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Statement of

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concerning

Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement

before the

The Committee on Financial Services
United States House of Representatives

December 6, 2007

Office of Thrift Supervision
Department of the Treasury

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I. Introduction

Good morning, Chairman Frank, Ranking Member Bachus, and Members of the Committee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on loan modifications, foreclosure prevention and several amendments considered during House deliberations and passage of H.R. 3915, the Mortgage Reform and Anti-Predatory Lending Act.

In your invitation letter, Mr. Chairman, you ask us to address ways to improve the pace and volume of mortgage loan modifications to help troubled borrowers remain in their homes. In particular, you ask us to address how to accomplish loan modifications on a wholesale basis, the barriers to doing so, and the need for policy changes to facilitate a more broad-based approach to reach more borrowers more rapidly to modify troubled loans.

You also ask us to address the following issues in this testimony:

- The need for more broadly-based loan modifications, steps mortgage servicers and other industry participants should be taking to achieve this goal, and any legislative or regulatory changes that may be needed to facilitate this process.
- The extent to which the threat of lawsuits has become, or is in our view likely to become, a barrier to more widespread modification of troubled loans.
- Who we think could be likely the target of any lawsuits and what would be the likely legal basis for such suits?
- What approaches, including the approach taken in H.R. 4178, is appropriate to address this potential problem?
- Whether, and to what extent, the Frank-Miller-Watt amendment would enhance the capacity provided to the regulators under H.R. 3915 to combat "patterns" of behavior violating its ability-to-repay and tangible net benefit standards for mortgage loans.
- Other measures that should be considered to improve regulatory enforcement of the proposed new rules under H.R. 3915.

In addressing these issues, I will first discuss the current state of the subprime mortgage markets and include context on the overall mortgage and housing markets. Next, I will discuss the issues in structuring a viable loan modification program and the experience, albeit brief, of several lenders' efforts to structure such a program. I will also discuss the views of the OTS on the necessary elements of an effective program and ways that these can be achieved. I will conclude my testimony with observations on the Castle bill, H.R. 4178, the Emergency Mortgage Loan Modification Act, and the Frank-Miller-Watt Pattern or Practice Liability amendment.

Before proceeding, Mr. Chairman, I want to note that many of the issues we are discussing today were debated earlier this week at the OTS National Housing Forum. In addition to remarks from Treasury Secretary Paulson, HUD Secretary Jackson and former FDIC Chairman William Seidman, we had four panels of distinguished speakers from the industry, community organizations, financial firms, media and the government. The entire proceedings of the day's events are available at the OTS website. If you have the opportunity to do so, I encourage you to view it.

II. Current State of the Subprime Mortgage Loan Market

Based on recent data, total outstanding mortgage loans in the U.S. are approximately \$10.4 trillion. Of this total, subprime loans account for \$1.2 trillion, or 11.5 percent of the U.S. mortgage market. Subprime 2/28 and 3/27 mortgage loans account for a total of \$496 billion, or roughly 4.8 percent of aggregate outstanding U.S. mortgage debt and 41 percent of outstanding subprime mortgage loans.

In 2005, subprime originations were approximately \$625 billion, representing roughly 20 percent of the \$3 trillion mortgage origination market that year. In 2006, subprime loans of \$600 billion again accounted for approximately 20 percent of originations of \$3 trillion. These two years accounted for the majority of subprime 2/28 and 3/27 loans currently outstanding. The vast majority of these subprime mortgages were 2/28 or 3/27 loan products. Most of these 2/28 and 3/27 loans were underwritten to pretax debt-to-income ratios of 45 percent and higher. Typically, these borrowers paid initial "starter rates" for their loans that were between 7 percent and 9 percent. Many of these loans are now due to reset upward by as much as 300 basis points. Several additional points regarding subprime 2/28 and 3/27 are worth stating:

- Subprime 2/28 and 3/27 mortgage loans have significantly higher delinquency rates than other subprime loan products.
- Based on recent data, 24 percent of subprime 2/28 and 3/27 mortgage loans were more than 90 days past due, compared to a 19 percent 90-day past due rate for all subprime loans.

- 30 percent of all subprime 2/28 and 3/27 loans experience delinquency prior to a rate reset.
- More than 27 percent of subprime 2/28 and 3/27 loans made in connection with a home purchase with no money down become delinquent.
- 41 percent of subprime borrowers that experience a rate reset become delinquent.

Clearly, these are troubling numbers. Of particular relevance to the current discussion is the fact that while a rate reset can be a significant event triggering delinquency, many subprime 2/28 and 3/27 loans experience delinquency (although many are cured) even before a rate reset. A loan modification that extends the starter rate will not help borrowers who ultimately will be unable to pay under their current starter rate. Generally, an effective loan modification program will focus on reaching borrowers who make it to their rate reset relatively free of serious past payment problems.

