Statement of
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Accelerating Loan Modifications,
Improving Foreclosure Prevention
and
Enhancing Enforcement
before the
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Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding loan modifications of subprime hybrid adjustable rate mortgages (ARMs). Problems in the subprime mortgage markets are affecting the broader U.S. housing markets and the economy as a whole and pose a significant policy challenge for the industry and regulators.

Between now and the end of 2008, subprime hybrid ARMs representing hundreds of billions of dollars in outstanding mortgage debt will undergo payment resets. Our calculations based on owner-occupied subprime mortgages included in private mortgage-backed securitizations (MBS) indicate that almost 1.3 million hybrid loans are scheduled to undergo their first reset during 2008.[1] An additional 422,000 subprime hybrid loans are scheduled to reset in 2009, which means these problems will not end anytime soon. The combination of declining home prices and scarce refinancing options will stress these mortgage holders and could result in hundreds of thousands of additional mortgage foreclosures over the next two years. These foreclosures will inflict financial harm on individual borrowers and their communities as they potentially drive down home values. Studies show that property sales associated with foreclosures tend to reduce average home prices in the surrounding neighborhood, placing stress on remaining homeowners and their communities.

My testimony will provide some brief background on the current situation and describe an approach that I believe provides the best means we have at this juncture to avoid unnecessary foreclosures and provide for long-term, sustainable solutions. I also will comment on legislative proposals that address the issues of servicer liability for participating in loan modifications and penalties for market participants who engage in a pattern or practice of making loans that borrowers cannot repay.

U.S. Housing Markets and Mortgage Credit Performance Have Deteriorated

The U.S. housing boom of the first half of this decade ended abruptly in 2006. Housing starts, which peaked at over 2 million units in 2005, have plummeted to just over half of that level, with no recovery yet in sight. Home prices, which were growing at double-digit rates nationally in 2004 and 2005, are now falling in many metropolitan areas and for the nation as a whole. With declining home prices, there are large increases in problem mortgages, particularly in subprime and Alt-A portfolios.2 The deterioration in credit performance began in the industrial Midwest, where economic conditions have been the weakest, but has now spread to the former boom markets of Florida, California and other coastal states.

Over the past year, investors and ratings agencies have repeatedly downgraded their assumptions about subprime credit performance. A study published over the summer by Merrill Lynch estimated that if U.S. home prices fell by just 5 percent, subprime credit losses to investors would total just under $150 billion and Alt-A credit losses would total $25 billion. Subsequent to this report came news that the Case-Shiller Composite Home Price Index for the 10 large U.S. cities had fallen in August to a level that is already 5 percent lower than a year ago, with futures traded on this index now pointing to the likelihood of a similar decline over the coming year.

The complexity of many mortgage-backed securitization structures has heightened the overall risk aversion of investors, resulting in what has become more generalized illiquidity in global credit markets. These disruptions have led to the precipitous decline in subprime lending, a significant reduction in the availability of Alt-A loans, and higher interest rates on jumbo loans. The reduced availability of mortgage credit has placed further downward pressure on home sales and home prices in a self-reinforcing cycle that now threatens to derail the U.S. economic expansion.

Subprime Hybrid Mortgages and Securitization

The current problem in subprime mortgage lending arose with the rapid growth of 2- and 3-year adjustable rate subprime hybrid loans after 2003. Between year-end 2003 and mid-2007, some 5 million of these loans were originated. Of these, just over 2.5 million loans with outstanding balances of $526 billion remain outstanding.

The typical structure of these loans is to provide for a starter rate (usually between 7 and 9 percent), followed in 24 or 36 months by a steep increase in the interest rate (typically 300 basis points within the first year after the reset) and a commensurate rise in the monthly payment. Almost three quarters of subprime mortgages securitized in 2004 and 2005 were structured in this manner, as were over half the subprime loans made in 2006. Most of these loans also imposed a prepayment penalty if the loan was repaid while the starter rate was still in effect.

Despite the steep "payment shock" these loans impose on subprime borrowers, they actually performed reasonably well in recent years. Rapid home price appreciation in many areas of the U.S. allowed even highly-leveraged borrowers to refinance or to sell their home if necessary when the loans reset without a loss to themselves or mortgage investors, thereby masking the underlying weakness of the structure and underwriting of these products. In today's much more challenging environment, payment reset will lead less often to refinancing and more often to default and foreclosure.

