modification Program may actually have the unintended consequence of *discouraging* loan servicers from helping the borrowers most in financial need.

Under its system of incentives, participating servicers receive a financial reward when borrowers stay current on their payments for three years under modified terms. As a result, this incentive system may steer servicers away from the most financially troubled borrowers, who are most in need of a mortgage modification.

For more than 2 years, this Committee has carefully considered the causes and consequences of the mortgage foreclosure crisis. We offered a meaningful yet modest solution to the problem by granting bankruptcy judges the authority to modify mortgage terms, including a so-called "cramdown" of mortgage principal to more reasonably reflect actual market values.

Last March, the House passed H.R. 1106, the "Helping Families Save Their Homes Act of 2009," which contained a provision authorizing judicial mortgage modification.

The version of the legislation that ultimately was signed into law, however, failed to include this critical provision, which was perhaps the one provision that would have most effectively helped families save their homes from foreclosure.

I am disappointed not for myself or for the Members of this Committee. Rather, my disappointment stems from my deep concern for the millions of families now facing the loss of their homes and a life of insecurity and desperation.

If Congress and the Administration fail to respond to the mortgage foreclosure crisis in a more assertive and thoughtful manner, I fear for our Nation's future.

I thank the witnesses for being here today, I and eagerly await their testimony.

RESPONSE TO POST-HEARING QUESTIONS FROM ALAN M. WHITE, ASSISTANT PROFESSOR OF LAW, VALPARAISO UNIVERSITY SCHOOL OF LAW, VALPARAISO, IN

Qnestions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on Home Foreclosures: Will Volnntary Mortgage Modification Help Families Save Their Homes?"
July 9, 2009

Alan M. White, Assistant Professor of Law, Valparaiso University School of Law

Questions from the Houorable Steve Cohen, Chairman

1. **Does the Home Affordable Modification Program's financial reward to loan servicers of $1,000 a year for three years if the borrower remains current nnder modified terms provide an incentive for servicers to modify loans only for more financially secure borrowers rather than those who are may be more financially distressed?**

The $3,000 in servicer payments should be sufficient to allow servicers to fully recover costs of modifications. The GSE's and FHA have provided payments to servicers for modifications in the past that were considerably smaller. Of course, the payments are contingent on modifications being successful, and to that extent, servicers may be reluctant to approve modifications they believe will fail. However, the HAMP contracts require servicers to offer modifications to all borrowers whose payments exceed 31% of their income and who meet the other eligibility rules. Thus,

2. **Why are mortgage lenders, loan servicers, and investors hesitant to offer voluntarily a meaningful modification of mortgage terms if they all stood to recover less money in foreclosure sale than in repayment on a modified mortgage?**

Servicers and lenders hesitate to offer modifications for a variety of reasons. They may prefer to encourage borrowers to refinance with other lenders, or simply hope that delinquent borrowers will find some way to become current, although self-cure rates have plummeted during the crisis and are now below 10%. They may project very high redefault rates for modified loans based on past experience, and therefore assume that most modified loans will end in foreclosure. There is also a reluctance to report the immediate loss that results from a modification reducing either interest or principal, because of potential investor criticism. For some servicers the problem has simply been one of their capacity and business model. They were accustomed to servicing mostly on-time accounts, and do not have systems and personnel capable of handling large volumes of workouts with troubled borrowers. A number of these factors can be summarized as being in denial and living in the past.

3. **The recent Office of the Comptroller of the Currency Mortgage Metric report for the 1st quarter of this year indicates that while payment-reducing modifications have increased, they still represent only 54.1% of all modified loans and that 18.5% actually increased the monthly payment? Are these figures consistent with your research?**

My review of mortgage-backed securities reports shows, consistent with the OCC reports, that in recent months, a growing portion of modifications resulted in payment reductions for homeowners. For the period October 26 to November 25, 2009, fully 68% of modifications resulted in a lower monthly payment and 11% left the payment unchanged, while 21% increased the monthly payment. I expect this trend to continue as the HAMP program is fully implemented, because HAMP requires payment reduction for all modifications. It should be noted, however, that these payment reductions are often temporary. Many HAMP modifications reduce interest to 2% for a five-year period, but the rate, and payment will increase after that.

4. **Do you have au estimate of the number of homeowners seeking relief under the Home Affordable Modification Program who cannot receive help because their monthly payments cannot be reduced to 31% of gross monthly income under the Program's guidelines? What should be done to help such people?**

I have no way to calculate the portion of homeowners with different levels of debt ratios, because the publicly available data sources do not include the homeowners' income. Treasury has this data, and should be reporting it in December. Specifically, Treasury requires servicers to report on all HAMP modification requests that are denied, and the reasons for denial.

For some homeowners, HAMP is insufficient either because their income is too low or the mortgage debt is simply too large, and exceeds the home value. Two additional steps would certainly help some of these homeowners: reducing mortgage debt to align it with home values, in bankruptcy or through HAMP, and providing temporary direct financial assistance to homeowners with a temporary loss of income such as unemployment.

5. **Is it possible to design a voluntary mortgage modification program that can be effective in stemming foreclosures absent judicial mortgage modification authority or a requirement for principal reduction?**

In the current housing and mortgage market, any program that fails to reduce principal mortgage debt for underwater homeowners will fall short of preventing all preventable foreclosures. Residential mortgage debt in the United States has increased 250%, to a total of more than $10 trillion, over the past twelve years. Mortgage debt has far outpaced rising incomes, and has reached unsustainable levels. American homeowners can be deleveraged in two ways: either we allow debt to be written off over a period of three to five years or more of historically high foreclosure levels, or we recognize reality and start writing down the debt of homeowners in homes today. Without debt reduction, modifications that reduce payments will necessarily involve temporary rate reductions and principal postponement, which in turn will produce future payment increases and negative equity. In other words, HAMP as presently designed continues to kick the can down the road. Sooner or later we will need to deal with systematic mortgage debt reduction.

6. **If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.**

Some commentators have argued that modifications are not an effective foreclosure prevention tool, because foreclosures are a result of unemployment and negative equity. The current foreclosure crisis is historically unprecedented (at least since the Great Depression.) Foreclosures are now at four times or more their pre-crisis levels. We have had periods of rising unemployment before in the past fifty years, and have never experienced the current level of foreclosures. The fact is that the current crisis was produced not by a single cause but by multiple causes. The bubble in home prices, and its subsequent collapse, was obviously a factor. But the bubble was produced in part by the extensive use of mortgage loans that did not require principal repayment (interest-only and negative amortization) and/or that were unsustainable for other reasons. To solve the foreclosure problem requires taking on the multiple causes with all available tools.

