Statement of Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
on Possible Responses to Rising Mortgage Foreclosures
before the
Committee on Financial Services, U.S. House of Representatives;
2128 Rayburn House Office Building
April 17, 2007

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 our continuing efforts to address the problems faced by subprime mortgage borrowers.

As the Committee knows, the evolving problems in this market are a major concern of the FDIC. On March 1, the FDIC and the other federal banking agencies issued for comment supervisory guidance to address the underwriting and marketing of subprime adjustable mortgages. The guidance focuses on two fundamental consumer protection principles. First, a loan should be approved based on a borrower's ability to repay according to its terms (not just at the initial rate, for example). Second, borrowers should be provided the information necessary to understand a transaction at a time that will help them decide if the loan is appropriate for their needs. The FDIC and the federal and state banking agencies feel strongly that clear, common sense standards regarding the underwriting and marketing of subprime adjustable mortgages are necessary to protect consumers and reinforce market discipline, while preserving a flow of capital to fund responsible lending.

While the recent supervisory guidance is directed at preventing future abuses, there remains the urgent issue of how to address the current circumstances of many borrowers who have mortgages they cannot afford and have little prospect of refinancing given today's real estate and loan market conditions. Almost three-quarters of securitized subprime mortgages originated in 2004 and 2005 were "2/28 and 3/27"[1] hybrid loan structures.[2] Most of these borrowers are having difficulty making the payments on these loans after the "reset" to higher payments – often an increase of thirty percent or more -- that occurs after the initial two or three years of loan payments. According to one study, the interest rates for an estimated 1.1 million subprime loans will reset in 2007 and an additional 882,000 subprime loans will reset in 2008.[3] Fewer and fewer of these borrowers are able to refinance because of the slowing rate of housing appreciation, higher interest rates and the problems faced by subprime lenders.

Many subprime borrowers could avoid foreclosure if they were offered products that allow for affordable mortgage payments. Restructuring their loans into more affordable products, especially 30-year fixed rate mortgages, would bring them back to good standing, allow them to repair their credit histories, and dampen the impact that foreclosures may have on the broader housing market. Most important, people would be able to stay in their homes.

In the past, lenders often worked with troubled borrowers to restructure their loans or find other ways to avoid foreclosure. Today, the growth of securitization in the subprime mortgage market has complicated the ability of interested parties to apply flexibility and creativity to assist borrowers facing difficulty. My testimony will address the growth of securitization in the subprime mortgage market, describe the roles and responsibilities of the different participants in a securitization and identify challenges in developing workable solutions for troubled borrowers.

Growth of Securitization in the Subprime Mortgage Market

Securitization represents an essential process in U.S. mortgage markets. By packaging loans in a way that is attractive to investors, securitization has increased the volume of credit available to borrowers and improved the liquidity of the mortgage markets. The result has been the development of a wide array of lending products that have contributed to unprecedented levels of home ownership in this country.

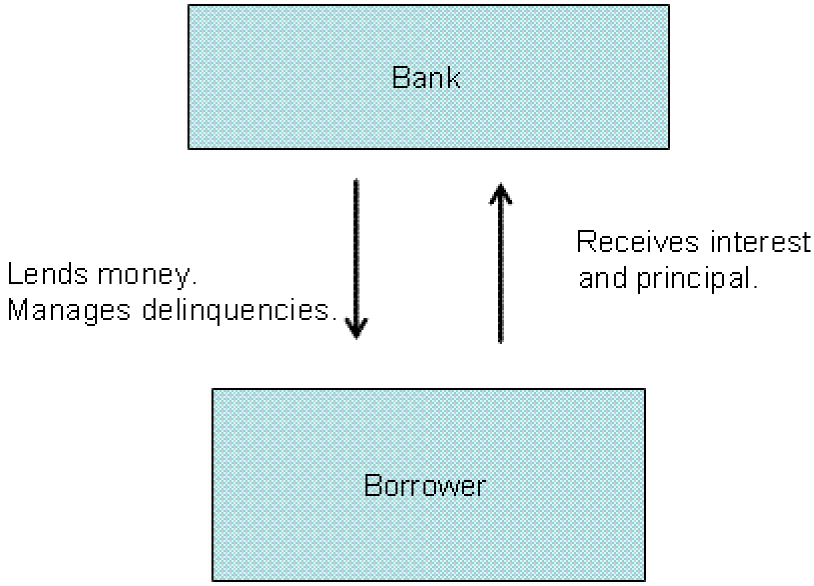
The liquidity provided by the private label mortgage-backed securities (MBS) market has been an important factor in the growth of nontraditional and subprime mortgage lending. The share of U.S. mortgage debt held in private-label MBS more than doubled between 2003 and 2006, from 9 percent to 18 percent, while the share held by government-sponsored enterprises shrank from 52 percent to 41 percent.[4]