The securitization of these 2/28 and 3/27 subprime hybrid ARMs has been very common in recent years and increases the complexity of achieving loan modifications. The servicer's primary objective is to maximize the value of the assets in a securitization trust; therefore the servicer's interests are primarily aligned with the investors. The pooling and servicing agreement (PSA) describes the roles and responsibilities of the servicer. It also discusses the servicing of the mortgage loans and addresses foreclosure and loss mitigation alternatives, including modifications. While initially there was concern that the securitization documents and the PSAs might place limits on the ability of servicers to modify loans in the securitization pool, most documents provide the servicers with sufficient flexibility to modify loans. In practice, however, third party servicers have been slow to exercise this flexibility on a large scale.

Two key elements of most PSAs determine how servicers can modify loans. While the language varies, the majority of PSAs require that servicers: (1) protect the interests of investors, and (2) conduct a net present value (NPV) analysis when determining the appropriate loss mitigation strategy in a default scenario.

Under the guidance developed by the American Securitization Forum, servicers should be bound to the interests of bondholders in the aggregate.3 This guidance provides a common sense approach to a very thorny issue because it simplifies the servicer role in attempting to protect investor interests overall by limiting losses to the pool, instead of trying to consider how each loss mitigation decision will impact each class of bondholder and speculating as to what the various classes might desire.

Servicers must also ensure that they pursue loss mitigation actions that will present the least amount of loss to the pool. While the PSA language varies, the industry calls this an "NPV analysis." Generally, servicers that document that the net present value of the payments on the loan as modified are likely to be greater than the anticipated net recovery that would result from foreclosure will establish that the modification is in the best interest of the securitization of the pool as a whole. Particularly in the case of a declining housing market, the loss on modification will generally be less than the cost of foreclosure. The use of the NPV guideline is also discussed in the American Securitization Forum statement of principles.4

Studies show that foreclosure costs can run to half or more of the loan amount.5 These loss rates will only rise in today's troubled housing markets -- particularly if more subprime borrowers are needlessly pushed into foreclosure. Studies also show that foreclosures tend to drive down the value of other homes located nearby.6 As these loans reset from the starter rate to the full contract rate, credit losses will mount as more borrowers default and enter foreclosure. This will be self-defeating for investors, impose hardships on homeowners, and have wider negative effects on local communities and the overall economy.

A Proposal for Loan Modification

It appears that subprime borrowers can be split into four basic groups: the small subset of borrowers whose loans can be expected to perform after reset, without modification; those borrowers whose loans became past due under the starter rate and whose loans will have to be individually re-underwritten to determine whether there is a way to restructure the loans so that they can repay; borrowers who might be able to refinance their loans; and, finally, borrowers who generally have been able to keep their loans current prior to reset, but will likely not be able to make the much higher monthly payments.

Based on the limited data, it is difficult to estimate exactly how large each group might be. It is important to emphasize, however, that these loans were underwritten to perform only at the starter rates and may include other risk factors, such as limited documentation of the ability to repay the loan. In addition, as two or three year loans with embedded payment shock, these loans inherently required refinancing by the initial reset date, an option no longer readily available to most borrowers. The FDIC's calculations, based on owner-occupied subprime mortgages included in private MBS, indicate that about 1.7 million hybrid loans worth $367 billion are scheduled to undergo their first reset during 2008 and 2009. Of these, over 200,000 loans are already 90 days or more past due or in some stage of foreclosure prior to reset. For loans that remain current or less than 90 days delinquent, only 2.9 percent show both a loan-to-value ratio below 80 percent at origination and a debt service-to-income ratio below 30 percent -- attributes that might indicate a high probability of remaining current even after reset. Based on these criteria, our numbers suggest that the group of loans scheduled to reset that are current but may not remain so after reset are on the order of at least 1.4 million loans.

With regard to that small subset of borrowers who have the ability to repay without modification, these loans should continue according to their contractual terms. As for loans that are already past due prior to the reset, servicers should work with these borrowers to determine whether these loans can be restructured on a long-term, sustainable basis. For some who cannot reasonably be expected to repay, even with restructuring, there may be no alternative except for foreclosure. The same is true for loans that were made under fraudulent circumstances or by speculators.

For the group of borrowers who are able to refinance their high cost loans into affordable fixed rate loans, this may be the best option available to them. However, refinancing is not without its own risks and problems. There are a number of potential pitfalls inherent in refinancing, as opposed to restructuring, which borrowers should carefully consider. While loans can be restructured for little or no cost, refinancing, if it is available under today's market conditions, can involve substantial fees for the borrower. There is also the possibility of prepayment penalties in a refinancing if it is not timed properly, whereas prepayment penalties would not be associated with a restructuring. Servicers should strongly consider waiving prepayment penalties in these circumstances. Restructuring existing loans also may provide more flexibility than refinancing through a lender.

