American SECURITIZATION FORUM®

Statement of

Tom Deutsch
Deputy Executive Director
American Securitization Forum

Testimony before the

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United States House of Representatives

Hearing on

"Private Sector Cooperation with Mortgage Modifications-Ensuring That Investors, Servicers and Lenders Provide Real Help for Troubled Homeowners"

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360 Madison Avenue, 18th Fl. ▪ New York, NY 10017-7111 ▪ P: 212.313.1111 ▪ F: 212.313.1032
1101 New York Avenue, NW, 8th Fl. ▪ Washington, DC 20005-4269 ▪ P: 202.962.7300 ▪ F: 202.962.7365
www.americansecuritization.com

Chairman Frank, Ranking Member Baucus and distinguished Members of the Committee,

My name is Tom Deutsch and I am the Deputy Executive Director of the American Securitization Forum (ASF).[1] I very much appreciate the opportunity to testify before this Committee again on behalf of the 330 member institutions of the ASF, including mortgage lenders, servicers and investors, regarding loan modifications and how the mortgage-backed securities (MBS) industry and government can work together to prevent avoidable foreclosures.

I testify here today with one simple overarching message—industry participants have been and will continue to deploy aggressive and streamlined efforts to prevent as many avoidable foreclosures as possible. But macro economic forces bearing down on an already troubled housing market are simply too strong for private sector loan modification initiatives alone to counteract the nationwide increase in mortgage defaults and foreclosures. In my testimony today, I will outline a number of ways that the industry and the government can work together to target relief to troubled homeowners, while simultaneously helping to restore capital flows into the U.S. housing markets.

Overview of Testimony

The testimony that follows addresses four principal topics:

1) Current economic and housing market conditions, and the challenges those conditions impose on efforts to prevent foreclosures via loan modifications;
2) The goals, progress and limitations of industry loan modification initiatives targeting securitized residential mortgage loans to date;
3) Additional efforts underway within the securitization industry to further facilitate and streamline the loan modification process; and
4) Perspectives on additional steps that we believe the federal government should consider to expand opportunities to modify and refinance troubled mortgage loans, to avoid foreclosures and to help stabilize the broader housing market.

Current Economic and Housing Market Conditions; Challenges for Loan Modification Initiatives

Economic and housing market conditions have significantly deteriorated over the last eighteen months, and that deterioration has intensified recently. The primary factors our members have identified that have combined to put severe strain on homeowners and drive rising delinquencies, defaults and foreclosures include:

[1]ASF is a broad-based professional forum of over 330 member organizations that are active participants in the U.S. securitization market. Among other roles, ASF members include institutional investors, servicers, issuers, financial intermediaries, and professional advisers working on securitization transactions backed by all types of mortgage and consumer credit assets. ASF's mission includes building consensus, pursuing advocacy and delivering education on behalf of the securitization markets and its participants. Additional information about the ASF, its members and activities may be found at ASF's internet website: www.americansecuritization.com. ASF is an independent affiliate of the Securities Industry and Financial Markets Association (SIFMA).

1) unavailability of mortgage credit for refinancing opportunities;
2) declining home values;
3) high levels of non-mortgage credit outstanding (e.g., credit card, auto loan, other debt)
4) prevalence of 2nd liens; and
5) rising unemployment levels and reductions in income, making mortgage payments unaffordable.

While critically important and increasingly employed, industry-led loss mitigation initiatives, including loan modifications, are not a panacea for declining home prices, mortgage defaults and foreclosures. Loan modifications are a viable foreclosure avoidance option for only a subset of mortgage borrowers now at risk of default. In general, loan modifications are appropriate and can be effective only for borrowers who: a) cannot afford their current or future mortgage payment; b) wish to remain in the home and are capable of managing the broader responsibilities of home ownership; and c) can afford a reasonable mortgage payment as modified. Loan modifications cannot overcome situations in which a borrower does not evidence a desire to stay in the home, or cannot afford payments on the loan as modified, even with significant reductions in interest or principal payments. Unfortunately, an increasing number of borrowers share one or both of these characteristics. A brief examination of recent mortgage market dynamics helps to explain why this is the case.