The growth in private-label MBS injected vast amounts of liquidity into the subprime mortgage market. This increased liquidity allowed lenders to make these mortgages more widely available. Subprime loans more than doubled as a share of all mortgage loan originations, from 7.9 percent in 2003 to 20 percent in 2005.[5] The volume of subprime loans included in private-label securitizations grew to at least $672 billion by year-end 2006.[6] Approximately 75 percent of the estimated $600 billion of subprime mortgages originated in 2006 were funded by securitizations.[7] Thus, a substantial portion of subprime mortgages are ultimately funded by securitizations, and any policy responses to the expected increase in subprime foreclosures must be crafted with consideration to the legal rights and obligations of the various securitization stakeholders.

Securitization Structure

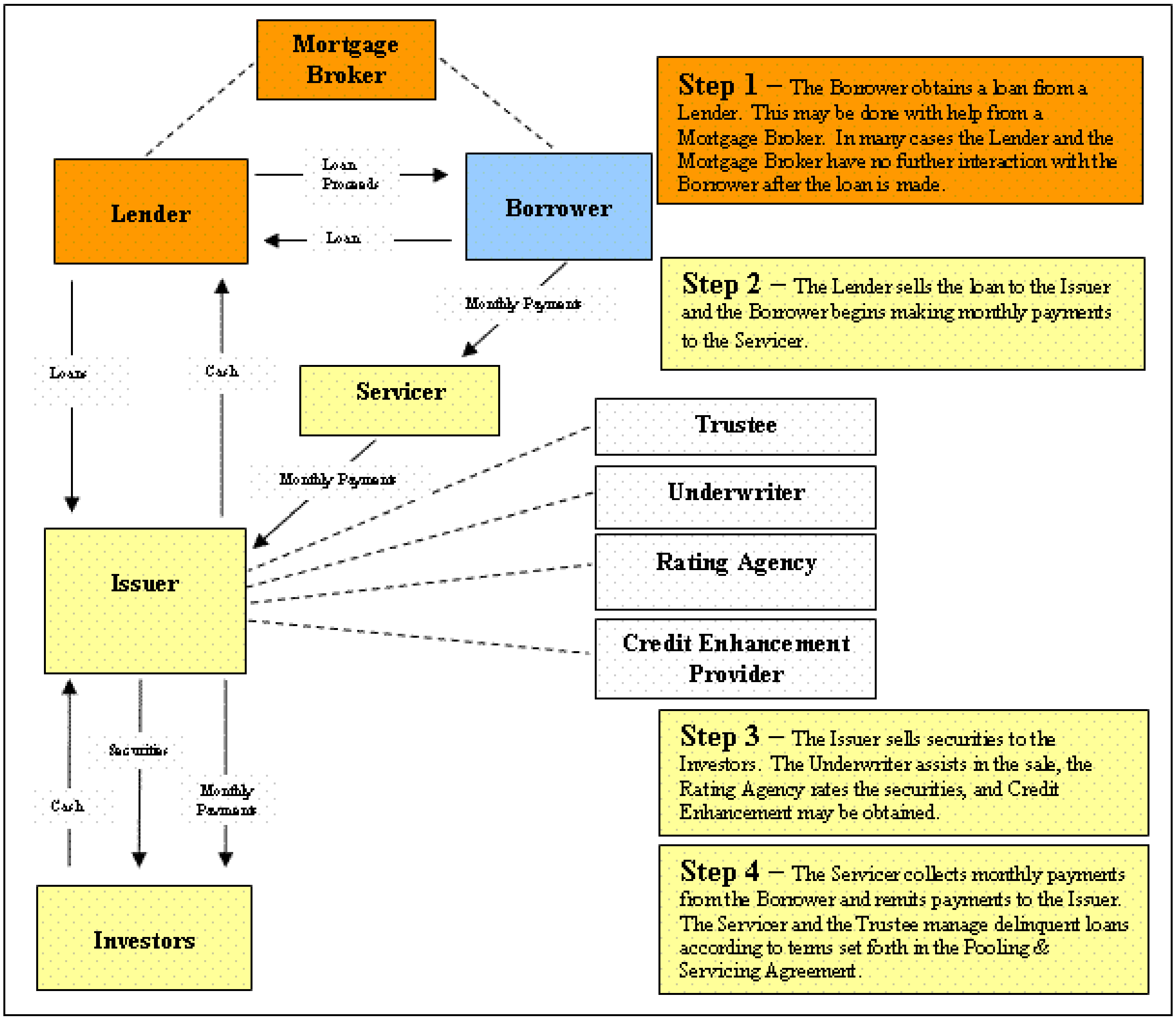
Prior to the widespread use of securitization, home finance typically involved a bank or savings institution granting a loan to a borrower. The lending institution would make the decision to grant credit, fund the loan, and collect payments. In the event of borrower default, the same institution could choose to restructure the loan or foreclose on the property. The lender also might have an established relationship with the borrower, and, thus, be able to evaluate the relative long-term benefits of various alternatives. This relatively simple relationship between the borrower and lender illustrated in the diagram below has given way to a far more complicated securitization structure which includes multiple parties, each with unique and often divergent interests.

