Speeches & Testimony

American Securitization Forum (ASF) Annual Meeting
Remarks of FDIC Chairman Sheila C. Bair
June 6, 2007

I would like to acknowledge up front the leadership of the American Securitization Forum in working with us to address some of the problems in the subprime market. I thank you for stepping up to the plate – especially your Chairman, Greg Medcraft, and your Executive Director, George Miller. It hasn't been easy for any of us. This is a very complicated market. There's a lot of money at stake, and millions of people whose homes are on the line.

But I think we're making good progress in developing solutions that promote a stable secondary market, and that benefit most market participants and borrowers. The immediate task is to sustain homeownership by ensuring that servicers have the flexibility they need to make prudent loan modifications, if it is reasonably foreseeable that a loan may default. The next thing we need to do is to come up with **national standards** for all subprime lenders.

Strong underwriting standards will bring stability to this market going forward. It will help keep families in their homes and help others buy homes in the years ahead. The market also needs to know when and how troubled loans are modified. Transparency promotes market stability.

Subprime mortgages have benefited Wall Street, and boosted homeownership across the country. The trick now is getting all the actors working together -- from Main Street to Wall Street to Washington -- to get this market on track as an engine for sustainable homeownership.

Positive Benefits

With little doubt, mortgage securitization has been a net positive for many middle- and lower-income communities, as well as the broader economy. Homeownership is at record levels. And lenders have an effective tool for managing and diversifying risk. The liquidity provided by private label mortgage-backed securities (MBS) has been a significant factor in the growth of nontraditional and subprime mortgage lending.

Let me give you a couple of numbers:

- The share of U.S. mortgage debt held in private label securities doubled between 2003 and 2006, from 9 percent to 18 percent.

This increased liquidity allowed lenders to make these mortgages more widely available.

- As a **share** of all mortgage loan originations, subprime loans more than doubled from 8 percent in 2003 to 20 percent in 2005.

Problems

While this market-driven process has evolved in remarkable ways over the years, the process is now clearly under stress. Significant changes in the subprime mortgage market in recent years have

substantially complicated the relationship between borrowers and lenders. Mortgages have become commodities, involving multiple players. As a result, it may be easier to get credit but it's much harder to resolve troubled loans. When the market turns as we've seen in recent months, workout strategies for troubled loans in securitized structures are much tougher to put together.

Further complicating the situation is the fact that the investors may see their interests differently, with each other, or with the borrower. As all of you know, the problems in this market are a major concern for the FDIC. In March, the FDIC and other federal bank regulators jointly proposed new guidelines for underwriting and marketing subprime mortgages. We've received over 100 public comments on the guidelines. And we hope to finalize them later this month.

Protecting Current Borrowers

These proposed rules are designed to assure strong underwriting and consumer protection for subprime mortgage lending by banks. I am hopeful that Congress or the Fed will act to impose comparable requirements on nonbank lenders to prevent future abusive lending practices. There remains the urgent issue of how to address an estimated 2 million loans that will reset over the next 18 months. Almost three-quarters of securitized subprime mortgages originated in 2004 and 2005 were "2/28 and 3/27" hybrid loan structures. These loans have lower payments during the first two to three years but then reset to higher interest rates that impose payment "shocks" of 30 percent or higher. Those are huge increases. Most subprime borrowers will be unable to make the payments on these loans after they "reset."

Further compounding this problem is that fewer and fewer of these borrowers are able to refinance because of the slowing rate of housing appreciation, and the financial difficulties facing subprime lenders. Many borrowers could avoid foreclosure if they were offered alternatives that allow for affordable mortgage payments. Restructuring their loans would bring them back to good standing, allow them to repair their credit histories and dampen the impact that foreclosures have on the broader housing market. Most important, people would be able to stay in their homes.

In April, I testified before Congress on the subprime market and the difficulties that exist in developing practical solutions for troubled borrowers whose loans are in securitization structures. The FDIC, along with the other federal regulators and industry, including your own George Miller, have been talking regularly about how to deal with this problem, most recently last week in Washington. We have focused mainly on how market participants could help resolve the difficulties in modifying the mortgages that are locked into securitized pools. Our goal is to facilitate an exchange of ideas and industry-led consensus on ways to help struggling borrowers avoid foreclosure, while maintaining the integrity of the secondary market.

One of the clear messages we heard is that loan modifications that provide sustainable mortgages for borrowers are generally the best option for investors and borrowers. Foreclosure rarely is. Sustainable mortgages help give the markets stability both for current borrowers and investors, and for those in the future as well. This is an issue I hope we address squarely and not just end up kicking the can down the road.

Another important message from the industry, not surprisingly, is that more and better information is needed. As loans are modified, investors need to know. They need to see the details. This ties in very closely to our goal of sustainable mortgages. If a loan modification puts a borrower into a loan that he or she can afford, and the details about that modification are disclosed, we believe this will create additional market pressure for sustainable loan restructuring. Sustainable loan modifications avoid ongoing financial distress for borrowers, help keep them in their homes, ease demands on servicer resources and help assure stable income flows for investors. This, too, will give greater stability to the market.

ASF Principles

The ASF has taken a real leadership role in trying to resolve these issues. I commend the ASF and the membership for developing principles and guidelines for modifying subprime loans. Those principles

recognize and support many of the key conclusions reached in our discussions with the industry. These include:

- The importance of loan modifications as a loss mitigation tool;
- The importance of establishing early contact with borrowers and taking action prior to default where it is reasonably foreseeable;
- The need for modifications that provide sustainable and long-term solutions;
- The need for amendments to existing securitization agreements that prohibit or restrict servicer flexibility; and
- The need to establish greater clarity and consistency in investor reporting and the treatment of modified loans for purposes of "triggers" that control the release of excess cash flow.

I also want to highlight the principle that specifically encourages servicers to conduct modifications that are in the best interest of the borrower. This principle alone should ensure that the borrower's needs are not subordinate to the interests of everyone else. Finally, I fully support the ASF's commitment to develop standard, uniform model contractual provisions governing a loan servicer's ability to make loan modifications in **future** securitizations.

I appreciate that ASF has a number of interests to balance. However, I do wish to emphasize my strong belief that modifications should be for the long term. This is an absolute necessity if we are to stabilize neighborhoods and preserve the homeownership gains of recent years.