The other useful data that we have from the subprime market is that, as referenced previously, hybrid ARMS are the predominant mortgage product. In fact, 2/28 and 3/27 hybrid ARMs are almost exclusively underwritten to the subprime market. Currently available data indicate that 43 percent of outstanding 2/28 and 3/27 hybrid ARMs were purchase money loans (with 25 percent to first time buyers); 49 percent of these ARMs were cash out refinances; and 8 percent were no-cash out refinances. This split of purchase money and cash out loans underscores a critical fact about the subprime market given the depreciation in housing values that has occurred in many areas of the country – many subprime borrowers now have little, if any, equity in their homes in today's market. This is a significant factor, and perhaps the paramount challenge, in structuring loan modifications that are meaningful to the borrower as well as prudential to the lender.

III. Structuring a Viable Loan Modification Program

As highlighted in the Committee's invitation letter, one of the most important considerations in structuring a viable loan modification program is reaching as many borrowers as possible as quickly as possible. In our view, this translates into conducting an expeditious and systematic review of outstanding loans approaching reset – or for which a rate reset has already occurred – in order to identify broad categories of borrowers eligible for loan modifications. As simple as this concept sounds, in application it has many challenges. I believe it is critical in this effort to provide servicers with as much guidance and flexibility as practicable to conduct meaningful reviews to identify borrowers in need of assistance.

In structuring a viable loan modification program, three goals should be recognized and incorporated. First, and most fundamental, the program should preserve and sustain homeownership. Second, of course, the program should protect homeowners from avoidable foreclosures due to interest rate resets. Finally, it is extremely important that the program be structured to preserve and maintain market integrity, as well as ensuring the continued safety and soundness of depository institutions and the broader financial services industry.

Currently, about two million American families have subprime 2/28 and 3/27 mortgages that are scheduled to reset by the end of 2008. As I mentioned earlier, the initial "starter rate" for these loans typically ranged from 7 percent to 9 percent; and about 30 percent of delinquent 2/28 and 3/27 loans were past due before the rate reset. Between 1980 and 2000, the national foreclosure rate was below 0.5 percent of aggregate mortgage loans. In fact, as recently as 2005, the national foreclosure rate stood at 0.38 percent. Since then, the foreclosure rate has risen 55 percent to almost 0.6 percent of outstanding mortgage loans. Far more troubling is that, among subprime borrowers holding a 2/28 or 3/27 loan product, foreclosures are projected to rise from about 6 percent currently to about 10 percent by 2009.

There are several important factors in structuring a viable loan modification program that can influence these projections downward. First, as I note at the outset, expediency is critical. Servicers should quickly review their loan portfolios to identify characteristics of groups of borrowers eligible for loan modifications. Eligibility standards will determine the likelihood of achieving meaningful impact under a loan modification program. Generally, borrowers should qualify if, due to rate resets, they are either in default, or there is a reasonable foreseeability of default.

A program's success will also hinge on providing adequate time for troubled borrowers to work out of their current economic problems. We believe servicers should be prepared to extend the starter rate for a minimum of 36 months, but a good argument can be made for a minimum of five years. And it may also make sense to include a trial period, such as six months, for certain borrowers to be able to demonstrate that they can continue to pay under the starter rate before the starter rate is locked in under a loan modification. Generally, a trial period will serve to protect the interests of the lenders, avoid including in a modification program loans that are destined to fail, and provide resolution to borrowers rather than delaying the inevitable for an additional 36 months or longer.

We are aware of a number of loan modification programs that have already been established. While these programs have been in place for generally short periods of time, i.e., several months, it is our understanding that strategies similar to those articulated above have been successfully deployed to modify significant numbers and dollar amounts of subprime 2/28 and 3/27 loans held in securitizations. For example, several programs have employed broad-based borrower identification criteria to identify groups or classes of loans at risk, and then applied established eligibility requirements to hone in on individual loans and borrowers at risk of default. Other programs have opted for more comprehensive fixes by identifying borrowers and re-underwriting with full documentation for a 30 year term. We are supportive of all of these programs and efforts to address the problem and encourage that any standards or guidelines provide maximum flexibility to servicers and lenders to address troubled subprime loans in a manner that protects both the borrowers and the underlying economic interests of investors.

It is also critical in exploring viable solutions that our actions preserve the integrity of the broader mortgage markets, including capital market participation in the continued funding of the mortgage markets. While there have been some who have suggested that solutions from the capital markets have fueled speculative and unsafe mortgage lending activities, there remain many U.S. consumers who are homeowners solely because of favorable mortgage rates and terms that they received as a result of the efficiency of the U.S. capital markets. In other words, we must take great care that our efforts on behalf of some consumers who entered into bad deals do not compromise the greater, collective interests of all consumers. It would be a policy failure to produce a result that alters mortgage funding so that the future cost or availability of mortgage credit is adversely affected for all U.S. consumers.