Borrowing Under the Traditional Borrower/Lender Relationship



The securitization structure diagram below shows the components of a typical securitization. It is important to note that not all securitizations are identical. For example, the lender and the servicer are sometimes the same entity, or in other arrangements brokers may not play a role. Nevertheless, the diagram generally illustrates the roles of the various participants in a securitization structure.

Borrowing Under a Securitization Structure



As the terminology is used in the securitization contracts and in the diagram above, the key elements to a typical securitization include the following:

- **Issuer** - A bankruptcy-remote special purpose entity (SPE) formed to facilitate a securitization and to issue securities to investors.[8]
- **Lender** - An entity that underwrites and funds loans that are eventually sold to the SPE for inclusion in the securitization. Lenders are compensated by cash for the purchase of the loan and by fees. In some cases, the lender might contract with mortgage brokers. Lenders can be banks or non-banks.
- **Mortgage Broker** - Acts as a facilitator between a borrower and the lender. The mortgage broker receives fee income upon the loan's closing.
- **Servicer** - The entity responsible for collecting loan payments from borrowers and for remitting these payments to the issuer for distribution to the investors.

The servicer is typically compensated with fees based on the volume of loans serviced. The servicer is generally obligated to maximize the payments from the borrowers to the issuer, and is responsible for handling delinquent loans and foreclosures.

- **Investors** - The purchasers of the various securities issued by a securitization. Investors provide funding for the loans and assume varying degrees of credit risk, based on the terms of the securities they purchase.
- **Rating Agency** - Assigns initial ratings to the various securities issued by the issuer and updates these ratings based on subsequent performance and perceived risk. Rating agency criteria influence the initial structure of the securities.
- **Trustee** - A third party appointed to represent the investors' interests in a securitization. The trustee ensures that the securitization operates as set forth in the securitization documents, which may include determinations about the servicer's compliance with established servicing criteria.
- **Securitization Documents** - The documents create the securitization and specify how it operates. One of the securitization documents is the Pooling and Servicing Agreement (PSA), which is a contract that defines how loans will be combined in a securitization, the administration and servicing of the loans, representations and warranties, and permissible loss mitigation strategies that the servicer can perform in event of loan default.
- **Underwriter** - Administers the issuance of the securities to investors.
- **Credit Enhancement Provider** - Securitization transactions may include credit enhancement (designed to decrease the credit risk of the structure) provided by an independent third party in the form of letters of credit or guarantees.

Securitization takes the role of the lender and breaks it into separate components. Unlike the more traditional relationship between a borrower and a lender, securitization involves the sale of the loan by the lender to a new owner--the issuer--who then sells securities to investors. The investors are buying "bonds" that entitle them to a share of the cash paid by the borrowers on their mortgages. Once the lender has sold the mortgage to the issuer, the lender no longer has the power to restructure the loan or make other accommodations for its borrower. That becomes the responsibility of a servicer, who collects the mortgage payments, distributes them to the issuer for payment to investors, and, if the borrower cannot pay, takes action to recover cash for the investors. The servicer can only do what the securitization documents allow it to do. As described below, these contracts may constrain the servicer's flexibility to restructure the loans.