So, where do we go from here? The next big step is finalizing our regulatory guidance. As I said, we hope to get these rules out in June. Our new rules focus 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.

We say subprime loans should be qualified and underwritten based on the borrower's ability to meet fully-indexed and amortizing terms. In my view, this is simple common sense. I don't think any of us would advise our kids to take out a loan they can't repay. But to make good choices, borrowers need clear, easy-to-understand information.

The proposed guidance provides that mortgage product descriptions and ads should provide clear, detailed information about all costs and features, including payment shock. All the regulators, both federal and state, feel very strongly that clear, common sense underwriting and marketing standards for subprime mortgages are extremely important. So, I believe our current draft will remain largely intact. Without strong rules we can't protect consumers. Nor can we reinforce the market discipline that preserves a steady flow of capital for responsible lending.

Looking to the future, I believe that the ultimate solution is a national standard for subprime mortgages regardless of who does the underwriting. There are two core elements for developing a national standard: One, underwriting standards that truly measure the ability to repay. And two, marketing standards that require upfront, complete, and clear cost disclosures for adjustable rate and non-traditional loans and prohibit deceptive advertising based on teaser rates or misuse of the word "fixed."

A national standard should deal with abusive prepayment penalties and the use of "stated income" loans, issues that are also addressed in our proposed guidance. One way is for the Federal Reserve to use its powers under the Home Ownership and Equity Protection Act (HOEPA). New HOEPA rules could strengthen protections for subprime borrowers. And they would apply to bank and non-bank lenders alike. An additional advantage would be a clearer standard for secondary market liability by allowing it only if the loan was abusive on the face of the loan documents. This feature could provide necessary comfort to the market, while protecting against truly egregious lending. Members of the Senate Banking Committee have urged the Fed to use this authority. The Fed will hold a public hearing next week on HOEPA. The FDIC supports the Fed's efforts and would welcome new rules against abusive subprime or predatory lending practices.

Investors and Good Citizenship

I'd like to end by pointing to the obvious. We're all in this together. All of us bear some responsibility for the turmoil in the subprime market. And all of us need to be a part of the solution. And let's be honest about it. Hybrid ARMs were never made based on the assumption that the borrowers would be able to make the payment once the loan reset. They were designed as two- or three-year "bullets," with the assumption that home appreciation would allow the borrower to refinance at or before reset. Given current conditions in the housing market, this business model is no longer viable. But market participants should not now claim to be shocked that borrowers are in distress.

Let me be clear, regulators support subprime mortgage lending. Securitization has injected tremendous liquidity and strengthened the American marketplace. But products such as the 2/28 and 3/27 hybrid ARMs create such a huge payment shock at reset that they cannot be sustained through normal economic cycles. I am hopeful that more secondary market funding can be directed at traditional 30-year fixed-rate loans. These loans are steady and predictable, yet still provide a healthy return. They do not put subprime borrowers in the position of having to gamble on home price appreciation or the direction of interest rates. I think the more subprime borrowers we can put into fixed-rate loans the better off everyone will be. As I told Congress, there is no silver bullet. This problem will take time to work out. But our talks with the industry, the ASF Principles, and reviews of the accounting and REMIC rules are all steps in the right direction.

I would ask that you work with us to support national standards for responsibly underwritten subprime mortgages. I would ask that in making your own investing decisions; you seek out securities backed by responsibly underwritten mortgages. I believe this is in everybody's best interest -- lenders, investors and homebuyers. And it is in the national interest because it will go a long way to preserving the American dream of owning a home.

Thank you very much.

Back Send to Printer

Real estate settlement services take bite out of borrowers
By Jack Guttentag

(This is Part 1 of a four-part series.)

"The impression I get from reading your articles is that our mortgage system doesn't work well for borrowers...Isn't there any way to fix it?"

In some respects, the United States housing finance system is the best in the world. In other respects, it is unworthy of a banana republic.

Our housing finance system has a primary market and a secondary market. The primary market is the market the borrower sees, where loans are executed. The secondary market is where the loans originated in the primary market are sold to investors, the ultimate source of funds.

Our secondary market is the envy of the world. Investors acquire mortgage-backed securities at the smallest possible margins over U.S. government securities. However, much of the benefit stemming from our efficient secondary market is eaten away by excessive costs in the primary market.

The first three articles in this series focus on excessive charges paid by borrowers to third-party settlement service providers, lenders and brokers. The fourth article is directed toward making it easier for borrowers to shop effectively.

Why third-party settlement service charges are too high:

Third parties involved in the lending process include title insurance companies, mortgage insurance companies, appraisers, credit-reporting agencies, flood insurance companies and escrow companies. Their costs are generally higher than they would be if they were purchased in a normally competitive market.

The reason is that third-party service providers compete not for the favor of borrowers, who pay their fees, but for the favor of the lenders who select them. This type of competition is perverse because it drives up the costs of the service providers. This in turn raises prices to borrowers or prevents prices from falling in response to improvements in technology.

For example, borrowers pay for private mortgage insurance, but the insurance company (PMI) is selected by the lender. Lenders use their referral power primarily to benefit themselves. The process is much the same in the markets for other third-party services.

The direct payment of referral fees has long been illegal under the Real Estate Settlements and Procedures Act (RESPA). However, RESPA is ineffective because it does not eliminate referral power, which is the crux of the problem. Small players often ignore the rule because HUD, which is responsible for enforcement, cannot possibly police all the ways in which one party can transfer something of value to another.

Large lenders circumvent RESPA through circuitous but legal devices, such as reinsurance affiliates that share the insurance premiums paid by borrowers. The process of legalizing referral fees increases the costs that borrowers ultimately pay. So long as referral power is allowed to persist, the cost to borrowers might be lower if referral fees were paid openly in cash.

Why do borrowers pay for services required by lenders?

We have lived with this practice for so long that it seems the natural state of affairs, but in fact, there is nothing natural about it. If automobiles had to be shopped in the same way as mortgages, the shopper might only receive the chassis from the dealer, purchasing tires, electrical system and painting from third parties. Can there be any doubt what would happen to the price of these components if, instead of purchasing them as a package, they had to be purchased separately from vendors selected by the dealer?