We are currently at what can best be described as a crossroads to addressing the wave of rate resets for subprime 2/28 and 3/27 mortgage loans. There are a number of programs that have been reasonably successful in structuring viable loan modification approaches, but more needs to be done – and soon.

As recently reported, there have been significant industry efforts to identify practices and approaches to structure guidelines for viable loan modification programs that can be implemented quickly, efficiently and effectively in the marketplace. Our understanding is that many of the issues previously identified as significant obstacles to broad-scale loan modifications may, in fact, be issues that can be addressed within the terms of the pooling and servicing agreements that dictate the rights of servicers and impact on investors under terms of the trusts that hold the securitized assets. Given this, we believe that legislative and/or regulatory actions could hinder rather than help at this point in the process. Instead, we encourage the industry to identify and implement solutions that work, with the full understanding that regulatory intervention will occur quickly if it becomes clear that any proposed solution(s) will not be effective.

IV. The Emergency Mortgage Loan Modification Act – H.R.4178

H.R. 4178, the Emergency Mortgage Loan Modification Act, would provide a safe harbor from liability for creditors, assignees, servicers, securitizers and other holders of residential mortgage loans in connection with loan modifications they conduct during the six month period after enactment of the legislation. Based on our review of the bill, it is intended to cover troubled debt restructurings of residential mortgage loans (other than prime loans and other qualified mortgages under H.R. 3915) in or facing default. In addition, in order to be protected under the bill, it provides that a workout would have to maximize the net present value of the loan in the pooling and servicing agreement under which it is held.

While we understand and appreciate the intent of this legislation, there are several issues that should be considered in connection with any action on the bill by the Committee. First, it is unclear whether the intent of the bill is to override pooling and servicing agreement contract terms. If so, then the bill raises potentially larger issues that would have to be carefully considered and would likely be challenged in court. It has also been suggested that many servicers already have adequate flexibility to address issues covered by the bill. In the end, the costs and benefits of H.R. 4178 come down to three points. Will it be effective in helping securitizers keep borrowers in their homes? Will it unduly interfere with or override contract rights? And will it do anything to keep future investors from continuing to fund the housing market?

In addition to a big picture cost-benefit analysis, the bill raises a number of issues. First, it does not distinguish between rate reset delinquencies and those where other issues were a problem. Borrowers in default for other than a rate reset appear to be covered by the terms of the legislation. Similarly, the bill lacks sufficient criteria for narrowly focusing coverage on loan modifications for borrowers who are current in their payments (or in default only due to a rate reset). We urge the Committee to explore the necessity and utility of these broad and comprehensive approaches within the bill. More narrowly focusing the scope and coverage of loans covered by a litigation safe harbor would enable servicers to dedicate their resources to the class of borrowers and loans that most agree deserve attention – mortgages securing owner-occupied properties at risk due to a rate reset (or already in default due to a rate reset).

We also question whether the bill could create liability against a servicer that opts not to engage in loan modifications. And, conversely, whether the bill could permit securitizers and others to "game the system" by conducting loan modifications that are not in good faith or the best interests of the borrower simply to inoculate themselves from litigation.

Finally, the bill does not extend the safe harbor protection to loan modifications that occurred before its effective date. This disadvantages those who acted first to implement loan modifications – arguably the class of servicers most deserving of protection from a policy standpoint because of their proactive and aggressive efforts to address the problem in the first place. In a similar vein, if a safe harbor approach is implemented, the Committee may wish to consider extending the safe harbor beyond six months since significant loan modification activity may extend beyond a six month window.

In sum, there are numerous unanswered questions regarding the extent of litigation that may result from large-scale loan modifications. It is unclear, however, whether legislation such as H.R. 4178 will be able to alter such actions, particularly if the terms of existing pooling and servicing agreements clearly spell out the terms that bind the parties to the agreement. To the extent that H.R. 4178 may be beneficial in areas where either the terms of the agreement are silent or unclear, we believe that the parameters of the bill should be altered to focus on mortgages secured by owner-occupied properties at risk from a rate reset (or in default due to a rate reset). And the Committee should consider extending coverage to loan modifications occurring before the effective date of the legislation if enacted, and perhaps longer than six months after enactment.

V. The Miller-Watt-Frank Amendment

The Miller-Watt-Frank amendment would impose a civil penalty of $1 million and not less than $25,000 per loan on a creditor, assignee, or securitizer for engaging in a pattern or practice of originating, assigning, or securitizing residential mortgage loans that violate the duties of care established under H.R. 3915. These duties of care include assuring the ability to repay requirement for certain mortgage loans under H.R. 3915 and the net tangible benefit requirements for certain mortgage loan refinancings under the bill.