Certainly some investors speculated in home values and have no interest in avoiding foreclosure, and those foreclosure sales will go forward. On the other hand, more than 650,000 homeowners have enrolled in HAMP since April, and the vast majority of them are making their temporary payments, so there are many homeowners who want and need relief.

Even unemployed homeowners can retain their homes in some instances, given sufficient reduction of principal and interest, and perhaps some temporary financial assistance. As for foreclosures primarily resulting from falling home prices, those are the cases most directly crying out for tools, such as modification in bankruptcy, that are not currently available. If we simply allow massive foreclosures to realign home values and mortgage debt, the result will be significant dead weight losses and external costs borne by neighbors, municipalities and communities, as well as by the millions employed directly or indirectly in the housing and mortgage industries.

RESPONSE TO POST-HEARING QUESTIONS FROM JAMES H. CARR, CHIEF OPERATING OFFICER, NATIONAL COMMUNITY REINVESTMENT COALITION, WASHINGTON, DC

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes?"
July 9, 2009

Jim Carr, Chief Operating Officer, National Community Reinvestment Coalition

Questions from the Honorable Steve Cohen, Chairman

1. **Dr. Calabria contends that neither predatory lending nor exploding adjustable rate mortgages were the real cause of the mortgage foreclosure crisis. Please respond.**

The significant role that abusive, high-cost loans and predatory marketing and steering played in the ongoing foreclosure crisis is well documented and widely accepted. Of course, these were not the only sources of the continuing foreclosure crisis, but predatory loans and adjustable rate mortgages both number among its major causes.

For years before the collapse of the housing bubble community leaders advocated the elimination of predatory lending practices. The National Community Reinvestment Coalition, for example, testified before Congress as early as 2007 regarding the contributions of alternative mortgage products such as "exploding" 2/28s and 3/27 to rising foreclosure rates.[1] NCRC published studies documenting the prevalence of predatory lending as early as 2002.[1] I published two articles on predatory lending in 2001 alone.[1] During my tenure as the editor of the journal *Housing Policy Debate*, articles on the dangers associated with predatory lending and exotic, unaffordable mortgage products appeared regularly. Dr. Calabria's contention that these issues are not among the causes of the foreclosure crisis is contrary to numerous experts' research and analysis.

In fact, almost every institutional actor involved in the mortgage financing process bears some responsibility. Brokers steered borrowers to risky loans because the higher cost of these loans increased brokers' profits. Lenders offered high-risk products that they knew would require refinancing in order to maintain affordability and failed to maintain adequate underwriting standards. Appraisers inflated home values in order to keep brokers' business. Consumers did not understand the equity sapping effects of constant refinancing nor the actual risk of a downturn in the housing market.

Eric Stein of the Center for Responsible Lending has thoroughly documented the causes of the exponential rise of predatory loans and ARMs. According to Stein, the "central cause of this dangerous lending was Wall Street demand for the riskiest loans."[i] The Wall Street firms paid premium prices for high□risk mortgage products, spurring lenders to provide as many such loans as possible. These products comprised the mortgage□backed securities that the credit ratings agencies stamped as investment grade, despite the apparent risks in the underlying loans. Those same securities are now known colloquially as "toxic assets."

In 1999, North Carolina passed the nation's first comprehensive anti□predatory lending law in response to concerns about the growth of unsustainable exotic mortgage products that targeted vulnerable consumers and minorities. This law was modeled on the federal Home Owners' Equity Protection Act

(HEOPA), but significantly expanded some of its provisions and provided for more robust enforcement.[ii] Several states followed suit, but the Office of the Comptroller of the Currency officially exempted all federally chartered lenders from state laws starting in 2003. Research into the effects of state-level antipredatory lending laws on lending practices indicates that such legislation reduces the origination of subprime loans.[iii]

Today, experts anticipate another wave of subprime and ARM-driven foreclosures in 2010 through 2012, which could have an impact on as much as $2.5 trillion in outstanding loans.[iv]

2. **What is your view of Dr. Calabria's suggestion that, in response to foreclosures, lenders should be given the flexibility to lease foreclosed homes to current residents?**

The National Community Reinvestment Coalition for more than a year has supported a rental option for homeowners facing foreclosure. In the past year both Fannie Mae and Freddie Mac have implemented and expanded rental option programs for foreclosed borrowers whose loans they have guaranteed, and NeighborWorks has a small pilot program, but these initiatives are limited and should be further expanded.

The Fannie Mae Deed for Lease program is designed to assist borrowers who are in trouble but ineligible for government foreclosure prevention programs such as Making Home Affordable. These borrowers can avoid foreclosure by voluntarily signing their property over to the lender in exchange for a one year lease at an affordable monthly rent. Renters can continue living in the property longer than one year on a month-to-month basis. Fannie Mae manages the transfer of property to the lender and implements property management services through a third party company.

The Freddie Mac REO Rental Initiative is somewhat more limited. Borrowers must already be in the foreclosure process and their rental agreements are month-to-month only, set at the area market rate. Freddie Mac offers an additional program, however, that provides relocation assistance for foreclosed residents facing eviction; the "cash for keys" program is particularly helpful to renters whose landlords foreclose, who are often left with few options and limited time to find new housing accommodations.

NCRC has identified several alternatives to strengthen and enhance rental option programs. One such alternative is to develop more comprehensive sale-leaseback programs through Fannie and Freddie that, as appropriate, permit lease-to-purchase arrangements. This would allow owners who face foreclosure to sell their home to the lender or an investor, maintain the right to rent for a period of time, and have an option to re-purchase the property at a later date if their finances improve. This strategy would provide family and neighborhood stability and an opportunity for homeowners to rebuild their credit.

In July 2009, the House passed the Neighborhood Preservation Act, which, if made into law, would "remove legal impediments blocking federally regulated banks from entering into long-term leases — up to five years — with the former owners of foreclosed houses. It would also allow banks to negotiate option-to-purchase agreements permitting former owners to buy back their houses."[v] However, this is a voluntary option for banks and only applies to leases entered into within two years after the bill's passage.[vi] Critics oppose the voluntary nature and the fact that banks are left as landlords.[vii] Stronger legislation could, "within the bounds of constitutional protection of contracts", require lenders to accept a surrendered deed in place of initiating foreclosure and to lease the property back to the borrower, with an option to purchase after a set period of time.[viii]

Another option is the "seamless short-sale," in which the bank enters into a short sale with an investor, but the investor is contractually bound to lease the home back to the previous owner for a specified period of time; typically under this arrangement, the former owner qualifies only if "they have sufficient income to afford a fair market rent and can handle the other expenses, including maintaining the property." [ix] This option is particularly attractive to underwater homeowners who can find an investor willing to pay current market value; the tenant can then re-purchase the home at a "preset buyout price after the lease-back period. That price is higher than the short-sale price paid by the investor, but lower than the original price of the house paid by the foreclosed owners." [X]

Under a more aggressive plan, the government could create a new version of the Great Depression-era Homeowners Loan Corporation (HOLC). The new entity would more actively pursue loan modifications using exceptional powers, such as eminent domain, to secure distressed loan products from investors and modify as many loans as possible to make them affordable and sustainable.[xi] NCRC first proposed such an entity in January 2008 in testimony before the U.S. House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law.xii Under the NCRC proposal, loans would be purchased at a reasonable discount (between current market value and face value). Since the average loss severity in foreclosures is 65 percent[xiii], the government can purchase homes at a discount, which would be applied to modify the loans, including principal forgiveness. This process would greatly reduce the cost to taxpayers of broad-scale loan modification.