The unbundled package of mortgage services is a historical relic of usury laws limiting the interest rates lenders could charge. When lenders could not raise interest rates to cover their costs, it seemed reasonable to lawmakers to allow them to pass costs through to borrowers. They didn't realize that this was a sure-fire recipe for referral abuse. When the abuses became too obvious to ignore, they responded with RESPA, which made referral fees illegal but left referral power unchanged. RESPA is essentially a make-work project for lawyers.

The remedy is to eliminate referral power:

This could be done by the enactment of one legal rule that is as simple as it is obvious: any third-party service required by lenders must be paid for by lenders.

If lenders paid the charges, they would be included in the rate, of course, but would cost borrowers far less than now. Competition by third-party providers to sell lenders would force the prices down, and rate competition by lenders would force them to pass the savings on to borrowers. Indeed, if lenders had to pay for all these services, they would discover that some that they had found essential when borrowers had to pay were not really necessary after all.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at www.mtgprofessor.com.

Copyright 2005 Jack Guttentag

Back Top Send to Printer

Back Send to Printer

Eliminating mortgage lender fee surprises
By Jack Guttentag

(This is Part 2 of a four-part series. See Part 1: Real estate settlement services take bite out of borrowers.)

The first article in this series indicated that third-party settlement services are overpriced because borrowers paid for them but lenders selected the service provider. Lenders generally use their referral power to benefit themselves rather than to drive down prices to borrowers. The remedy is to eliminate referral power through the adoption of a simple rule: Any third-party service required by lenders must be paid for by lenders.

This article is directed toward lender fees, sometimes referred to as junk fees. These are fees charged by lenders to cover specific lender costs. They are defined in dollars, as opposed to points, which are defined as a percent of the loan. Where points are one number, junk fees can be a whole bunch of numbers, each covering a specific charge.

The problem is that some retail lenders increase these fees after it is too late for the borrower to back out. Often, the borrower finds out about it at the closing table. It happens because of borrower inattention, industry locking practices, and terrible disclosure rules.

Borrower inattention: Borrowers are usually only dimly aware of lender fees. When they shop, their focus is mainly on interest rate and points, which are all that appear in media ads. The borrower's first exposure to lender fees is likely to be when they receive a Good Faith Estimate of Settlement (GFE), but this typically doesn't happen until after an application has been submitted. At that point, the borrower will be at least partially committed.

Industry locking practice: The mortgage market is highly volatile, with prices changing from day to day and sometimes within the day. Hence, rate/point quotes are not binding until the lender locks them. Lender fees, in contrast, are not volatile, and therefore the practice is not to include them in locks. The presumption is that at closing, they will be exactly what they were when the borrower received the GFE, and with honest lenders, they will be. But with dishonest lenders, the practice of excluding fees from the lock provides an opportunity to cheat.

The Good Faith Estimate: The GFE makes it all too easy for the cheaters. Lenders are not bound by any of the numbers on the GFE, which are "estimates." This is ridiculous, since lenders know their own charges. In addition, the GFE confuses borrowers by showing each individual lender fee but no total, when the total is all that really matters. If the GFE were deliberately designed to take the borrower's eye off the ball, it couldn't have been done better.

Mortgage brokers provide protection: Excessive junk fees generally are not a problem on loans that go through mortgage brokers. Brokers know the fees charged by all the lenders with whom they do business, and they would not accept fee surprises at the closing table that put no money in the broker's pocket. Broker fees are another matter, to be discussed in article 3 of this series.

Home purchases are most vulnerable: Excessive junk fees are more likely to arise on a home purchase transaction than on a refinance. On a home purchase, a buyer cannot walk away from the mortgage without walking away from the house. On a refinance, in contrast, a borrower can usually begin anew at any point without much loss.

Eliminating junk-fee escalation: In article 4 of this series, I propose a mandatory fixed-dollar fee on all mortgage transactions. The fee would cover all lender and third-party charges. Among other

benefits, this would eliminate fee escalation at the closing table. Fee escalation could also be eliminated by a rule stipulating that when lenders lock the rate and points, they also lock their fees.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at www.mtgprofessor.com.

Copyright 2005 Jack Guttentag

Back Send to Printer

Mortgage brokers struggle with consumer distrust
By Jack Guttentag

(This is Part 3 of a four-part series.)

The first two articles in this series dealt with overcharges by third-party settlement service providers, and lender fee escalation at the closing table. This one is about high mortgage broker fees.

Role of Mortgage Brokers: Because brokers deal with multiple lenders, they play a critical role in helping a borrower find a lender who offers a particular type of loan program. When the needed loan is one offered by many lenders, brokers are able to shop among them to find the lowest price. That's the good news.

Excessive Fees: The bad news is that broker charges per transaction are generally excessive. In part, this is due to low productivity. Brokers spend a lot of time looking for clients, and they also spend a lot of time with potential clients who don't close and waste their time. Low productivity generates pressure to earn more on the deals that do close.

Brokers are able to charge a lot per transaction because borrowers usually don't know at the outset how much the broker will make. If they find out, usually the deal is too far advanced to do anything about it.

Only the loosest relationship exists, furthermore, between broker charges and the amount of work the broker does for the borrower. The general rule is that brokers charge what the market will bear. Unsophisticated borrowers who visit a single broker will generally pay more than knowledgeable borrowers who shop alternative sources.

The Independent Contractor Model of the Industry: The dominant ideology of mortgage brokerage, as promulgated by the National Association of Mortgage Brokers and the various state associations, is that brokers are independent contractors. They view themselves as merchants who buy at one price and sell at another price, and how much they make on a transaction is no one's business but their own. The independent contractor model supports the view that brokers are entitled to make as much per transaction as they can.

The Independent Contractor Model Generates Distrust, Which Increases Costs: Distrust runs like a red line through the hundreds of letters I receive every month from borrowers relating experiences with brokers. And distrust translates into higher costs.

Brokers detest borrowers who flit from one broker to another, submit applications through multiple brokers, or pump them for information and then deal elsewhere. Yet these practices arise from attempts by borrowers to protect themselves against brokers they don't trust. Borrower reactions to distrust raise broker costs, which pressures brokers to make more per transaction, which generates more distrust in a vicious circle.

Other Fallacies of the Independent Contractor Model: The fact is that brokers are service providers, not merchants; they do not buy and resell anything. Furthermore, shopping mortgages is so difficult that few borrowers can do it effectively. Brokers are the experts at shopping mortgages, not borrowers. The optimal arrangement for most borrowers, therefore, is to purchase the shopping expertise of brokers for a fixed fee. Fortunately, it is now possible to do this.