As structured, the amendment would impose a strict liability penalty for engaging in a pattern or practice as described above. The penalty would not be discretionary and would be in addition to any enforcement action or penalty that an agency may impose. Penalties paid under the amendment would be deposited in a trust fund (administered by the Treasury Department) for consumers who hold loans eligible for rescission or cure due to violation of a duty of care, but have no party against whom to assert such remedies.

The bill further provides that any person with information regarding a pattern or practice violation could report it to a TILA enforcement agency. That agency would then bring the complaint to the attention of any other TILA enforcement agency with jurisdiction over the violation.

The amendment would require the Treasury Department to issue regulations to establish a consumer claims process, administrative procedures for handling claims, and a payment process for consumers eligible for relief. The amendment also provides that any claim determination made by the Treasury Department under these provisions will be final, and not subject to judicial review.

Based on our review of the proposed amendment, there is uncertainty regarding the scope and application of the proposed amendment. Coupled with its strict liability requirement, the amendment could have a significant impact on mortgage lending to certain market sectors. We urge the Committee to explore this issue. In particular, we note the following:

- The federal banking agencies already have authority, which includes a significantly lower threshold than the "pattern or practice" standard, to pursue actions against an insured depository institution and its subsidiaries, holding company parents, affiliates and service providers. As such, we urge the Committee to consider an approach excluding insured depository institutions entirely from coverage under the amendment. Insured institutions are currently subject to extensive prudential supervision, regulation and oversight by the federal banking agencies. The banking agencies have pursued actions against lenders (including their subsidiaries, affiliates, holding companies and service providers) subject to their jurisdiction for programmatic lending violations on a wide range of issues and matters, including predatory lending activities.

- A mandatory monetary penalty not only removes regulatory discretion raising policy concerns, it eliminates discretion for a court or agency to alter a civil penalty for a violation or the amount of the civil penalty. Federal banking agency discretion is important to address programmatic lending violations and impose penalties and remedies tailored to the nature and extent of a violation. Administrative discretion is also necessary for reasons of safety and soundness, particularly since the amount of the penalty is so high. The provision holds a creditor, assignee, or securitizer strictly liable for the full civil penalty in any pattern or practice case without regard to the circumstances or financial impact. TILA currently permits even statutorily mandated remedies to take into account the circumstances of the violation and potential impact of the remedy.

- An open-ended pattern or practice standard could infuse significant uncertainty into the mortgage markets, particularly given the strict liability penalties under the amendment. For example, "pattern of practice" could be more clearly defined to cover only willful and blatant violations. In addition, the bill could delegate authority to define a "pattern of practice" by joint regulation to the federal banking agencies and the other TILA enforcement agencies. This would permit the agencies to set clear standards on what would or would not constitute a "pattern or practice."

- It is unclear if a private right of action is intended under the amendment. While it may make sense from a policy standpoint to impose a strict liability standard and penalty on unregulated originators, creditors, assignees and securitizers, if a private right of action is intended, it may make it more difficult for the federal banking agencies to pursue actions against insured depository institutions since agency actions could lay the groundwork for private actions.

- Similarly, a statutory provision barring judicial review of a claim determined by the Treasury Department may raise a significant issue of law. We defer to the Committee with respect to the merits of a statutory provision barring judicial review of a final agency action.

For all of these reasons, we encourage the Committee to explore a carve-out from coverage of the amendment to insured depository institutions.

VII. Conclusion

The OTS shares the concerns of the Committee regarding the expediency of structuring and implementing programs that produce viable loan modifications. Foreclosure prevention is a critical issue that requires our attention, efforts and actions. However, we must ensure that our actions are appropriately tailored to assist those legitimately in need of assistance. There are four categories of subprime borrowers: (1) those who can afford the interest rate in their mortgage loan; (2) those who cannot afford to pay even at the starter rate on their loan; (3) those who can refinance their mortgage; and (4) those with steady incomes and relatively clean payment histories who can afford to continue to pay at their starter rate, but not the reset rate.

The bulk of our efforts should be directed at the latter two categories of subprime borrowers. This is where we can make a difference to preserve and sustain homeownership, and protect existing homeowners from avoidable foreclosures due to interest rate resets. Again, the focus of all of these efforts should be on keeping existing homeowners (i.e., owner-occupiers) in their homes, not assisting speculative buyers who are now at risk of foreclosure.

Thank you, Mr. Chairman, Ranking Member Bachus, and Members of the Committee for the opportunity to present the views of the OTS on these issues. We look forward to working with the Committee to structure and implement standards or guidelines supporting viable loan modifications.

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