A new HOLC should directly purchase at risk mortgages in order structure and implement a meaningful loan modification program which takes into account current home values, with the intention of longterm investment: as a long-term investor/holder, the government can undertake modifications on far more flexible terms than any private servicer or investor. And as the economy improves and borrowers' ability to repay debts increases, the government will be able to recoup a sizeable share of its initial outlay.[xiv] This program could be implemented through eminent domain[xv], TARP funds[xvi] and/or through government bonds.[xvii]

For loans that cannot be modified, the government could become the "short sale investor" who buys mortgages and leases them back to the owners. This arrangement would avoid foreclosure and circumvent lender inaction.[xviii] Moreover, subsidies could be arranged by the government for unemployed homeowners either through deferred rent payments or subsidized payments.[xix] Again, because the government would be a long-term investor, initial losses in a subsidized rental program could be withstood; no other owner would likely be able to provide this service for the unemployed. The government-owned mortgages could be managed by HUD, turned over to a rental management company, or managed by local non-profits.

3. In your estimation, what percentage of mortgage loans could be classed as "predatory" or fraudulent?

a. Of these, how many were refinancings of prime mortgages?

Insufficient data makes it difficult to quantify how many mortgages were fraudulent, in part because relatively little legal action has been pursued by the federal regulatory agencies against lenders whose behaviors were potentially or likely fraudulent. Secondly, not all predatory loans were fraudulent, because many irresponsible, unethical practices were and continue to be legal. Predatory loans as those which share any combination of three factors: targeted marketing to households on the basis of their race, ethnicity, age or gender or other personal characteristics unrelated to creditworthiness; unreasonable and unjustifiable loan terms; and outright fraudulent behavior."[xx]

Given the data limitations, these estimates are neither definitive nor exhaustive, but I would estimate that up to 80% of subprime ARMs were predatory, including nearly all the notorious 2/28 and 3/27 "exploding" ARMs. Furthermore, as many as one third of all subprime refinance loans exhibit predatory features.[xxi]

b. Did any of these refinancings result in homeowners losing significant equity?

Many mortgage refinances resulted in significant loss of equity because the fees and up□front costs of the transactions were unreasonably high or because from origination the loans would require further refinancing due to long□term unaffordability. According to the Center for Responsible Lending, predatory mortgage refinancing "has, since the beginning of the subprime market, been a prime tool for stripping the equity from homeowners."[xxii]

c. Were these types of mortgage products disproportionately targeted at certain groups of homeowners?

High□cost, subprime loans have frequently been targeted toward vulnerable groups such as the elderly and minority communities. According to the 2009 paper, "Income is No Shield," published jointly by NCRC and the National Council of Negro Women, middle□ and upper□income African□American females were approximately two times more likely than middle□ and upper□income white females to receive high cost, subprime mortgages during the height of the housing boom.[xxiii] After examining lending patterns by race, geography, and Congressional district, Maurice Jourdain□Earl of the credit market research group Compliance Tech concludes that "Blacks and Hispanics have a higher incidence of subprime rate loans."[xxiv]

These problems have also been documented over many years. For example, the peer□reviewed journal *Housing Policy Debate*, where I was the editor for ten years, published a special issue on racial discrimination in mortgage lending as early as 1992.[xxv]

4. In your hearing testimony, you contended that certain communities that have borne the brunt of the current recession's effects disproportionately should

receive a disproportionate share of federal aid. Please outline what specific steps the federal government should take to aid such communities.

Certain communities have borne a disproportionate share of the damage and pain wrought by the foreclosure and economic crises, and should therefore be targeted for priority allocation of economic recovery funding. Areas that should receive priority funding are characterized by a convergence of three factors:

1. Significantly higher levels of unemployment;
2. Significantly greater concentrations of foreclosures; and
3. Historically under-funded, inferior, or poorly maintained infrastructure.

The federal government has recently signaled its desire to fund long-neglected infrastructure investments through the Housing and Economic Recovery Act (HERA), the American Recovery and Reinvestment Act (ARRA), and policies implemented under Cabinet departments such as Housing and Urban Development, Treasury, Transportation, and Labor. Such investment would be an important contribution to rebuilding the economy while investing in communities. The billions of dollars appropriated for infrastructure should be linked to and coordinated with other efforts to rebuild communities that have been damaged by the foreclosure crisis. Channeling dollars to the individuals and communities that need them most will immediately stimulate the economy and save and create jobs. Families that live on the edge of survival will pour these recovery dollars immediately back into the economy through spending on groceries, medicine, clothing, child care, energy, transportation, and other basic necessities. Prioritizing areas hardest hit by widespread unemployment and mounting foreclosures would more directly stabilize the housing market and steady falling home prices. Finally, investing in areas most in need of infrastructure improvements would provide a needed enhancement of the quality of life in communities long-neglected.

To stabilize and reinvigorate the hardest-hit neighborhoods, a redevelopment strategy should comprehensively address the unemployment→foreclosure→home price declines→weak consumer confidence and spending→unemployment →foreclosure cycle. Ideally, redevelopment efforts will simultaneously address each of these following aspects of recovery:

1. Prevent Foreclosures and Promote Access to Wealth Building Opportunities
2. Stabilize REO and Vacant Properties: Stabilize Community Housing and Rebuild Neighborhood Infrastructure
3. Promote Sustainable Employment and Entrepreneurship

The federal government should provide priority funding for foreclosure prevention programs established by state and local governments and non-profits that incorporate a variety of long-term and short-term strategies, including financial education; counseling for homeowners; 24-hour foreclosure hotlines; refinancing or emergency loan programs; and assistance in negotiating with banks for loan modifications or alternatives to foreclosure. Federal funding should simultaneously prioritize programs that operate in geographic areas characterized by high unemployment, concentrated foreclosures, and deficient infrastructure.