As prices have declined over the last two years, approximately 1 out of every 4 mortgage borrowers now owes more on their homes than what those homes are worth (underwater mortgages). Although these value declines are clearly unwelcome, they ultimately do not increase the monthly payment obligations for borrowers and therefore do not affect the affordability of their mortgage obligations. As such, most of these borrowers continue to pay on time. Unfortunately, some borrowers choose to ignore their obligations and 'walk away' from their homes, resulting in a foreclosure. Similarly, as financial obligation ratios have reached an all-time high,[3] servicers are finding an increasing number of borrowers whose mortgage and consumer debts (such as credit cards and auto loans), even after significant mortgage modifications, simply are too high, given their incomes, to sustain their mortgage payments. These borrowers face challenges in meeting debt obligations that extend well beyond their mortgage. This may help to explain why some 30-50% of mortgage payment defaults proceed to foreclosure with no borrower response to servicer outreach via phone calls and mailings—even where some of those borrowers might otherwise qualify for a modification.

Many borrowers having difficulties meeting their payments on their primary mortgage also have a 'silent' second lien (in the form of a home equity loan or line of credit). Second liens are serviced separately and often times by a different servicer than that of the first lien. A recent study estimates that approximately half of 2006 borrowers with a securitized subprime first lien mortgage have a second lien exposed or hidden behind that first lien.[4] In addition to contributing to an increased debt load and low or negative home equity for borrowers, the existence of these second liens creates significant difficulties for servicers who might be considering modifying the

[3] Loan Performance Data
[4] Loan Performance Data

first lien, especially in situations like a Hope for Homeowners (H4H) refinancing where the owner of the second lien is required to extinguish to allow the first lien to refinance. Also, servicers of first liens seeking to apply loss mitigation techniques, including interest and/or principal reductions, have to take into account the second lien. They cannot compel the second lien controlled by a different servicer to employ equal or greater loss mitigation strategies on the second lien as the first lien. Proper and efficient coordination of second liens has and is expected to continue to be a significant obstacle in expediting help for troubled borrowers.

We support changes such as one made in the Emergency Economic Stabilization Act (EESA) to the H4H program that allows the Department of Housing and Urban Development (HUD) to make payments "to any holder of an existing subordinate mortgage, in lieu of any future appreciation payments…"[5] Given the existing operational, legal and economic difficulties of extinguishing these second liens, the ability to provide direct payments rather than equity upside incentives will help expedite the process of appropriately clearing away second liens.

Even in situations where servicers successfully identify, grant and communicate a loan modification that meets a distressed homeowner ability to pay, up to 44% of borrowers have redefaulted after the lender has granted a modification concession.[6] As such, a redefault by a modified loan can expose the holder of that loan to even greater losses in a declining home price market.

Potentially the most troubling macro economic factor impacting the housing market today is the rapidly increasing levels of unemployment in America, which will continue to increase the rate of mortgage defaults and foreclosures. For example, Freddie Mac found that in June of 2008 45.5% of all delinquencies were due to unemployment or loss of income. Given recent announcements of additional job reductions across a wide range of industries and geographic regions, servicers are preparing for an even larger uptick in delinquencies due to rapidly rising unemployment levels. Especially in protracted economic downturns like our current one, a borrower who is laid off is not likely to find new employment that ultimately supports the same lifestyle and mortgage payment as his or her previous employment. In these situations, retention of the borrower's current home may not be sustainable even with an aggressive loan modification.

Ultimately, it must be recognized that the seismic economic challenges in the United States, the epicenter of which is the housing market, are too great for purely private sector loan modification solutions. As such, evolving servicer loss mitigation activities, though playing an important part of the solution, will not be sufficient to address the steep challenges the American housing market faces today. In addition to expanded industry efforts, federal government initiatives, such as H4H and the Troubled Asset Relief Program (TARP), will have to be even more aggressive in their efforts to stabilize homeownership, neighborhoods and communities around the country.

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[5] Emergency Economic Stabilization Act, Section 124 (2008).
[6] Credit Suisse Fixed Income Research, Subprime Loan Modifications Update, October 1, 2008.
[8] Hope Now Alliance October Data Release.