With so many parties and components involved, securitizations are significantly more complicated than the traditional borrower/lender relationship. The securitization is governed by securitization documents and is administered by a trustee. This separation of the functions previously done by a single lender creates a funding mechanism that has facilitated new types of financing and has expanded credit availability. However, the increased complexity of the structure and the different interests of the various securitization parties can make credit workout strategies more complicated than in a direct borrower/lender relationship.

The interests and obligations of the various parties are set forth in the securitization documents and are closely monitored by the trustee. Further complicating the situation is the fact that the interests of the participants might not be aligned – with each other or with the borrower. Generally speaking, this arrangement complicates the loan modification process.

Loan Restructuring Challenges

When difficulty arises in making payments on a securitized loan, the borrower generally will not be dealing with the local banker with whom there might be an established relationship. Instead, the borrower will be dealing with a servicer. The servicer has responsibilities defined in the securitization documents that are substantially different than those of a lender. The servicer and the trustee are responsible for taking actions that are in the best interest of the investors who purchased portions of the securitization. Protecting the investors means determining the best alternative that would bring the maximum recovery on a defaulted loan on a present-value basis. If the servicer determines that a workout or modification of the loan achieves that goal, then there is an alignment of the investor/servicer/borrower relationship. However, if liquidation of the collateral (through a foreclosure or other means) results in the highest net present value of cash flows, the servicer may be bound by the terms of the securitization to pursue this approach to the benefit of the investor despite the resulting detriment to the borrower.[9]

Even if a modification to the loan looks like the right approach, other factors might limit the servicer's options. Most securitizations are established as Real Estate Mortgage Investment Conduits (REMICs). The REMIC structure provides considerable tax benefits, (i.e., only the investors are subject to tax, not the conduit itself) but also includes provisions that could limit the flexibility of a servicer to modify a borrower's loan terms in a proactive manner. To qualify for tax-advantaged status, the pool of loans securitized in a REMIC must generally be treated as a static pool, which usually precludes modifying loans in the pool. An exception to this general prohibition allows for modifications when default is reasonably foreseeable. Once a determination is made that default is *reasonably foreseeable*, most securitization agreements provide significant flexibility for the servicer to modify terms of the loan. This allows for modification of terms when a loan has defaulted, but may prohibit changes to loans that are current.

The Internal Revenue Service (IRS) leaves it to servicers to determine what "reasonably foreseeable" means as it relates to default, which makes these determinations dependent upon the facts and circumstances of each mortgage. In many cases, servicers would likely need to seek legal determinations from outside counsel, especially with respect to whether a default was reasonably foreseeable, in order to modify loans in the pool. Some securitization documents indicate that once a loan is delinquent for a certain amount of time, for example, 60 days, modifications of the terms may be allowed, subject to REMIC laws. In some deals, the servicer must certify with a legal opinion that a modification of loan terms would not result in an adverse REMIC event. Therefore, while some flexibility is available, the specifics are often unclear. Further clarification regarding permissible modification activities under REMIC laws would improve the servicer's ability to work through problems with the borrower.

Aside from the restraints imposed on modifications by the REMIC structure, the PSA can also impose barriers to loan modification. The language in each PSA is different and each establishes the rules about how a particular securitization operates or what needs to be done to change those rules. Many PSAs contain more than 200 pages of dense legal verbiage. The PSA provides a blueprint as to how cash flows and losses are allocated and distributed to the various parties, and establishes the rules that the servicer must abide by in managing this critical function in the transaction. The PSA sets forth whether and how a servicer can modify the underlying loans in a securitization. The documents will also identify the other parties in the transaction who might have an important role in this decision.

If the PSA's terms and conditions regarding modifications prove to be overly restrictive, changing the PSA can be very difficult and may require extraordinary actions, such as obtaining the consent of two-thirds or all of the investors. In some deals, the PSA is quite explicit in allowing the servicer flexibility in modifying delinquent loans,[10] while in other transactions the language is vague.

Even if the servicer can arrange a modification of terms, the servicer may still be limited in the ability to take a proactive approach to modifying a loan. If a servicer foresees problems on the horizon for a group of borrowers that is currently paying as agreed, the servicer might not be able to modify the terms of the loan until the borrower enters into the "imminent default" category. For example, following Hurricane Katrina, some banks granted blanket payment moratoria for borrowers with homes in the Gulf Coast region, but many servicers were limited in their ability to grant similar blanket moratoria for mortgages that were securitized. Instead, these servicers had to make modifications on a case-by-case basis based on the facts and circumstances of each borrower. In situations like this, waiting for the borrower to fall behind in payments may not be the most prudent course of action for any of the parties involved. If solutions could be reached to forestall a problem, the result would be greater flexibility for servicers and possibly loss mitigation.