Foreclosure prevention efforts need to be effective at addressing the main causes for foreclosure, which currently are unemployment and negative equity.[xxvi] In cases of unemployment, emergency grants or loans allow homeowners to pay their mortgage while they look for work. Foreclosure moratoria, potentially tied to unemployment benefits, would provide the homeowner respite from worrying about losing their home at the same time they are looking for a job. Just as state governments created long term foreclosure moratoria during the Great Depression and the federal government currently provides moratoria on government-backed mortgage foreclosures after a natural disaster, the government could establish a similar moratorium for families hardest hit by the foreclosure and unemployment crises; considering that the government bought more than 80 percent of the mortgages issued by Fannie Mae and Freddie Mac[xxvii] and nearly 90 percent of all new home loans are funded or guaranteed by the government[xxviii], this measure could have a significant impact on preventing future foreclosures.

To address homeowners with negative equity, loan modifications should not only make monthly payments more affordable, but should also write down the principal to reflect market conditions. Determining market conditions require standards for property value assessment that accurately reflect current market conditions and to incorporate expected price declines. Bankruptcy reform that allows court-ordered mortgage modifications would provide a much needed incentive for banks to write down loans. Currently, bankruptcy courts can modify repayment terms on the outstanding debt on a luxury yacht or investment property, but not the family home. This disparity in treatment is unfair, inequitable, and serves no public policy goal. Furthermore, expanded bankruptcy protection could address as much as 30 percent of loans heading to foreclosure and at no cost to the American taxpayer. This threat of repayment terms being modified in bankruptcy court would also encourage more banks to proactively modify loans on their own terms before homeowners have to resort to bankruptcy.

Federal government purchase of at risk mortgages is an aggressive but appropriate strategy to address the scale of the foreclosure crisis. The federal government could create a new version of the Great Depression-era Homeowners Loan Corporation (HOLC). The new entity would more actively pursue loan modifications to secure distressed loan products from investors and modify as many loans as possible to make them affordable and sustainable.[xxix] NCRC first proposed such an entity in January 2008 in testimony before the U.S. House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law.[xxx]

Under the NCRC proposal, loans would be purchased at a reasonable discount between current market value and face value. Since the average loss severity in foreclosures is 65 percent[xxxi], the government can purchase homes at a discount, which would be applied to modify the loans, including principal forgiveness. This process would greatly reduce the cost to taxpayers of broad-scale loan modification. A new HOLC should directly purchase at risk mortgages in order structure and implement a meaningful loan modification program which takes into account current home values, with the intention of longterm investment: "as a long-term investor/holder, the government can undertake modifications on farmore flexible terms than any private servicer or investor. And as the economy improves and borrowers' ability to repay debts increases, the government will be able to recoup a sizeable share of its initial outlay"[xxxii].

For loans that cannot be modified, the government could become a "short sale investor" who buys mortgages and leases them back to the owners. This arrangement would avoid foreclosure and circumvent lender inaction.[xxxiii] Moreover, subsidies could be arranged by the government for unemployed homeowners either through deferred rent payments or subsidized payments. Again, because the government would be a long-term investor, initial losses in a subsidized rental program could be withstood; no other owner would likely be able to provide this service for the unemployed. The government-owned mortgages could be managed by HUD, turned over to a rental management company, or managed by local non-profits.

Finally, some areas have passed regulation that provides protection from risky lending practices in the future. Such regulation includes minimum licensure standards for mortgage brokers to ensure financial stability and technical fitness of mortgage brokers to carry out responsibilities[xxxiv] and minimum underwriting and loan product standards, such as requiring "ability to pay" standards, prohibiting nodoc loans, and limiting pre-payment penalties.[xxv]

Foreclosure prevention will stabilize communities and families, but for hard-hit neighborhoods to recover, residents need opportunities for improved economic mobility. First, residents need enhanced access to mainstream finance. The Community Reinvestment Act is responsible for the expansion of trillions of dollars in capital in minority and lower income neighborhoods since its creation in 1977.[xxvi] The CRA can be strengthened and impact more families by expanding it to apply to non-bank lending institutions and brokers and expanding its mandate of affirmatively meeting credit needs in low- and moderate-income neighborhoods to also specifically cover minority communities would ensure financial institutions.

Federal agencies should work directly with banks and community groups to launch local programs that will prepare current residents for homeownership, help residents leverage their homes for wealthbuilding opportunities, and link residents to mainstream sources of banking services.

To ensure that wealth created by redevelopment activity benefits the current community, strategies can include resident ownership mechanisms to provide low- and moderate-income residents the opportunity to enhance their financial assets and gain an ownership stake in redevelopment initiatives. Resident ownership mechanisms can be applied to many initiatives, including homeownership, commercial real estate development, and new business development. Example programs include community development initial public offerings, worker-owner cooperatives, employee stock ownership plans, and community land trusts.

I would be pleased to provide copies of the forthcoming NCRC article on REO redevelopment strategies at the request of any Members of the Committee or their staffs.

[i] Stein, Eric. "Testimony at the hearing titled Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis." Submitted to the U.S. Senate Committee on Banking, Housing, and Urban Affairs. October 16, 2008. Accessed online at: http://www.responsiblelending.org/mortgage-lending/policylegislation/ congress/senate-testimony-10-16-08-hearing-stein-final.pdf.

[ii] Bostic, Raphael W., Kathleen C Engel, Patricia A. McCoy, Anthony Pennington-Cross, and Susan M. Wachter. "The Impact of State Anti-Predatory Lending Laws: Policy Implications and Insights." Joint Center for Housing Studies, Harvard University. February 2008. Accessed online at: http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-9_bostic_et_al.pdf.

[iii] Ding, Lei, Roberto G. Quercia, and Alan M. White. "State Anti-Predatory Lending Laws: Impact and Federal Preemption Phase I Descriptive Analysis." Center for Community Capitalism, University of North Carolina. October 2009. Accessed online at: http://www.ccc.unc.edu/documents/Phase_1_report_Final_Oct5,2009_Clean.pdf. See also Bostic, et al: 2008.

[iv] Smith, Hubble. "As ARMs Reset, Joblessness Grows, LV Market will Suffer." *Las Vegas Review Journal.* December 16, 2009. Accessed online at: http://www.lvrj.com/business/more-foreclosures-on-horizon-say-analysts-79392917.html.