The Agency Approach of Upfront Mortgage Brokers: Upfront Mortgage Brokers (UMBs) operate according to a different set of rules than the remainder of the industry. UMBs view themselves as the

agent of the borrower, to whom they owe a fiduciary responsibility. A UMB agrees with the borrower on total broker compensation from the transaction, and passes through the best price from the broker's lenders.

The advantage of the UMB approach is that it breeds confidence, which lowers costs and increases productivity. I know UMBs who charge half the industry average per transaction but close 3-4 times as many loans. Their secret is a continuous stream of referrals from previous clients - and from me. They are listed on my Web site.

Implementation of the Agency Approach: The way to break the circle of distrust is to change the operating model, from independent contractor to agency. The broker trade associations will never do this, because they cater to the lowest common denominator of member opinion.

Government should but probably won't mandate the agency approach because it would be opposed not only by the broker associations, but also by the wholesale lenders, who are as short-sighted as the brokers. They support the independent contractor model in order to limit their own liability for broker misdeeds. The agency approach will have to win the battle in the marketplace, which it will, slowly but surely. When this was written, there were 113 UMBs, many with multiple loan officers.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at www.mtgprofessor.com.

Copyright 2005 Jack Guttentag

Back Top Send to Printer

Back Send to Printer

Cost consolidation improves real estate loan shopping
By Jack Guttentag

(This is Part 4 of a four-part series.)

The three previous articles in this series advanced proposals for reducing the cost of settlement services provided by third parties, eliminating the escalation of lender junk fees at the closing table, and making mortgage broker compensation transparent to borrowers. This one is about making it possible for borrowers to shop effectively. Shopping is extremely difficult now because mortgages have so many price dimensions.

Even if lenders paid for all the services provided by third parties, which I proposed in the first article, a borrower would have three prices to juggle: interest rate, points, and fixed-dollar fee. (On ARMs, there are more, but I'll ignore that for now). This is confusing and makes shopping difficult. The solution is to mandate one fixed-dollar fee covering lender and third-party costs.

Mandating a Fixed Fee: If government mandated the same fixed-dollar charge for all lenders and all programs, borrowers would have to shop only rate and points, which is easily manageable. For example, a borrower can shop for the lowest rate at zero points, or the fewest points on a 6 percent loan.

Within reasonable limits, the exact amount of the fixed charge is not important, provided the charge is the same for every lender and every loan. It is the variability in these costs that makes it difficult to shop.

This is price-fixing by government, but in a good cause. When a service carries one price, price-fixing invariably reduces the supply of the service. When a service carries three prices, however, fixing one price merely channels market adjustments into the remaining prices, making it easier for consumers to shop.

A Fixed Fee Would Discourage Predatory Lending: Perhaps the greatest benefit of the one-price rule would be in the sub-prime market, where predatory practices are widespread. Under a fixed-charge rule, these practices become much more difficult to execute.

A common feature of price gouging, for example, is the inclusion of large fees in the loan balance, which borrowers often know nothing about until they get to the closing table. With a fixed-price rule, along with a rule that limits the financing of points, any gouging would have to be in the interest rate, where the potential for snookering the borrower is limited. Even unsophisticated borrowers understand the difference between 7 percent and 12 percent.

In a similar vein, making loans that borrowers can't repay, or churning loans in successive cash-out refinances, are profitable only if the lender can load heavy fees into the balance. The fixed-charge rule should eliminate both practices.

Enforcement of a Fixed-Fee Rule Would Be Easy: Lawmakers sometimes give little consideration to whether, and at what cost, the rules they promulgate can be enforced. This is certainly true of the existing law against the payment of referral fees, which couldn't be effectively enforced with an army of examiners. State laws directed at predatory lending that bar loans that "fail to benefit the borrower," or that "borrowers do not have the capacity to repay," present similar enforcement problems.

In contrast, the fixed-charge rule would be virtually self-enforcing, because it is unambiguous, and

every borrower would be a potential enforcement agent. Borrowers would know what the allowable charge was, and the closing documents would reveal whether the lender was in compliance.

How Much Should the Fixed Fee Be? The fee should not be so high that lenders can make money on the origination process, regardless of what happens later. That encourages abusive practices. Nor should it be so low that early prepayment will cause the lender serious loss because then there won't be any loans made without prepayment penalties. $3,000 is about right for now. This is the fee set by Innovation Mortgage, a sub-prime lender out of California, which has adopted a one-price rule voluntarily as a marketing tool.

Eliminating Low-Ball Price Quotes: If price quotes can't be depended on, price shopping goes for naught. Some lenders and brokers routinely offer low-ball price quotes designed to capture the customer, which they retract at the time the price is locked. Because the market is so volatile, borrowers are rarely positioned to contest a loan provider's statement that market rates increased more, or decreased less, than they did in fact.

Full protection against this common tactic requires a "twin sibling rule." Lenders must lock at the same rate that they would quote to the borrower's twin who is shopping the same loan on the lock date. This rule would also be easy to enforce, since loan providers do quote prices to shoppers on the same days that they lock prices to borrowers in process.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at www.mtgprofessor.com.

Copyright 2005 Jack Guttentag

Back Top Send to Printer

Back Send to Printer

Discount brokers not upfront about real estate loan fees
By Jack Guttentag

"In my market search I have come across discount brokers who seem to uphold many of the same ethical standards as Upfront Mortgage Brokers (UMBs) but do not charge any fees for their service. They claim they are compensated by the lenders. Isn't that even better?"

The term "discount broker" implies that the broker is providing services at a bargain price. Nothing could be further from the truth. If they were practicing full and candid disclosure, here is what they would say to you:

"You are paying me in the interest rate, which is higher than it would be otherwise. I prefer to charge you this way because I fear you will resist paying out of pocket and will haggle about the amount. By charging you in the rate, payment is spread out over time in the form of a higher monthly mortgage payment. This will upset you less than a cash payment, especially since you are unlikely even to be aware of how much higher the mortgage payment is. This is really win-win, since I get to charge you more and my fee upsets you less."