While the servicer has an important role in the decisions relating to the underlying borrower, there are other parties involved in the transaction whose views also carry significant weight. In most older deals (and some more recent), the servicer must obtain the consent and approval of the rating agency and bond insurer before considering loan modifications in amounts greater than 5 percent of the total transaction. Yet, excessive modifications might be viewed as a negative factor when ratings are reviewed by the ratings agencies.

Financial guarantors and other credit enhancement providers have become more involved in the structured finance market as well, often providing insurance on the deeply subordinated tranches of securitizations to facilitate the sale of these more risky positions. In this role, a guarantor steps in and absorbs losses should the underlying collateral begin to deteriorate. Therefore, the guarantor has a vested interest in the decisions made by the servicer in dealing with distressed borrowers. In some transactions, the servicer is required to gain the prior written consent of the credit enhancement provider for any modification, waiver, or amendment that would cause the aggregate number of outstanding mortgage loans which have been modified, waived or amended to exceed 5 percent of the original pool balance. Whether the credit enhancement provider, servicer, and borrower share the same interest will depend on the facts and circumstances of the specific situation. If their interests are not aligned, however, the credit enhancement provider’s demands will no doubt have a large effect on the ultimate outcome.

The accounting rules also play an important role in the decisions made by the various parties. Securitization is often used as a balance sheet management strategy, whereby assets sold into a securitization are removed from the seller’s books, thus freeing up resources such as capital. Lenders must meet strict accounting requirements before they can remove assets from their books, to show that they no longer “control” these assets, and that the risks and rewards associated with the loans have been transferred to the investors.

Overall, the ability to securitize pools of such mortgages certainly helped to make mortgage loans available and has reduced the cost of credit for borrowers. However, the securitization structure also has introduced a number of new participants and complexities into the loan relationship, which reduces flexibility for addressing the problems of distressed borrowers.

Dealing with Credit Distress

A key element in addressing alternatives to foreclosure for borrowers experiencing credit distress is early communication between the borrower and the servicer. It is important that a borrower contact the loan servicer, the entity to which the borrower sends the monthly payment, as soon as possible if the borrower anticipates difficulty in making payments when the loan resets. The contact information for the servicer can be found on the monthly billing statement. In addition to borrowers contacting their loan servicers, it appears that a number of loan servicers are proactively contacting borrowers several months before their loans are due to reset to determine the prospect of repayment and modifying loan terms if necessary to avoid default. This is a highly positive development that should be encouraged. Failure to establish timely communication could result in some foreclosures that might have been prevented.

In addition, borrowers should explore all financing options that might be available. Borrowers with ARMs or hybrid ARMs, such as “2/28” or “3/27” mortgage loans should inquire about traditional fixed rate products. Particularly when borrowers can document income, fixed rate products may be available at lower interest rates -- and therefore lower monthly cost -- than more exotic products.[11] I also encourage lenders and servicers to be as flexible as they can in efforts to accommodate borrowers concerned about losing their homes. Fundamentally, borrowers should be given loans they can afford to repay both today and in the future.

My testimony up to this point has focused on borrowers who have been making steady payments but face a reset of their interest rate that will make it difficult or impossible to make the significantly higher monthly payments. It is important to note that there is another class of borrowers who immediately defaulted on their loans or obtained their loans under potentially fraudulent pretenses. It would be hard to argue that these borrowers deserve the same type of assistance that might be appropriate for borrowers who acted in good faith.

The April 16 Forum

The FDIC, along with the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Federal Reserve, the Securities and Exchange Commission, and the Office of Federal Housing Enterprise Oversight, recently announced its intention to jointly host a forum on April 16 on the issues surrounding subprime mortgage securitizations. Lenders, servicers, and other participants in the subprime market have been invited to participate in an exchange of ideas about how they can help struggling subprime borrowers avoid foreclosure while maintaining the integrity of the secondary market.

The goal of the forum is to provide an opportunity for market participants to develop a common understanding of problems and to identify workable solutions for rising delinquencies and defaults, including alternatives to foreclosure.[12] The forum is an example of the role that the regulatory community can play in fostering dialogue with the private sector to focus efforts on important public policy goals.