[v] "Legislators Hope Lease-Back Programs Ease Foreclosure Blow." Chicago Daily Herald. August 14, 2009. Accessed online at http://www.allbusiness.com/government/elections-politics-politics-political-parties/12669676-1.html

[vi] "Neighborhood Preservation Act." H.R. 2529. 111th Congress (2009). Accessed online at http://www.govtrack.us/congress/bill.xpd?bill=h111-2529&tab=summary

[vii] "Legislators Hope Lease□Back Programs Ease Foreclosure Blow." Chicago Daily Herald. August 14, 2009. Accessed
online at http://www.allbusiness.com/government/elections□politics□politics□political□parties/12669676□1.html
[viii] Alpert, Daniel. "Why Own When You Can Lease?" The New York Times. July 31, 2009. Accessed online at
http://www.nytimes.com/2009/08/01/opinion/01alpert.html?_r=1
[ix] "Legislators Hope Lease□Back Programs Ease Foreclosure Blow." Chicago Daily Herald. August 14, 2009. Accessed
online at http://www.allbusiness.com/government/elections□politics□politics□political□parties/12669676□1.html
[x] "Legislators Hope Lease□Back Programs Ease Foreclosure Blow." Chicago Daily Herald. August 14, 2009. Accessed
online at http://www.allbusiness.com/government/elections□politics□politics□political□parties/12669676□1.html
[xi] For more detail see: Carr, James H. "Responding to the Foreclosure Crisis." *Housing Policy Debate*, Vol. 18, Issue
4. 2007. Pages 837□860.
[xii] Carr, James. "Testimony on the subject of Responding to the Foreclosure Crisis." U.S. House of Representatives, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law. January 29, 2008. Accessed online at:
http://www.ncrc.org/images/stories/mediaCenter_testimony/respondingpercent20topercent20thepercent20fore closurepercent20crisis.pdf.
[xiii] White, Alan. "Testimony on Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their
Homes?" Submitted to the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Commercial and Administrative Law. July 9, 2009. Accessed online at
http://judiciary.house.gov/hearings/pdf/White090709.pdf
[xiv] Penn Institute for Urban Research. *Retooling HUD for a Catalytic Federal Government*. University of Pennsylvania. February 2009. Accessed online at
http://www.upenn.edu/penniur/pdf/Retooling%20HUDEntireReport.
pdf
[xv] Eminent domain could be justified as a method to "forestall damage to the overall economy and to reduce or stem blighting effects of concentrated foreclosures by acquiring the loans and modifying them." (Penn Institute for Urban Research)
[xvi] Penn Institute for Urban Research.
[xvii] According to Alan Mallach, a federal land bank entity (LBE) could be established to "acquire properties and provide resources to others to acquire properties"; the LBE would likely need an initial capitalization of "between $50 and $100 billion, which could take the form of Congressional authority to issue bonds backed by a federal repayment guarantee. In that fashion, the payments would be spaced over time, and could be offset in part by the likely downstream revenues that would be realized by the LBE. Alternatively, they could be financed in part through a "foreclosure assessment" levied at the filing of every foreclosure deed (or deed in lieu of foreclosure). Mallach, Alan. *Stabilizing Communities: A Federal Response to the Secondary Impacts of the Foreclosure Crisis*. February 2009.
[xviii] There is evidence that lenders are "beginning to turn down borrower requests for immediate "short sales," in which homeowners sell for whatever they can get and then give all proceeds to the lender, because this, too, means that the bank must record a principal loss at once, rather than down the road." (Alpert, Daniel. "Why Own When You Can Rent." The New York Times. July 31, 2009. Accessed online at
http://www.nytimes.com/2009/08/01/opinion/01alpert.html?_r=1
[xix] Pennsylvania's Home Emergency Mortgage Assistance Program, for example, provides a two_year loan of up to $60,000 for homeowners who become involuntarily unemployed to use for mortgage payments. For more information, visit the program website: http://www.phfa.org/consumers/homeowners/hemap.aspx. This model could be used to provide loans or grants to tenants under the sale_leaseback arrangement.

RESPONSE TO POST-HEARING QUESTIONS FROM IRWIN TRAUSS, MANAGER, ATTORNEY FOR THE CONSUMER HOUSING UNIT, PHILADELPHIA LEGAL ASSISTANCE, PHILADELPHIA, PA

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on Home Foreclosures: Will Voluntary Mortgage Modificatiou Help Families Save Their Homes?"
Jnly 9, 2009

Irwiu Trauss, Philadelphia Legal Assistance

Questions from the Honorable Steve Cohen, Chairman

1. **How many of yonr clients lost equity in their homes because of fraudulent refinancing schemes?**

Between 1994 and 2008 an ever increasing proportion of my clients have been the victims of loans that could be described as predatory and involved some element of equity stripping. During this same period the percentage of my clients with purchase money mortgages that exceeded the value of the property from the inception of the transaction also increased dramatically. These clients can also be seen as having been deprived of equity in their homes, because the value of the properties were fraudulently appraised to enable the sellers to obtain loan proceeds from the sale that exceeded the value of the property. As a result the properties were underwater from the day the homeowner obtained title.

Of the approximately 350 open case that I presently have, approximately 1/2 or 175 involve either some element of excessive costs, fees or unconscionable interest that ate into the equity the homeowner had built up in his or her home; or involved a sale, targeted toward an unsophisticated, low income buyer, that involved a fraudulent appraisal and a property that was mortgaged at the time of sale for more than it was worth at the time of the sale. In these latter cases, it was the seller or the seller's agent who arranged for the mortgage.

2. **From your perspective as an active attorney with 33 years' experience of working with low income homeowners facing foreclosure, do you believe that the current mortgage foreclosnre crisis has become worse in the last six months?**

Since the beginning of 2009 the nature of the crises has changed. The universe of people we are seeing who are faced with foreclosure has broadened. The number of people with conventional mortgages facing foreclosure has increased as more and more people find themselves without jobs or with reduced hours of employment and as unemployment compensation benefits run out.

Also we are seeing people with subprime or predatory loans who were able to afford the payments on the overpriced mortgages while they were employed, but who fell into default because they lost all or a part of their income.

Overall the number of people seeking help from the Hotline in 2009 exceeded the number seeking help in 2008 by about 20%.

From where we sit it appears the number of foreclosures continues to increase, the range of people effected by foreclosure is broadening and there is nothing to suggest that the problem will abate anytime soon.

3. Have any of your clients attempted to take advantage of the Home Affordable Modification Program? If so, have any been successful in receiving a modified mortgage?

In my program, we presently have dozens of clients attempting to take advantage of HAMP. As of July 9, 2009, we had no clients who actually received a permanent HAMP modification. Since the Subcommittee hearing on July 9, 2009 we have had three or four cases in which the clients have been offered permanent modifications.

However, in at least one of these cases, a case in which I am personally involved, the servicer is demanding payment of approximately $7,000.00 in excess escrow payments, to which it is not entitled and which it cannot justify and more than $11,000.00 in attorneys fees and costs - which are not permitted by applicable law. Taken together these two sums equal about 20% of the proposed modified loan balance. In this particular case the lender has agreed to review the numbers it is seeking to add to the modified loan balance. We do not yet know the extent to which the unjustified amounts are the result of an honest mistake or an example of overreaching by the servicer and we do not yet know if the lender will voluntarily eliminate the charges from the proposed modified loan balance.