In addition, a borrower should carefully evaluate refinancing options to ensure that they will result in a long-term, sustainable loan. Loans that are refinanced by regulated financial institutions will be made under the Interagency Guidance on Nontraditional Mortgage Product Risks and the Statement on Subprime Mortage Lending issued by the federal banking regulators that will require that the new loan be underwritten to the fully indexed rate and that its terms be appropriately disclosed. However, borrowers should be aware that there are currently no national standards for mortgage lending and that many non-bank lenders are not covered by the guidance issued by the banking regulators -- which could result in the borrower trading one high cost loan for another.

Long-term, Sustainable Modifications

A key issue is how to address the mortgage loans for owner occupied properties where the borrowers are current on their payments but will not be able to maintain the payments following reset. If servicers do nothing and allow all of these loans to reset to the full contract rate, the result will be the eventual default and foreclosure on hundreds of thousands of additional loans.

For this group of borrowers, I have recommended that servicers take a systematic and streamlined approach to restructuring these loans into long-term, sustainable loans at the starter rate -- which is already above market rates for prime loans. Servicers should reach out proactively to borrowers approaching their reset dates to determine the borrowers' ability to make the payment following reset using common matrices, such as debt-to-income ratios. Commonly used matrices, such as debt-to-income ratios (DTI), can help define which borrowers are most likely to be unable to make payments after reset. For example, the FDIC, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have jointly advised that DTIs for all recurring debts in excess of 50 percent will increase the likelihood of future difficulties in repayment, as well as delinquencies or defaults.

Where the homeowner has generally remained current at the starter rate, but cannot make the higher reset payments, the loan should be modified to keep it at the starter rate for a long-term, sustainable period of five years or more. In today's market, it is virtually certain that this modification will exceed the net present value of allowing the loan to go into foreclosure. In addition, with the volume of resets that many servicers are facing, loan-by-loan approaches will not maximize the value of the loan pool because servicers lack the resources to address the loans on a timely basis.

There are several advantages to the approach I am recommending. A streamlined approach can be undertaken much more rapidly than a loan-by-loan restructuring process. Also, this approach does not involve a bailout involving federal tax dollars. Finally, this policy does not involve government action that would affect the contractual rights of mortgage investors because it is based on voluntary action by servicers and existing legal rights and responsibilities. This approach makes economic sense and is an appropriate, proactive response to rapidly changing market conditions. Modifying loans before reset will avoid negative credit consequences for borrowers, permit borrowers to keep their homes while making payments they can afford, and provide investors with a return that exceeds any return they would receive from foreclosures. Under today's conditions, we believe that the net present value analysis itself can be streamlined for many markets. Declining housing prices and experience point to the likelihood of substantial losses through foreclosure in contrast to the income stream that can be achieved by sustainable, long-term loan modifications.

Correcting Misconceptions about Mortgage Restructuring

Let me turn now to a number of misconceptions about the impact of the loan modification proposal I have recommended and how it would work.

Misconception: Restructuring Will Create a Windfall for Subprime Borrowers

Some have expressed concern that restructuring subprime loans to a long-term, sustainable mortgage at the starter rate will result in a windfall for subprime borrowers. This misconception is based on the belief that the starter rates for these loans are similar to the low 1 to 2 percent "teaser" rates that were aggressively advertised for prime borrowers. In fact, of subprime hybrid mortgages originated in 2006, the average starter rate was 8.29 percent, which exceeded the average rate on subprime fixed rate loans made in that same year (8.06 percent), and was well above rates paid on prime fixed rate loans. These subprime borrowers will continue to pay higher subprime rates even after restructuring.

Misconception: Restructuring Will Deny Investors Their Expected Return

Another popular misconception is that restructuring will deny investors a large stream of interest payments that would rightfully accrue to them after the loans reset to the full contract rate. The reality is that very few hybrid borrowers actually remain in the pools after reset and pay the full contract rate. Among such loans made and securitized in 2003, only one in 30 continues to pay at the full contract rate after four years.

Clearly, these loans generally were never designed or underwritten to perform at the full contract rate after reset. Among subprime hybrid loans made in 2006, nearly half had loan-to-value ratios above 90 percent, and more than half had monthly debt service-to-income ratios above 40 percent. Given that, on average, the full contract rate on these loans is five full percentage points above the starter rate, it is clear that they are not designed for long-term repayment.

Misconception: Restructuring Just Delays Eventual Default

Some have argued that this proposal will just delay inevitable defaults. However, borrowers who are current after two years have clearly demonstrated a consistent willingness and ability to repay at the starter rate, which bodes well for their ability to repay at that rate over the long run. The likelihood that these borrowers will continue to make payments at the starter rate is strong because it is the features of the loan causing the current economic distress, not the changed circumstances of the borrower. Restructuring these loans by extending the starter rate provides a sustainable long-term solution, rather than just pushing the problem off to a future date.