Borrowers - and only borrowers - pay mortgage broker fees. However, payment can be made in two ways. One way is to pay the broker in cash at closing, in which case the broker fee becomes a closing cost to the borrower.

The second way is to pay a premium interest rate to the lender, who pays the broker's fee at closing as a quid pro quo for the higher rate. In this case, the broker's fee is not a closing cost to the borrower. Rather, the borrower pays for it every month as an increment to the mortgage payment.

Here is an illustration. On a 30-year fixed-rate mortgage, the lender quotes a rate of 6 percent at zero points, 5.75 percent at 2.5 points, and 6.25 percent at -2 points. The lender will pay 2 points for a 6.25 percent rate, a payment referred to in the trade as a "rebate" or "yield spread premium."

If the borrower agrees to the 6.25 percent rate and the broker receives the rebate as his compensation, the broker typically tells the borrower that "my fee is being paid by the lender." But this is true only in the most superficial sense. The lender pays the rebate in order to get the higher interest rate, and the borrower pays the higher rate. The 2 points paid by the lender to the broker is the present value of the higher payments the borrowers will be making in the future.

Bottom line, the borrower pays the broker fee one way or the other. But many borrowers do not understand how the process works, and are much more focused on the cash required to close than on future payments. Further, the amount of any rebate paid to the broker is not readily apparent on required disclosure forms. The borrower knows what the broker fee is when he pays it out of his pocket, but may have little idea of what it is when he pays for it in the rate.

The result is that borrower resistance to broker fees is much weaker when the fees appear to be paid by the lender. And increasingly, brokers seek their compensation entirely in this way. The so-called "discount brokers" have merely formalized the process.

There is nothing wrong with a borrower electing to pay the broker with a higher rate rather than cash, provided that this is a deliberate selection. For a borrower with a short time horizon who won't be paying the high rate very long, paying with a higher rate makes sense. On the other hand, a borrower who expects to have the mortgage a long time and has the cash does better using it to pay the broker.

If you are a shopper who intends to select a loan provider based on price comparisons, the broker's fee

is irrelevant. Neither does it matter whether a loan provider is a broker or a lender. You find the loan provider who offers the best combination of rates and total fees, period.

But if you are not up to price shopping, which is extremely difficult to do effectively, and you prefer to retain a broker to shop for you, then you should know what you are paying for this service. Upfront Mortgage Brokers tell you, discount brokers don't.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at www.mtgprofessor.com.

Copyright 2005 Jack Guttentag

Back Top Send to Printer

Back Send to Printer

Should I do business with a broker or a lender?
By: Jack Guttentag

"I have read all your articles about mortgage brokers and lenders, and I still don't know which to go to. Can you convert your generalizations into specific suggestions about who should see a lender, and who should see a broker?"

If borrowers could shop for home loans as easily as they can shop for the houses that secure the loans, it wouldn't matter whether you dealt with a broker or a lender. You would shop the market for the best price, and whether the loan provider offering it was a broker or a lender wouldn't matter. Because the home loan market is so difficult to shop, however, the type of loan provider can matter to some borrowers.

The key difference between brokers and lenders is that brokers offer loan programs from many different lenders. This means that brokers are more likely to find a loan that will meet the specialized needs of borrowers than a single lender.

For example, many lenders won't offer loans to borrowers with poor credit, borrowers who can't document their income or assets, borrowers who want a mortgage on which the payment starts low and rises over time, borrowers who can't make any down payment, borrowers who want to purchase a condominium as an investment, borrowers with very high existing debts, borrowers who need to close within 72 hours, or borrowers who reside abroad. The list goes on and on.

But there are lenders in every one of these niches, and brokers can usually find them when needed. The implication is that borrowers with special needs such as these can save much time and effort by patronizing a broker.

Borrowers who fall into generic market niches that are serviced by all lenders can go either way. Their decision should be based on whether they want to shop the market on their own, or whether they prefer to retain a broker to shop for them.

If you elect to shop on your own, you are exposed to all the booby traps that await the unwary in this market. Here are just a few:

- Loan prices are reset every day, so you can't compare A's price on Monday with B's on Tuesday.

- Loan prices depend on the type of loan, loan features, type of property, purpose of loan, and more. Unless you specify them all, A may give you the price of a sedan and B the price of an SUV.

- Loan prices have at least three price dimensions (interest rate, fees expressed as a percent of the loan, and fees expressed in dollars). If you don't take them all into account, you may not select the lowest overall price.

- Lenders and brokers do not guarantee prices until they are locked, and some give "low-ball" quotes to snare the business. If you don't know how to avoid phony price quotes, you may be snared.

Those who elect to shop for themselves should read "Steps in Shopping For a Mortgage," which is available on my Web site. It will guide you on how to deal with these and other impediments to effective shopping.

If you don't feel up to the challenge and would prefer to delegate responsibility to someone else, go

with a mortgage broker. Brokers are experts at shopping the market. They are far better positioned than consumers to select the best deal available from competing lenders on the day the terms of the loan are locked.

The problem in dealing with a broker is that most brokers view themselves as independent contractors, and as such their interests are not fully aligned with those of borrowers. The broker's income on a transaction is the mark-up of the wholesale price quoted by the lender. The higher the price the broker can induce the borrower to pay, the larger the markup.

To minimize this conflict, borrowers should retain brokers as their agents for a fixed fee negotiated in advance. The fee must include any compensation received from the lender, since you are paying that fee indirectly in the interest rate. Upfront Mortgage Brokers, listed on my Web site, operate this way as a matter of course, but others will as well if customers request it. Make sure the fee is in writing.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left www.mtgprofessor.com.

Copyright 2004 Jack Guttentag

Back Top Send to Printer

Upfront mortgage brokers veer from traditional business model
By Jack Guttentag

Q: "I want to be an Upfront Mortgage Broker because I already do business the UMB way. I am concerned, however, with the part of the UMB 'Commitment' that states that 'the broker will be the customer's representative or agent.' The model broker disclosure form of the National Association of Mortgage Brokers states that 'in connection with this mortgage loan we are acting as an independent contractor and not as your agent.' What does this mean?"

A: The mortgage broker trade associations have always promoted the independent contractor model and warned against the agency model, because the agency opens the broker to claims of violation of fiduciary duty. If you want to be a UMB, however, you must accept the agency model and the obligations that come with it.