This example highlights how vulnerable homeowners are to servicers who are inclined to overreach in the still rare cases in which a modified loan is offered under HAMP. There is no mechanism for the homeowner to review or challenge the legitimacy of the amounts that go into the calculation of the modified principal balance under a HAMP loan mod. An unrepresented homeowner is pretty much stuck with whatever number the servicer demands. And there is little to restrain those demands - especially when it comes to attorney fees and costs incurred in connection with a foreclosure.

Permanent HAMP modifications are still being offered in less that 20% of the cases in which we have sought them. And even when they are offered, they often involve modified principal balances that equal to or substantially exceed the value of the property and payments that are likely to become unaffordable in five years when, under the program, the interest rates are allowed to begin to increase.

4. How would you suggest improving the Home Affordable Modification Program? Would it be possible to improve the program without granting bankruptcy judges the authority to modify mortgages in bankruptcy?

There are several fundamental problems with HAMP which must be remedied if it is to reduce the number of foreclosures in a meaningful way.

The most fundamental problem with the program is that it is at bottom a voluntary program that gives the homeowner little or no leverage to force compliance. One of the most effective ways to address this failing is to grant bankruptcy judges the authority to modify mortgages in bankruptcy. Making a compulsory modification available to homeowners through a bankruptcy will substantially increase the willingness of servicers to enter into voluntary modifications under HAMP and will increase their compliance with the requirements of the program.

Another failing of the program is that the sole criteria for whether a servicer is required to modify a loan or not is whether the value of the loan as modified will be higher to the lender than the loan in its defaulted state. No value is attributed in the criteria to the benefit to the homeowner and to society at large from preventing the foreclosure. The benefit to the lender cannot be the sole criteria for requiring loan modifications and the loan holders and servicers cannot be allowed to point to language in pooling and servicing agreements as a basis for the wholesale refusal to modify loans. The HAMP guidelines need to be modified to require modifications in circumstances when the loan as modified fails the NPV test and to eliminate language in the pooling and servicing agreements as a basis for refusing to provide modifications.

HAMP program guidelines need to be changed to eliminate modified loan balances that exceed the value of the property and there needs to be a mechanism for policing the amounts that can be added to the modified principal balance to insure that new junk fees and costs do not become part of the modified loan. Caps on the addition of fees and costs and penalties for overreaching need to be imposed, to prevent homeowners from being further deprived of any remaining equity in their homes, under the guise of a loan modification designed to help them avoid foreclosure.

The HAMP guidelines that permitted FNMA and Freddie Mac to modify mortgages without regard to the NPV need to be reinstated.

The HAMP program needs to be supplemented by a HAMP part B, that is designed to address the predicament of homeowners who are in default because they have lost their jobs and for that reason are unable to make mortgage payments. The Philadelphia Unemployment Project has a proposal that provides for homeowners who are in default because they have lost their jobs to be immediately enrolled in a temporary modification that requires payment of not more than 31% of income, without regard to the NPV test and without regard to the small size of the income, and the creation of a loan program, as part of HAMP, loosely based upon the Pennsylvania Homeowners Emergency Assistance Program (HEMAP) . This proposal needs to be adopted.

The National Consumer Law Center has made a number of thoughtful suggestions for the improvement of the HAMP program. I am attaching a summary of those suggestions prepared by NCLC to these comments.

While it is theoretically possible that the HAMP program could be modified in the ways suggested to make it more effective than it is presently, it is not likely that it could be changed sufficiently under the present framework to make it as effective as a change to the Bankruptcy Code that would empower bankruptcy judges to impose affordable modifications and to reduce loan balances to the value of the property. This change to the law would immediately and dramatically reduce the number of homes lost to foreclosure.

5. **If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.**

Thank you for the invitation to testify before the subcommittee and for allowing me to share my perspective on the foreclosure epidemic that continues to plague our country.

NATIONAL CONSUMER LAW CENTER

Home Affordable Modification Program Updated Recommendations*

July 6, 2009

Introduction

Several months into the Home Affordable Modification Program ("HAMP"), advocates for homeowners report that the program is not providing a sufficient number of loan modifications to homeowners,[1] the modifications offered often do not meet the guidelines of the program, and the program itself still presents serious barriers to mass loan modifications. While the introduction of the program is the best effort yet to stem the tide of foreclosures, substantial additional steps are needed.

Certain Key HAMP Policies Must Be Changed to Provide Sustainable Modifications and Save Communities

The NPV model for qualifying homeowners must be available to the public.

A homeowner's qualification for a loan modification under HAMP is determined primarily through an analysis of the Net Present Value ("NPV") of a loan modification as compared to a foreclosure. The test measures whether the investor profits more from a loan modification or a foreclosure. Most investors require that servicers perform some variant of this test prior to foreclosure.[2] The outcome of this analysis depends on inputs including the homeowner's income, FICO score, current default status, debt-to-income ratio, and property valuation, plus factors relating to future value of the property and likely price at resale. Participating servicers are required to apply this analysis to all homeowners who are 60 days delinquent and those at imminent risk of default. Homeowners and their advocates need access to the program to determine whether servicers have actually and accurately used the program in evaluating the homeowner's qualifications for a HAMP modification. Without access to the NPV analysis, homeowners are entirely reliant on the servicer's good faith.

All foreclosure proceedings must be stopped, not just at the point before sale.

While many servicers are placing homeowners in foreclosure and proceeding to sale in violation of HAMP guidelines (as described below), even compliance with the current rule is pushing homeowners into costlier loan modifications and tilting the scales toward foreclosure. In judicial foreclosure states, servicers are aggressively pursuing foreclosures while reviewing homeowners for loan modifications. As a result, homeowners are incurring

* This analysis was produced by Alys Cohen, Staff Attorney, & Diane Thompson, Of Counsel.
[1] *See, e.g.*, California Reinvestment Coalition, *The Ongoing Chasm Between Words and Deeds: Abusive Practices Continue to Harm Families and Communities in California* (2009); Peter S. Goodman, *Paper Avalanche Buries Plan to Stem Foreclosures*, N.Y. Times, June 29, 2009.
[2] American Securitization Forum, *Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans* (June 2007), *available at* http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf.

thousands of dollars in costs. Servicers either demand these payments upfront (an apparent violation of HAMP) or capitalize the costs without permitting any review by the homeowner. In either event, these costs make it harder to provide an affordable loan modification and the continuation of the foreclosure causes homeowners great stress. All foreclosure proceedings should be stayed while HAMP reviews occur.

Homeowners need principal reductions, not forbearance.