Current and Future Industry Loan Modification Initiatives

Notwithstanding the formidable challenges outlined above, securitization industry participants have worked to avoid foreclosures and mitigate losses on defaulted loans wherever possible. From July 2007 through September 2008, some 2.5 million troubled borrowers were assisted by industry loan modification and loss mitigation initiatives. Those efforts continue, for example, in September 2008 alone, servicers helped some 212,000 borrowers avoid foreclosure, 30,000 more than the previous record established in August 2008.[8] Through these efforts, the number of loan modifications and workouts has increased by over six times the rate at which they were being provided to borrowers at this time last year.

Securitization industry participants have strong incentives to pursue loan modifications because, as a general matter, no securitization market constituency—including lenders, servicers and investors—benefits from loan defaults and foreclosures. Because foreclosure is usually the most costly means of resolving a loan default, it is typically the least-preferred alternative for addressing a defaulted loan, whether or not the loan is held in a securitization trust. Although there is variation among individual transactions, most securitizations provide servicers with significant flexibility to engage in loan modifications and other loss mitigation techniques, subject to contractual obligations that the particular loss mitigation alternative selected maximizes the net present value, or ultimate recovery, on the related mortgage loan.

Given the multiple variables and detailed analysis involved, this can be a complex and difficult judgment for servicers to make. Where a loan modification is pursued, the servicer must be able to demonstrate a reasonable basis for concluding that the particular modification selected is likely to produce a greater recovery than other loss mitigation alternatives available, including but not limited to foreclosure. ASF therefore recognizes and strongly supports the benefit of providing additional, industry consensus guidance on ways that servicers can fulfill more efficiently their obligations to mitigate losses and maximize recoveries on distressed mortgage loans, in a manner that is also consistent with their duties to investors. As outlined below, we have taken steps to provide this guidance in the past, and are actively engaged in additional efforts to provide additional guidance to servicers in light of the increasing challenges they face.

Over the past two years, the ASF has worked to develop several market standards and practices initiatives aimed at promoting the utilization of loss mitigation and loan modification strategies to prevent avoidable foreclosures. For example, in December, 2007, ASF announced the release of the first systematic protocol, the ASF Streamlined Foreclosure and Loss Avoidance Framework for Securitized Adjustable Rate Mortgages ("ASF Framework"), which outlines systematic criteria that servicers can use to streamline the evaluation of their subprime hybrid ARM portfolios and offer appropriate solutions to borrowers facing significant interest rate resets.

As a result of servicers' efforts under the ASF Framework, approximately 111,000 subprime ARMs have been modified with over 73 percent of these modifications having a duration of 5 years or longer.[9] As outlined in two scenarios in Appendix A of this testimony, servicers

[9] Hope Now Alliance October Data Release.

generally seek to employ interest rate modifications to achieve affordability for the borrower prior to contemplating any principal reductions. A recent study on the use of loan modifications notes that, "Because of ASF's streamlined loan mods plan beginning in January 2008, this type of mod [rate reset] currently makes up the largest group of subprime loan mods."[10] The fact that very few borrowers are experiencing delinquencies caused by a resetting interest rate on a subprime ARM ultimately demonstrates the ASF Framework has been effective in achieving the targeted aim.

Notwithstanding the above initiatives, in light of the recent deterioration in the broader economy and housing market, ASF is working aggressively to develop an expanded framework that servicers can use to modify loans in a manner that is consistent with appropriate loan modification goals, and with the contractual rights and commercial expectations of institutional investors. A group of ASF members, including investors, is reviewing criteria from other loan modification approaches that have recently been announced, such as the plan implemented by the FDIC with respect to loans it acquired via the receivership of IndyMac Bank or the plan the Federal Housing Finance Agency (FHFA) announced yesterday. We believe that the development and application of an investor-developed framework with input from all stakeholders can help to establish broader consensus on ways that loan modifications can be effectuated in a manner that appropriately targets them efficiently and effectively. We are optimistic that this new approach will promote an even greater number of appropriate loan modifications delivered throughout the industry via more streamlined processes.