Independent Contractor Versus Agency: The issue is a legal one but it has major financial ramifications. The independent contractor model views brokers as similar to merchants who buy at one price and sell at another. They can earn as much on transactions as they can induce borrowers to pay, need not disclose what they make except where required by law, and have no obligation to deliver the mortgages best suited to borrowers' needs.

The agency model, in contrast, accepts that brokers are service providers, not merchants, and they negotiate fees with clients upfront. Their services include finding mortgages that best meet borrowers' needs.

The agency model is in its infancy. The independent contractor model dominates the industry, and prevailing industry practices reflect that dominance.

The Independent Contractor Model and Industry Practices: Most brokers charge what the market will bear. This means that unsophisticated borrowers who accept what they are told and visit a single broker will pay more than knowledgeable borrowers who challenge the broker and shop alternative sources. There is very little relationship, therefore, between broker charges and the amount of work the broker does for the borrower.

Broker charges average more than 2 percent of loan amounts, which is about twice as high as they should be. A major reason for high fees is low productivity. Brokers spend an inordinate amount of time looking for clients, pay heavily for leads from an industry of lead generators, and also waste time with potential clients who don't close. Low productivity generates pressure to earn more on the deals that close.

A major reason for low productivity is distrust, which pervades the letters I receive from borrowers concerning brokers. A broker who is an independent contractor has the right to make as much money as possible from a complex transaction that the broker understands and the borrower doesn't. How can that not breed distrust?

Brokers detest borrowers who flit from broker to broker, submit multiple applications, or pump brokers for information and then deal elsewhere. Yet these practices are how borrowers try to protect themselves against brokers they don't trust. Borrower reactions to distrust raise broker costs, which pressures brokers to make more per transaction, which generates more distrust in a vicious circle.

The Agency Approach of Upfront Mortgage Brokers: UMBs operate according to a different set of rules than the remainder of the industry. UMBs view themselves as the agent of the borrower, to whom they owe a fiduciary responsibility. A UMB agrees with the borrower on total broker

compensation from the transaction, and passes through the best price from the broker's lenders.

The agency approach recognizes that shopping mortgages is difficult for borrowers, but brokers are experts at it. The optimal arrangement for many borrowers, therefore, is to purchase the shopping expertise of brokers for a fixed fee.

The advantage of the UMB approach is that it breeds confidence, which lowers costs and increases productivity. I know UMBs who charge half the industry average per transaction but close three to four times as many loans. Their secret is a continuous stream of referrals from previous clients -- and from me.

Implementation of the Agency Approach: The way to break the circle of distrust is to change the operating model, from independent contractor to agency. Government *should* mandate the agency approach, but probably won't because it would be opposed not only by the broker associations, but also by the wholesale lenders, who are as shortsighted as the brokers. They support the independent contractor model in order to limit their own liability for broker misdeeds.

The agency approach will have to win the battle in the marketplace, which will take time. When this was written, there were 135 UMBs. Growth will accelerate, however, with the activation of Upfront Mortgage Brokers Association, a non-profit organization dedicated to promotion of the agency approach to brokering.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at http://www.mtgprofessor.com.

Copyright 2006 Jack Guttentag

Back Top Send to Printer

It's Not Your Parents' Mortgage Market Anymore

Author(s): Edward Gramlich
Other Availability: Printer-Friendly Page
Posted to Web: April 06, 2007
Permanent Link: http://www.urban.org/url.cfm?ID=901063

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

WASHINGTON - Is the American housing dream going sour? The Dow Jones industrial average tumbled 243 points in early March when missed payments by holders of subprime mortgages hit a four-year high and foreclosures on all homes a four-decade peak.

The homeownership dream first solidified in the 1950s. Then, the mortgage of choice was the 30-year, fixed-rate mortgage with 20 percent down. Millions of middle-class households bought suburban houses, erected backyard swing sets, and sent their kids to new public schools. The overall homeownership rate shot up from 45 percent to 65 percent in just more than a decade.

But most lower-income families either could not make the down payment or the monthly payments. Racial and ethnic minorities faced discrimination to boot. Most of these households continued to rent, and the American homeownership rate stabilized near 65 percent for 35 years.

Following that postwar boom, other seismic shifts reverberated in mortgage markets—usury laws ended, credit scoring developed, and Fannie Mae and Freddie Mac made advances in packaging mortgages into securities. The Community Reinvestment Act obligated banks and thrifts to make low- and moderate-income mortgage loans. Many new independent mortgage companies sprang into action.

As these factors converged, the subprime mortgage market blossomed. Lending swelled from almost zip in the mid-1990s to more than $600 billion today, one-fifth of all new mortgages. About 12 million new homeowners emerged—including many moderate-income households and minorities previously excluded—raising the overall U.S. homeownership rate to about 69 percent, among the world's highest.

While an arbitrary threshold (defined by the rate of interest charged) delineates the lower edge of the prime mortgage market from the subprime market, the two are different animals.

Most prime mortgages go to credit-worthy households; most subprime mortgages go

to those with less-stellar credit records and carry higher rates, points, and fees. Most prime mortgages feature down payments; many subprime mortgages don't.

Made by banks and thrifts, most prime mortgages are fixed-rate. Negotiated by independent mortgage brokers, many subprime mortgages are adjustable. Most prime mortgages carry no prepayment penalties; most subprime mortgages do.

The bottom line? The new subprime mortgage market is far riskier than the old prime market. The foreclosure rate in the prime market has typically been less than 1 percent, compared with about 7 percent in the subprime market.

Now, the interest rates of the recent raft of subprime mortgages are about to rise (since they track short-term interest rates). The Center for Responsible Lending predicts foreclosure rates of about 20 percent, excluding distress sales. Millions of new homeowners who stretched to make their payments when short-term interest rates were very low are beginning to lose their homes.

Should we close down the subprime market and return to the world of the early 1990s? No way. Regrettable foreclosures notwithstanding, three-quarters of new homeowners are making their payments, building wealth and participating in the American dream.

Should we increase protections and safeguards for the new homeowners? Absolutely.

The key is stopping the shortcuts taken in the recent go-go subprime market. Lenders should scrutinize borrowers' ability to repay the loan, using the maximum rate on adjustable-rate mortgages—not the initial low rate. Lenders should escrow property taxes and insurance payments. Independent subprime lenders should be as carefully supervised as banks and thrifts making prime loans are.