Principal forgiveness is necessary to make loan modifications affordable for some homeowners. Existing data on loan modifications show that loan modifications with principal reductions tend to perform better. The need for principal reductions is especially acute – and justified – for those whose loans were not adequately underwritten and either 1) received Payment Option Adjustable Rate Mortgage ("ARM") loans that negatively amortize until as much as 125% of the original balance is owed; or 2) obtained loans that were based on inflated appraisals. Homeowners are more likely to default when they owe more on their homes than they are worth,[3] regardless of their payment level. The HAMP program recognizes this; the HAMP NPV model increases the probability of default the further underwater the homeowner is, even if payments are low and affordable. Yet HAMP does not address this problem, unlike the Federal Reserve Board's loan modification program, which mandated principal reductions when the outstanding loan balance exceeded 125% of the home's current market value. While forbearance provides affordable payments, it prevents a homeowner from selling or refinancing to meet a needed expense, such as roof repair or college tuition, and sets both the homeowner and the loan modification up for future failure.

Homeowners suffering an involuntary drop in income should be eligible for a second loan modification review.

Even after a loan modification is done successfully and is performing, homeowners may still become disabled, lose their jobs, or suffer the death of a spouse. These subsequent, unpredictable events, outside the control of the homeowner, should not result in foreclosure if a further loan modification would save investors money and preserve homeownership. Foreclosing on homes where homeowners have suffered an involuntary drop in income without evaluating the feasibility of a further HAMP modification is punitive to homeowners already suffering a loss and does not serve the interests of investors. Some servicers provide some modifications upon re-default as part of their loss mitigation program; this approach should be standard and mandated, and should include continued eligibility for HAMP modifications rather than only specific servicer or investor programs.

Homeowners in bankruptcy should be provided clear access to the HAMP program.

As a result of the HAMP guidelines providing servicer discretion on whether to provide homeowners in bankruptcy access to loan modifications under the program, homeowners generally are being denied such loan modifications. The HAMP guidelines should provide clear guidance on instances where a loan modification should be provided to homeowners in

[3] Andrey Pavlov & Susan Wachter, *Aggressive Lending and Real Estate Markets* (Dec. 20, 2006), *available at* http://realestate.wharton.upenn.edu/newsletter/pdf/feb07.pdf.

bankruptcy. The HAMP guidelines should explicitly provide that servicers must consider a homeowner seeking a modification for HAMP even if the homeowner is a debtor in a pending bankruptcy proceeding.

Servicers should be required, upon receipt of notice of a bankruptcy filing, to send information to the homeowner's counsel indicating that a loan modification under HAMP may be available. Upon request by the homeowner and working through homeowner's counsel, servicers should offer appropriate loan modifications in accordance with the HAMP guidelines prior to discharge or dismissal, or at any time during the pendency of a chapter 13 bankruptcy, without requiring relief from the automatic stay and in the case of a chapter 7 bankruptcy, without requiring reaffirmation of the debt. The bankruptcy trustee should be copied on all such communications. All loan modifications offered in pending chapter 13 cases should be approved by the Bankruptcy Court prior to final execution, unless the Court determines that such approval is not needed. If the homeowner is not represented by counsel, information relating to the availability of a loan modification under HAMP should be provided to the homeowner with a copy to the bankruptcy trustee. The communication should not imply that it is in any way an attempt to collect a debt. Finally, as discussed below, the trial modification payment rules should take into account the fact that payments may be passed through the bankruptcy trustee, rather than directly from homeowner to servicer.

Mortgages should remain assumable as between spouses, children, and other persons with a homestead interest in the property.

Federal law, the Garn-St. Germain Depository Act of 1982, specifically forbids acceleration when the property is transferred from one spouse to another and permits a spouse or child to assume the mortgage obligations.[4] Freddie Mac has long allowed mortgage assumptions by relatives as one method of working out delinquent mortgages. Such transfers are most likely to occur upon death or divorce, which may happen in the context of domestic violence. Following these policies, the HAMP program should allow mortgages for certain homeowners to be assumable. Homeowners who have recently suffered the death of a loved one should not find themselves immediately faced with foreclosure or suddenly elevated mortgage payments.

Transparency and fair lending principles must be ensured throughout the HAMP process.

Incentive payments for pre-default homeowners are aimed at the necessary policy of ensuring that homeowners already facing hardship obtain sustainable loans, yet the additional funds for such reviews may implicate fair lending issues. The home price decline protection program may result in payments focused more on non-minority areas and should be reviewed for fair lending concerns. Servicer incentive payments based on reductions in the dollar amount of a payment also may raise fair lending considerations. Moreover, hardship affidavits and paperwork must be made available in appropriate languages to ensure wide access to the program. Data on loan modifications and applications are essential to

[4] 12 U.S.C. § 1701j-3(d)(6) (2008) (transfer from borrower to spouse or children); 12 U.S.C. § 1701j-3(d)(7) (2008) (transfer to spouse pursuant to divorce decree or legal separation agreement).

ensuring equitable access to the program; these data must all be available as of Fall 2009. Any further delay will limit transparency and delay accountability.

HAMP application procedures should better recognize & lessen the impact of exigent circumstances.

Aspects of the loan modification procedures, or gaps in current guidance, create hurdles for certain homeowners. For example, victims of domestic violence are unlikely to be able to obtain and should not be required to obtain their abuser's signature on loan modification documents. While predatory lending and predatory servicing can create default and an imminent risk of default, as recognized by the HAMP plan, the hardship affidavit does not contain an explicit reference to either category. Thus, at present, a loan modification would be available only to a homeowner who realizes that the fraud and predatory behavior that resulted in unreasonable levels of debt are legitimate grounds for seeking a modification and who is able to articulate and defend that categorization to a line-level employee of the servicer who may be relying in a formulaic way on the categories contained in the hardship affidavit or may be outright hostile to claims of predatory behavior. The application process also should explicitly prohibit reaffirmation of mortgage debts in future bankruptcies (in light of the waivers described below), instead of requiring such reaffirmation, as it now does.

The trial modification program should be further formalized and clarified.

The trial modification program currently complicates matters for participating homeowners by increasing costs and failing to maximize the chances for long-term success. Payments received during the trial modification period should be applied to principal and interest, not held in suspense until the end of the trial period. Trial modification payments should be applied as if the modification, and any capitalization, occurred at the outset of the trial period, with payments allocated accordingly between principal and interest. The policy of capitalizing arrears at the end of the modification period, including any difference between scheduled and modified payments, penalizes homeowners (including those not in default at the time of the trial modification) by raising the cost of the modification and increasing the chances that some homeowners will not pass the NPV test. The use of suspense accounts and capitalizing arrears after the trial period render meaningless the term "modification" in "trial modification." In addition, homeowners who are not delinquent at the start of the trial period and who are making payments as agreed under the trial plan currently are reported to credit bureaus as making payments under a payment plan; they should not face decreased credit scores simply because they are seeking to attain a responsible debt load. For homeowners in bankruptcy, the new rules defining when trial payments are "current" fail to take into account the delay in initial disbursement that may occur when payments are made through the chapter 13 trustee. Finally, homeowners need some assurance at the time of the trial modification that, if their income is as represented upon approval of the trial modification, the servicer will provide a final modification on substantially similar terms. Homeowners are bound by the trial modification; it is not clear that servicers are.