Clearly there are significant issues created by the present structure of securitization vehicles and how the terms and conditions of these arrangements may complicate workable solutions. In some cases, the contracts and rules in place to restrict abuses on certain activities might have the unintended consequence of restricting a servicer’s ability to make prudent decisions that are in the interest both of the investor and the borrower. To address these issues, the forum is designed to focus on three key areas:

- Identifying current marketplace activities to help borrowers stay in their homes.
- Identifying whether there are legal restrictions, accounting rules, or contractual limits that unreasonably interfere with efforts to restructure borrowers' mortgages.
- Identifying alternatives to foreclosure and the strategies to implement those alternatives within the current securitization structures.

Conclusion

Mortgage securitization represents an essential capital market process that has helped to expand the availability of credit to U.S. homebuyers and improve the ability of lenders to manage risks. While this market-driven process has evolved in remarkable ways over the years, there continue to be challenges in terms of how this process operates in a time of credit distress. Significant changes in the subprime mortgage market in recent years have substantially altered the relationship between borrowers and lenders. In some cases, this makes it more difficult to resolve troubled loans in a way that preserves the availability of credit and benefits deserving borrowers, namely, by keeping them in their homes. These issues are complex and should be approached cautiously and deliberately to avoid unintended consequences that could negatively impact credit availability. The securitization forum is a first step to bring relevant parties together to seek workable solutions. The FDIC stands ready to work with Congress and all parties to explore solutions to assist troubled borrowers.

This concludes my testimony. I would be happy to answer any questions from the Committee.

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1. 2/28s and 3/27s are hybrid ARMs typically marketed to subprime borrowers. These ARMs are similar to ARMs that are prevalent in the prime market (known as 3/1 ARMs), in that they have a fixed rate for 2/3 years and then adjust to a variable rate for the remaining 28/27 years. However, the spread between the initial fixed rate of interest and the fully-indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points on 2/28 and 3/27s, versus 100-250 basis points on prime 3/1 ARMs.

2. Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.

3. Christopher L. Cagan, "Mortgage Payment Reset: The Issue and the Impact," First American CoreLogic, March 19, 2007, http://www.firstamres.com/MPR2007.

4. *Federal Reserve Flow of Funds.*

5. *Inside Mortgage Finance,* December 1, 2006.

6. LoanPerformance database of nonprime (subprime and alt-A) non-agency securitized mortgage originations. Volume represents active investor balance of subprime loans.

7. *Standard & Poor's Weighs In On The U.S. Subprime Mortgage Market,* April 2, 2007.

8. Bankruptcy-remote means that an SPE's obligations are secure even if the lender becomes insolvent. That is, due to its legal status and balance sheet structure, the SPE and its debt issuances are not affected by the bankruptcy of the lender.

9. For example, one securitization includes language that states “in the event that any mortgage loan is in default or, in the judgment of the servicer, such default is reasonably foreseeable, the servicer, may also waive, modify or vary any term of such mortgage loan (including modifications that would change the mortgage rate, forgive the payment of principal or interest or extend the final maturity date of such mortgage loan, accept payment from the related mortgagor of an amount less than the stated principal balance in final satisfaction of such mortgage loan or consent to the postponement of strict compliance with any such term or otherwise grant indulgence to any mortgagor; provided, that in the **judgment** of the servicer, any such modification, waiver or amendment could reasonably be expected to result in collections and other recoveries in respect to such mortgage loans in excess of net liquidation proceeds that would be recovered upon the foreclosure of, or other realization upon, such mortgage loan….”

10. For example “In the event that any mortgage loan is in default or is a 60+ day delinquent mortgage loan, the servicer, consistent with the standards set forth in Section 3.01, may also waive, modify or vary any term of such mortgage loan (including modifications that would change the mortgage interest rate, forgive the payment of principal or interest, extend the final maturity date of such mortgage loan or waive, in whole or in part, a prepayment premium), accept payment from the related mortgagor of an amount less than the stated principal balance in final satisfaction of such mortgage loan or consent to the postponement of strict compliance with any such term or otherwise grant indulgence to any mortgagor (any and all such waivers, modifications variance, forgiveness of principal or interest, postponements, or indulgences collectively referred to herein as forbearance).”

11. ***See*** Testimony of Chairman Sheila C. Bair on *“Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Institutions”* delivered to the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services U.S. House of Representatives on March 27, 2007.

12. The deadline for delivering this testimony to the Committee precluded a discussion in this document of the details and results of the April 16 forum.

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