Some of the key challenges that we are actively working to address include:

1. Developing a mechanism to distinguish between troubled borrowers needing assistance and borrowers who otherwise have an ability to pay and don't need assistance;
2. Addressing the motivations that might exist for non-troubled borrowers to default or to attempt to disguise their true ability to pay;
3. Streamlining methods of verifying troubled borrowers true income and occupancy status to avoid 'no doc loan mods' that assist housing speculators;
4. Addressing the complex challenges presented by pay option ARMs in a depreciating housing market;
5. Developing operationally-efficient, market-accepted methods to compensate and extinguish second liens to allow a first lien to refinance into a more sustainable loan;
6. Creating appropriate loss mitigations on second liens that are proportionate and appropriate in relation to the loss mitigation being applied to first lien positions;
7. Designing better evaluative tools for all of a borrowers' debts, including both mortgage and consumer debts, to make more effective and sustainable loss mitigation solutions;
8. Accounting for a borrower's relative income bracket, size of loan and geographical location in any calculation that compares their mortgage debt with their income;
9. Addressing operational challenges of detecting borrower, broker or other fraud in origination that would trigger alternative approaches; and
10. Providing greater market practice clarity to servicers to apply appropriate streamlined loss mitigation techniques in compliance with their pooling and servicing agreements.

[10] Credit Suisse Fixed Income Research, Subprime Loan Modifications Update, October 1, 2008.
[12] Emergency Economic Stabilization Act, Section 124 (2008).

Governmental Initiatives to Expand Refinancing and Loan Modification Alternatives

Although industry-driven loan modification and loss mitigation actions have been and will continue to be key components to preventing avoidable foreclosures, there are limits to their effectiveness in addressing the extraordinary challenges in the housing market. As such, we believe expanded government programs may be effective in bridging this gap, and helping to address the potential foreclosures that commercial and contractual arrangements cannot prevent. The nationwide home price correction and persistent uptick in foreclosures present systemic risks to the national economic infrastructure. Moreover, foreclosures are bad for everyone—borrowers, communities and investors. Vacant homes drive down home prices and invite crime. Given these extraordinary systemic risks and public policy concerns, we believe the federal government could helpfully supplement industry initiatives to modify and expand voluntary programs to aggressively seek to prevent additional foreclosures.

1. Expand Eligibility of Hope for Homeowners Program

We applaud you Mr. Chairman, and the hardworking members of this Committee for being a driving force in developing and enacting the Hope for Homeowners program last summer. The program has a number of innovative elements to help homeowners refinance into a new FHA loan and it provides incentives for servicers and loan holders to allow those homeowners to refinance. Unfortunately, the program has met with limited market reaction, as only a handful of loans have been put through the program in its first month of operation. We believe there are three significant impediments to greater participation, which include: 1) the current noteholder is required to write down the principal of the existing loan to a loan-to-value (LTV) ratio of effectively 87% of the current appraised value of the home; 2) significant uncertainties regarding the potential treatment of H4H loans under federal and state consumer credit laws exist, which affect the ability and willingness of lenders to participate in this program; and 3) the back-end DTI limit eliminates a substantial number of potential program participants due to the significant amount of debts (other than first-lien mortgages) being carried by the American population.

Our servicer and investor members have suggested that this LTV write-down requirement to 87% is too deep of a principal reduction to incentivize widespread participation in the H4H program. The recently enacted EESA recognized this challenge to the H4H program and allows "such higher percentage [LTV] as the Board determines, in the discretion of the Board."[12] The prevailing market view is that if the governing Board of the H4H program were to exercise its new authority to increase the LTV percentage to that of FHASecure (97%), the H4H program would incentivize servicers, based on investor approvals, to refinance a significantly higher volume of loans into the H4H program. This new LTV requirement would still require loan holders to make significant principal reductions and provide some limited equity in the new FHA mortgage for borrowers formerly owing more on their mortgage than their home's value.

The second impediment for servicer implementation of the program is the legal combination of an FHA-insured loan made by the lender to the borrower and two separate transactions between the borrower and HUD providing for a sharing of equity and appreciation on the sale or the property or refinancing of the loan. The federal and state consumer credit laws that apply to creditors would not at first glance seem to apply to these two separate transactions with HUD since HUD is not a creditor. Yet the fact that the two separate transactions are required to be consummated by the borrower to be eligible for the FHA-insured loan creates material uncertainty that a court would treat all three as a single integrated transaction.