The second lien program should be further developed to promote coordination with first lien modifications.

The second lien program should work in concert with the primary lien modification program to the greatest extent possible. Only such coordination will result in maximizing the potential of the program to save homes and communities.

Participating Servicers Violate Existing HAMP Guidelines

Waivers of claims and defenses are still being required by servicers.

The HAMP program rollout language prohibits waivers of legal rights. Many servicers still are seeking waivers from homeowners or an admission of default. Servicers also have asked homeowners to waive their right to a HAMP loan modification review in favor of a non-HAMP loan modification. Not only does this violate HAMP rules but it demonstrates bad faith. Some servicers also are requiring homeowners to sign a waiver that states that any HAMP loan modification will be suspended if the homeowner subsequently files for bankruptcy (which will be likely for some set of homeowners in part because re-defaults do not entitle homeowners to a second modification).

Foreclosures are proceeding during the HAMP review process in violation of HAMP guidelines.

Servicers often negotiate loan modifications on a separate track from the personnel pursuing foreclosure. This structure is resulting in homeowners being placed in foreclosure, and being subject to a foreclosure sale, while HAMP review is occurring.

Lack of transparency is resulting in summary denials and other unreasonable acts by servicers.

Servicers often spend many weeks processing a loan modification offer and then require a homeowner to return the paperwork after only a few days of review. The offer often includes assumptions about arrears that are undocumented and apparently overestimated. In other cases, homeowners are turned down for loan modifications without any explanation. Some servicers are scrutinizing homeowner expenses and using back-end ratios as a basis for denying HAMP loan modifications. The lack of NPV transparency makes these actions hard to counteract. NPV turndowns must be detailed and in writing, and based on a transparent process that conforms to HAMP guidelines. While some servicers claim they are doing a large volume of modifications for homeowners not eligible for HAMP, as well as many HAMP loan modifications, the claim that homeowners are not eligible comes with no public accountability. In addition, some servicers represent themselves on their websites as participating, but fail to provide any HAMP review. Confusion as to coverage of affiliated servicers is widespread.

NATIONAL CONSUMER LAW CENTER

Home Affordable Modification Program: Borrower Notices Fall Short*

Nov. 16, 2009

Introduction

The pace of loan modifications is still lagging behind foreclosures. Many homeowners who are eligible for modifications under the Home Affordable Modification Program ("HAMP") are pushed into foreclosure, and even have their homes sold at foreclosure sale, without proper consideration for HAMP while others remain in the limbo of temporary modification without any final resolution in sight.[1]

Supplemental Directive 09-08 (issued Nov. 3, 2009) purports to provide for servicer accountability. It requires notices to borrowers who fail to qualify for a temporary or permanent modification or who default on a temporary modification. The directive fails to provide homeowners with adequate information about HAMP reviews, and it creates new barriers to transparency in the HAMP review process.

Seven Suggested Improvements to the Borrower Notice Process

- Homeowners who fail the net present value ("NPV") test are not automatically provided with input data; the burden is on the homeowner to affirmatively request the input data. *Homeowners should be provided with NPV inputs when the denial is first communicated.*

- Servicers are required to provide only limited data, even in response to homeowner requests. The list of available inputs does not include such critical values as the current fair market property value, a major factor in determining a homeowner's eligibility for a loan modification. Moreover, homeowners are not provided with the dollar value of the NPV analysis, which shows how likely it is that a small error would affect a homeowner's qualification. *Treasury should require servicers to disclose all NPV inputs and outputs related to a particular loan modification review.*

- The NPV model itself has remained shrouded in secrecy and unavailable to homeowners even when it is the cause of a HAMP denial. Homeowners are unable to determine independently whether a servicer conducted the analysis properly, and advocates are unable to review the biases and inconsistencies in the model itself. The limited available information suggests serious concerns about fair lending implications, as well as inadequacy of the model itself. *The NPV model should be made*

---

* This analysis was produced by Alys Cohen, Staff Attorney, & Diane E. Thompson, Of Counsel.

[1] Homeowners and their advocates report that servicers have declined to provide permanent contracts to large numbers of homeowners who have completed their paperwork and actively sought permanent modifications after completing the trial modification requirements. Servicers often claim they have inadequate staffing or computer systems to handle or convert to permanent modifications. In some cases, servicers notify homeowners to keep paying under the trial plan, but in many cases, homeowners receive no such notice.

available to the public. Homeowners and their advocates need immediate access to a web portal in order to independently determine HAMP qualification.

- A homeowner who finds errors or outdated information in the NPV inputs used is only entitled to a second review where the inaccuracies are "material" and "likely to change the NPV outcome." Since the homeowner is not told what the NPV output is, nor given access to the NPV model, the homeowner is left at the mercy of front-line servicer staff in making this determination. Treasury provides no guidance on who should be making such a judgment or what the parameters of these terms might be. Re-running the NPV analysis should be a simple, quick task. *Servicers should be required to re-run the NPV analysis automatically when the homeowner provides updated or corrected information for the NPV inputs.*

- Disclosure of a denial based on investor or guarantor nonparticipation is both misleading and inadequate. Investors and guarantors are not participants in HAMP; servicers are participants. Investor or guarantor is not a reason under HAMP for denial. The model notice does not even require disclosure of the identity of the investor trust or guarantor, nor does it provide information identifying the contractual rules forbidding modification nor any reasonable efforts, as required by HAMP, taken by the servicer to obtain waiver of those rules. *Basic information including the investor or guarantor's name, identification of the controlling document, and a summary of efforts taken to secure participation in HAMP should be provided in each relevant denial notice.*

- The directive offers the HOPE hotline as a dispute resolution mechanism. As described, the HOPE hotline can only contact the servicer; the HOPE hotline lacks any authority to enforce or monitor compliance with program requirements. *Homeowners need access to an independent escalation process, as well as an independent review process within the servicer.*

- Under the directive, the servicer's receipt of a homeowner's request for the NPV data triggers a stop to the foreclosure sale. Homeowners report, however, that servicers frequently lose all submitted documentation. As a result, reliance on servicer receipt and processing of a homeowners' request will mean that many foreclosure sales proceed even when the homeowner has requested the NPV inputs. *NPV-based denials should automatically trigger a cease in the foreclosure process until the relevant timelines have elapsed.*