Congress can get going, too. The 1994 Homeowner Equity Protection Act imposed controls on predatory lending by preventing balloon payments on high-priced mortgages, outlawing long-term prepayment penalties, and forcing lenders to evaluate borrowers' creditworthiness.

HOPEA's rate thresholds could be tightened up, and strictures on balloon payments could be applied to rate hikes on adjustable-rate mortgages and other payment shocks. If both lenders and borrowers had to confront the long-term costs of a mortgage, fewer households would lose their homes.

The clock cannot be turned back on the subprime mortgage industry. But financial regulators and legislators could look forward by promoting less risky homeownership.

Edward Gramlich, a member of the Federal Reserve System's Board of Governors from 1997 to 2005, is the Urban Institute's Richard B. Fisher Senior Fellow and author of the forthcoming "Subprime Mortgages: America's Latest Boom and Bust."

The views expressed are those of the authors and should not be attributed to the Urban Institute, its sponsors, staff, or trustees.

Related Research

- Race, Schools, and Neighborhoods: Reducing Barriers to Achievement
- Promoting Neighborhood Improvement while Protecting Low-Income Families >>
- Housing Partnerships: The Work of Large-Scale Regional Nonprofits in Affordable Housing >>

Browse by Topics

- Housing >>

Other Publications by Authors

- Edward Gramlich >>

Disclaimer:

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

Terms and Conditions for use of this website:

Copyright of the written materials contained within the Urban Institute website is owned or controlled by the Urban Institute. This information may be used, with appropriate acknowledgment, for research, academic, policy or other non-commercial purposes. Proper attribution is required. Posting UI research papers on other websites is permitted provided the poster first gains approval from the Urban Institute. For approval, please contact us.
Source: http://www.urban.org | © 2005 The Urban Institute

Opportunity and Ownership Project

An Urban Institute Project Exploring Upward Mobility

THE URBAN INSTITUTE

No. 7, February 2007

America's Second Housing Boom

Edward M. Gramlich

Millions of new low- and moderate-income homeowners now have a chance to build wealth, have their children attend better schools, and reap other advantages of home-ownership. But any social change this large is likely to have some mixed blessings.

The American landscape changed dramatically after World War II, as home-ownership rates rose from 45 percent to 65 percent in little more than a decade. This burst was fueled by the opening of mortgage credit and ownership to the middle class, symbolized by the now-classic 30-year fixed-rate mortgage. Millions of American households were able to purchase their split-level homes in the suburbs and send their children to the public schools there.

Low- and moderate-income households were generally excluded from this earlier movement. Either they could not get mortgage credit at all, or could not afford the down payment or monthly payments. Minority families often faced discrimination on top of these other factors. As a consequence, the national homeownership rate stabilized at about 65 percent for 35 years (figure 1).

But recently, homeownership again expanded. The share of Americans who owned homes rose from 64 percent in 1994 to 69 percent by 2005 (figure 2). This time the new homeowners were largely low- and moderate-income groups, and minorities. Over the decade, the homeownership rate in the lowest tenth of the income scale rose 4 percentage points to 43 percent, the second lowest rose 4 percentage points to 49 percent, and the rates for blacks and Hispanics rose 7 and 8 percentage points, respectively, to 49 percent. About 12 million new homeowners have emerged, roughly half of them blacks, Hispanics, and others of mixed race. The overall rate of 69 percent moves the United States into the top rung in world home-ownership rates.

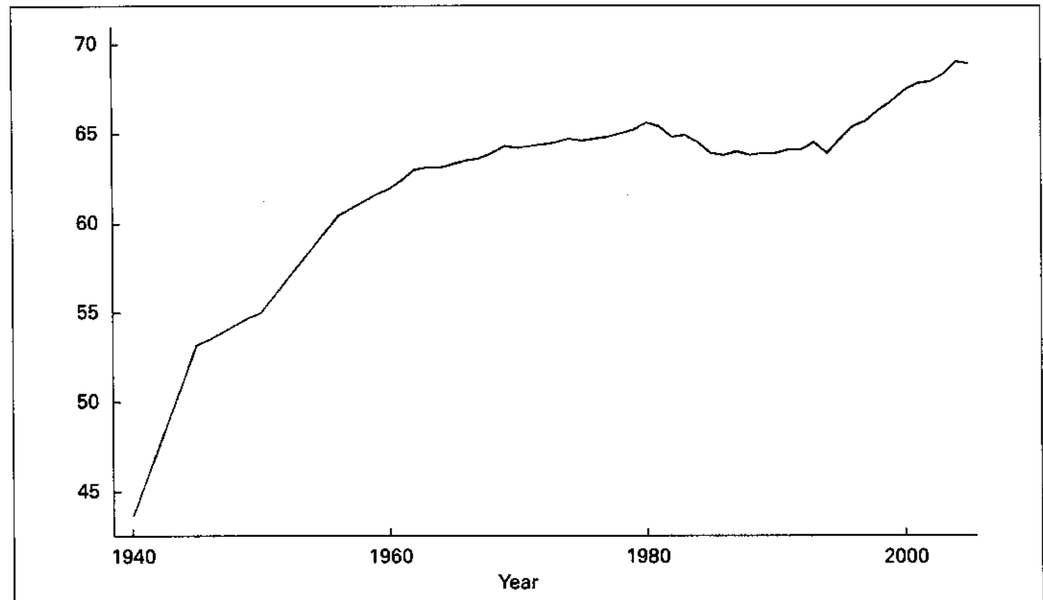
The Subprime Mortgage Market

While the first surge in ownership involved the prime mortgage market, the second surge has been largely fueled by the development of the subprime mortgage market. This subprime market can render down payments as low as zero. Subprime borrowers have lower incomes and inconsistent credit histories, forcing them to pay high interest rates, sometimes double-digit interest rates, to get their loans. Points and fees are higher for subprime mortgages and prepayment penalties are almost universal, making it much more costly for borrowers to get out of subprime mortgage loans.

This subprime mortgage market is a reasonably new financing option. Subprime mortgage originations were a mere $35 billion in 1994, less than 5 percent of total mortgage originations. By 2005, subprime originations had risen to $625 billion (figure 3), now up to 20 percent of total originations and 7 percent of the total outstanding mortgage stock. Over the decade, subprime originations increased 17-fold, a whopping 26 percent annual rate of increase.