Misconception: Restructuring is Unnecessary Based on Past Levels of Credit Losses

Some have argued that standardized and widespread restructuring is unnecessary based on past levels of credit losses. However, previous experience with losses of subprime hybrid ARMs provides very poor guidance regarding how these loans will perform going forward. For example, through August 2007 the cumulative default rate (CDR) for subprime hybrid loans originated in 2004 has been 10 percent; that is, of 1.6 million such loans originated that year, 162,000 have defaulted according to the latest data. However, with the benefit of rapidly rising home prices in many areas of the country, the vast majority of 2004 borrowers were able to repay their loans through refinancing or the voluntary sale of the property.

By contrast, loans resetting today are doing so in an era of declining home prices in many areas of the country and a virtual absence of private subprime lending. Of hybrid loans originated in 2006, the CDR is already 10.5 percent -- before any of these loans have reset. Under today's market conditions, interest rate reset is likely to drive the CDR much higher than levels experienced on previous vintages. This means that the benefits of restructuring cannot be measured against what credit losses were in previous years, but rather must be viewed in the context of how many borrowers can actually afford to pay at the full contract rate where refinancing options are extremely limited and the value of the property has decreased or not increased as anticipated.

Misconception: Standardized Loan Restructuring Cannot Be Accomplished on a Wide Basis

Critics of the proposal to restructure loans to the starter rate as described above argue that such an approach is untested and cannot be implemented on a broad basis. However, the FDIC is aware of servicers that have already begun to use a similar approach with borrowers. Those servicers are reporting that the approach is feasible and significantly reduces the cost of restructuring and its complexity.

Some loan servicers and investors have said that the approach cannot be applied consistent with PSAs because the duty to maximize NPV requires servicers to review loan by loan to set a new payment between the starter and reset rate. As I will explain below, this argument fails to consider that a loan-by-loan approach, given the current and anticipated rate of resets, will prevent maximization of NPV for the pool as a whole due to inherently limited servicer resources.

First, the volume of resetting loans means that in practical terms, the choice is between foreclosures on the one hand and systematic loan modifications for eligible borrowers on the other. A loan-by-loan calibration of what each borrower can pay will take too much time and too many resources. This increases the likelihood that a loan-by-loan approach will mean more foreclosures and loss of value to borrowers and investors. In contrast, following a streamlined modifications approach for eligible borrowers, as we have suggested, will free up resources to address the historic levels of resets that will occur in the coming 18 months and the more difficult loans and borrowers, such as those already delinquent and those with loans, such as Alt-A, that have risk layering characteristics. With any systematic loan modification program, you create categories of borrowers. While an individual determination needs to be made as to the category for each borrower, systemizing the categories and the modifications that are appropriate for that category of borrower will streamline the modification process.

I would also note that applying a modification that increases the starter rate by 1 or 2 percentage points, though not completely to the reset rate, will increase the potential delinquency rate without significantly increasing the actual cash flow into the trust. "Squeezing" the maximum increase out of a current borrower clearly increases the likelihood of delinquency compared to proven payments at the starter rate. In today's declining home market, it is against investors' interests to modify loans in a way that will increase the likelihood of default down the road.

Finally, I would note that brief extensions of the starter rate will not provide stability to the borrower, investors, or the market. Brief extensions simply increase the resource stress on servicers and decrease the ability of the market to determine market prices for mortgage assets.

On November 20th, the Governor of California announced that he has reached an agreement with several large loan servicers, including Countrywide, GMAC, Litton and HomEq, to streamline "fast-track" procedures to help keep more subprime borrowers in their homes. This agreement is based on the proposal described above, and together these four enterprises service more than 25 percent of issued subprime mortgage loans. I am greatly encouraged that servicers are recognizing the benefits of addressing problematic loans on a systematic basis. We believe that this is a very positive step because it is a public commitment to support stream-lined loan modifications by the governor of our most populous state and to implement that commitment by loan servicers who service loans throughout the country. We hope that this action will encourage other servicers to adopt this approach to speed up the pace of loan modifications.

Finally, I would like to pay tribute to Treasury Secretary Paulson's leadership in advocating systematic, sustainable loan modifications. Through the Treasury-led Hope Now effort, I am optimistic that national agreements on systematic loan modifications, combined with reporting templates for effective monitoring, are coming to fruition.