These legal arrangements create two significant difficulties for lenders. First, it is not clear how the combined transactions are to be treated under federal and state consumer credit laws, leaving the lender at risk that it will be subject to consumer and government claims for incorrect characterizations. Second, HUD obligates the lender to represent and warrant that the loan documents drafted by HUD comply with all state laws—a representation and warranty that is impossible to give in good faith given the material uncertainty of how the three transactions are treated under state laws, including those that outright ban shared appreciation mortgages.

To further facilitate the use of H4H, we believe the federal government should definitively clarify that (a) the insured loan between the borrower and the lender should be treated separately and apart from the shared equity and shared appreciation transactions between the borrower and HUD, (b) federal and state consumer credit laws do not apply to the two separate transactions because the originating creditor is not the payee or beneficiary under the documents and HUD is not a creditor and (c) federal law would control the characterization of the transaction through express federal preemption.

Finally, the governing Board of H4H should consider liberalization of the DTI requirements under the H4H program to better reflect the reality of the financial obligation ratios currently owed by the average American family the H4H program was designed to assist.

2. Troubled Assets Relief Program (TARP)

- **Federal Guaranty of Loan Modification Redefault Risk**

In addition to refinancing opportunities, the EESA also allows the federal government to use guarantees to incentivize additional loan modifications for distressed borrowers. In particular, the Act specifically authorizes that "the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures."[13] We believe there have been some positive proposals put forth by, for example, the Chairman of the FDIC that would have the federal government, through TARP, provide credit guarantees for redefaults on modified loans. Although there are a number of details that would need to be worked out on both the modification protocols as well as the guarantee arrangements, ASF believes there is significant opportunity for such an approach to work. A well-tailored program could result in a significant increase in loan modification activity to help homeowners stay in their homes and provide significant support for a declining housing market. In sum, there appears to be a substantial opportunity to marry a much larger industry-wide loan modification protocol with a guarantee program under TARP.

One particular benefit of a guarantee program under TARP is that the same outlay of funds through a guarantee program could provide support for a significantly higher number of outstanding loans than can be assisted via other means. Direct purchase of loans, although a

[13] Emergency Economic Stabilization Act, Section 109 (2008).

desirable option to consider requires direct and immediate use of the limited capital available under TARP. A guarantee program may in some cases then be a more efficient use of limited TARP funds.

- **Direct Purchase of Loans Out Of Securitization Trusts**

Since the TARP program was announced, there has been a great deal of discussion regarding what assets the program would purchase and how that ownership would give the federal government control over the servicing of those assets. If whole loans are purchased by TARP, for example, the government would clearly be able to apply its own loss mitigation protocols to those loans. If the TARP program were to buy mortgage-backed securities (MBS) though, their ability to exercise control over the servicing policy of any particular trust would be limited unless a supermajority of each outstanding class of notes of that trust were to vote to amend the underlying pooling and servicing agreements.

One potential opportunity is that TARP could purchase individual distressed loans out of MBS trusts, which could give the Treasury Department unlimited discretion to modify those loans. Historically, whole loans have not been sold out of securitization trusts by servicers for a variety of legal, tax, and accounting constraints. The ASF supports, where feasible, facilitating such purchases as part of a broader range of loss mitigation alternatives, and has recently undertaken a review of the various opportunities and obstacles for servicers to sell below par individual distressed loans out of MBS to the TARP.

- **Provide Lending or Guarantee Facilities for Servicer Advances**

Another area where the federal government, potentially through TARP or through other mechanisms, could provide critical liquidity in the housing market is in the area of servicer advances on MBS. As part of their contracts with investors, servicers often advance their own funds to cover unpaid principal, interest, taxes and insurance as well as for other property protection and related advances. The servicer ultimately receives a first priority reimbursement for these advances when troubled loans payoff or are liquidated. Due to the recent significant increase in delinquencies, the amount of advances that servicers must make to remain in compliance with their servicing obligations under these servicing agreements has risen exponentially. Simultaneously, the number of commercial banks that help servicers finance these advances has shrunk dramatically, thereby radically increasing these funding costs. Servicers unaffiliated with depository banks may soon simply not have the funds to continue to make these advances into the securities, forcing the servicing to transfer to another servicer. These transfers would cause significant disruptions to borrowers making payments or working out loans and ultimately less liquid securities. Federal government provision of lending or guarantee facilities for liquidity constrained servicers at little or no risk to the taxpayer, given the first priority reimbursements, would provide significant assistance to homeowners serviced by nondepositary institutions.