Legislative Proposals

A number of proposals have been introduced in Congress to address the fallout from the subprime mortgage crisis. Recently, the House of Representatives passed legislation drafted by this Committee to address some of the market excesses that have created problems. While this legislation would impact future loan originations, it cannot address loans that have already been made.

Legal Protections for Servicers Engaging in Loan Modifications

Although some servicers have expressed concerns regarding possible legal liability for engaging in loan modifications, the loan modification proposal described above is consistent with existing legal authority and the best practices of the industry. In addition, a number of servicers, representing a significant portion of the mortgage servicing industry, have already begun to engage in loan modifications without seeking additional legislative protection. While legislative action might be appropriate to clarify servicers' existing legal authorities, legislation should be carefully drafted to avoid the unintended consequence of slowing activity that is already underway or creating different litigation risks.

H.R. 4178, introduced by Representative Michael Castle, is laudable in its goal to spur loan modifications by providing certain legal protections. Specifically, it seeks to provide additional legal protection for servicers engaged in loan restructuring by exempting servicers and other loan holders from liability when they implement qualified loan modifications or workout plans. However, as originally drafted, the legislation would appear to override existing contracts which could create a Constitutional issue.7

If Congress determines that it is appropriate to assist servicers engaging in loan modifications, the FDIC would suggest consideration of a provision stating that, absent specific contract language to the contrary, (1) servicers have a duty to maximize the net present value of a loan pool for all investors and parties having an interest in the pool, not to any individual party or group of parties, and (2) servicers act in the best interests of all parties if they agree to or implement a modification or workout plan for a residential mortgage loan, or a class of residential mortgage loans, that meet specified criteria.

Penalties for Pattern or Practice Violations

The amendment to H.R. 3915 proposed by Chairman Frank and Representatives Miller and Watt would have imposed certain civil penalties on any originator, assignee, or securitizer that engages in a pattern or practice of originating, assigning, or securitizing residential mortgage loans that violate the requirements in Title II of H.R. 3915. Under current law, the federal banking agencies can bring enforcement actions against their regulated institutions, including civil money penalties, for violations of law. H.R. 3915 currently imposes limited civil liability (i.e. a private right of action) against assignees and securitizers with respect to loans that do not satisfy the requirements in Title II of the bill, but the bill does not make assigning or securitizing such loans a per se violation of law enforceable by the regulators. Because the FDIC does not anticipate that many of its supervised institutions are currently engaged in activities as assignees or securitizers, we would defer to the views of regulators with institutions that are more extensively involved.

Conclusion

Poor underwriting and abuses in the subprime mortgage market are having a significant negative impact on the housing markets and the U.S. economy. In the coming months, large numbers of subprime adjustable rate mortgages will reset to higher interest rates and borrowers will generally be facing default and possible foreclosure.

The FDIC is advocating a systematic approach to loan restructuring that will create long-term, sustainable solutions that enable borrowers to stay in their homes and provide a better financial result for investors than foreclosure. By restructuring subprime hybrid ARMs into long-term, sustainable loans at the starter rate for borrowers occupying their homes, servicers can proactively address a wave of likely defaults and foreclosures that will harm individuals and communities and instead provide for long-term, sustainable results. A systematic approach to restructuring for these borrowers also will free up servicer resources to work with troubled borrowers who will require more individualized solutions.

Thank you for the opportunity to testify. I would be happy to answer any questions the Committee might have.

1 FDIC estimates are based on the Loan Performance Securities Database. They reflect data collected through August 2007 on first-lien mortgages secured by owner-occupied properties where the mortgage has been securitized in private MBS issues. These figures have been adjusted to include an estimate of subprime securitized loans that are not included in the Loan Performance database.

2 Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.

3 American Securitization Forum Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, June 2007 (page 4). ("Generally, the ASF believes that loan modifications should only be made: a. consistently with applicable securitization operative documents (including amendments that can be made without investor or other consents); b. in a manner that is in the best interests of the securitization investors in the aggregate; c. in a manner that is in the best interests of the borrower...")

4 "The ASF believes that loan modifications meeting the criteria in Loan Modification Principles point 4 above are generally preferable to foreclosure where the servicer

concludes that the net present value of the payments on the loan as modified is likely to be greater than the anticipated net recovery that would result from foreclosure."

5 Karen Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," Federal Reserve Finance and Economics Discussion Paper 2003-16, May 13, 2003, p. 1.

6 Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," Housing Policy Debate (17:1) Fannie Mae Foundation (2006), www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf 281k (PDF Help)

7 Fifth Amendment takings issues have arisen in the financial services context. See, e.g., Cienega Gardens v. United States, 331 F.3d 1319, 1334 (Fed. Cir. 2003).

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