Mortgage and Consumer Credit Availability in the U.S.

There is currently $7.55 trillion dollars of securitized mortgage debt outstanding, which is slightly more than half of the $14.8 trillion dollars of mortgage debt outstanding in the United States.[14] Yet, only $500 million of securitization bonds were issued in October of 2008, which is less than 1% of the $50.7 billion issued in credit-constrained October of 2007.[16] As these figures indicate, private investment capital flows into the U.S. securitization market have all but disappeared, threatening the availability of credit to all current and future mortgage borrowers.

Significant action is being taken by the industry, such as through ASF's Project RESTART, designed to rebuild investor confidence in both the assets and process of securitization. The finance ministers of the largest economies of the world went so far as to articulate as one of their top five global priorities to, "take action, where appropriate, to restart the secondary markets for mortgages and other securitized assets."[17] Voluntary programs that incentivize private actors in securitization, such as servicers and institutional investors, to reduce foreclosures are the only constructive options to help address housing dislocations in a credit- starved environment. To the extent that governmental initiatives can offer loan modification and refinancing opportunities beyond those that are commercially feasible in the private market, those programs may provide an effective bridge to a wider range of troubled borrowers and help to stabilize housing prices and markets.

Conclusion

Chairman Frank and distinguished Members of the Committee, I thank you for the opportunity to participate in this hearing on some of the most pressing issues facing our country today and look forward to answering any questions you may have regarding my testimony.

Thank you.

[14] Statistical Supplement to the Federal Reserve Bulletin, October 2008, Table 1.54 Mortgage Debt Outstanding
[16] Wall Street Journal, Bond Woes Choke Off Some Credit to Consumers, C1, November 6, 2008.
[17] G-7 Finance Ministers and Central Bank Governors Plan of Action, October 10, 2008

Appendix A

LOAN MODIFICATION EXAMPLES

Original Scenario

Borrower and co-borrower earn $35,000 and $32,000, respectively and pay as agreed based on an adjustable rate mortgage.

	Original Economics
Income	$67,000
Home Value	$400,000
Loan Size	$320,000
Mortgage Rate	7.0%
Monthly Payment	$2,129
DTI	38%

Scenario 1 - Job Loss

Co-borrower loses job with limited employment options locally. The monthly housing obligation for the family is now unaffordable.

Job Loss	**New Economics**	**Job Loss - Rate Reduction with Interest Only for 5 yrs**	**Job Loss - Principal Reduction**
Income	$35,000	$35,000	$35,000
Home Value	$400,000	$400,000	$400,000
Loan Size	$320,000	$320,000	**$165,000**
Mortgage Rate	7.0%	4.2%	7.0%
Monthly Payment	$2,129	$1,120	$1,098
DTI	**73%**	38%	38%
Impact		**No Immediate Loss**	**Results in immediate loss of $155,000 or 48%**

Scenario 2 - Rate Reset

The initial interest rate was fixed at 7% for 2 years, providing for an affordable monthly payment. Upon resetting to 95, the loan is now unaffordable based on a 46% housing ratio.

Rate Reset	**New Economics**	**Rate Reset - Rate Reduction w Interest Only Period**	**Rate Reset - Principal Reduction**
Income	$67,000	$67,000	$67,000
Home Value	$400,000	$400,000	$400,000
Loan Size	$320,000	$320,000	**$265,000**
Mortgage Rate	9.0%	8.0%	9%
Monthly Payment	$2,575	$2,133	$2,132
DTI	**46%**	38%	38%
Impact		**No Immediate Loss**	**Results in immediate loss of $55,000 or 17%**