Just as the middle classes did at the close of World War II, these new low- and moderate-income homeowners now have a chance to build wealth, invest in their neighborhoods, have their children attend better schools, and reap other advantages of homeownership. Both presidents Bill Clinton and George W. Bush have engaged in significant cheerleading for the growth in homeownership. At this point most of the cheerleading has been from the bully pulpit, since there has been very little new federal money behind the growth in homeownership.

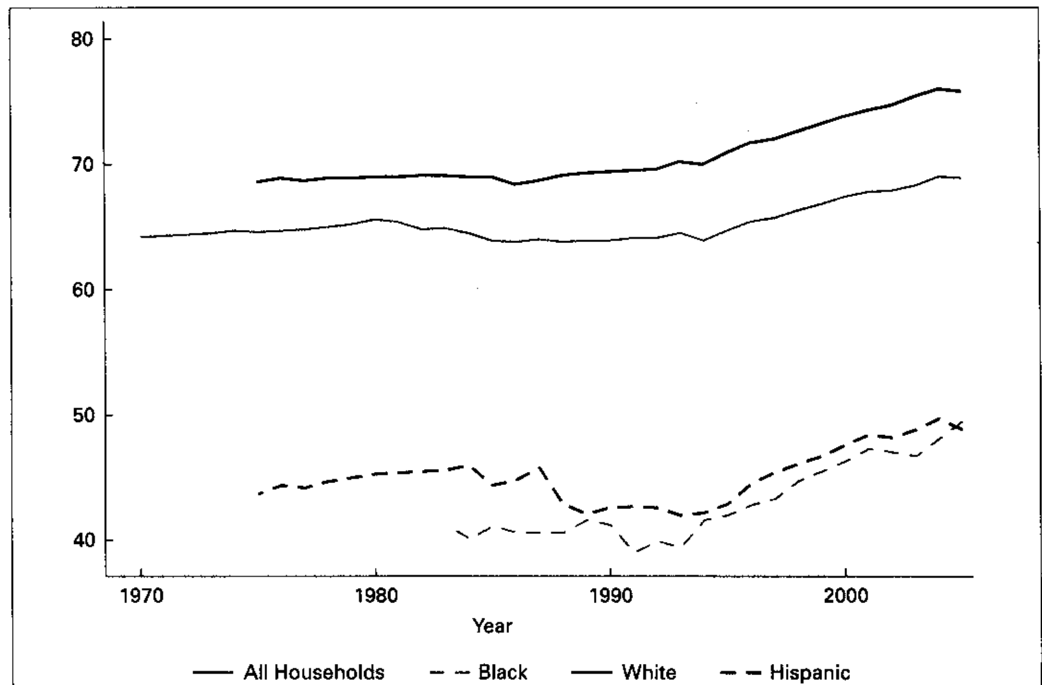
FIGURE 1. Homeownership Rates, 1940–2005 (percent)



Source: U.S. Census Bureau.

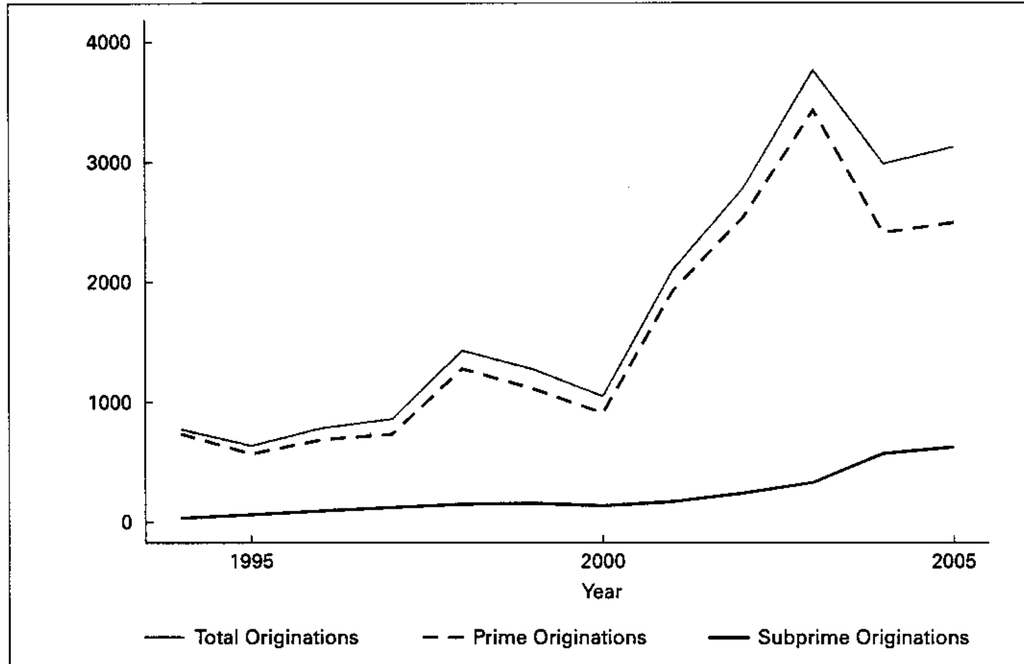
But any social change this large is likely to have some mixed blessings. Overall delinquency rates for subprime mortgages are on the order of 7 percent, 10 times as high as the normal rate in the prime market (Joint Center 2006). Various indicators suggest that another 10 percent of subprime borrowers could be flirting with credit problems, even if not in actual delinquency or foreclosure status

FIGURE 2. Homeownership Rates, 1970–2005 (percent)



Source: U.S. Census Bureau.

FIGURE 3. Mortgage Originations, 1994–2005



Source: Mortgage Statistical Annual.

(Schloemer et al. 2006). And foreclosures have likely been held down by the recent period of very low short-term interest rates and the proliferation of financing instruments that take advantage of these rates. Now that short-term rates establish more normal levels, interest payment burdens for many subprime borrowers are rising sharply, and further increases in delinquencies and foreclosures are almost sure to follow.

Indeed, early reports show exactly that happening in late 2006. Three subprime lenders have recently declared bankruptcy, and an intensive study of six million recently made subprime mortgages forecasts sharply higher foreclosure rates (Schloemer et al. 2006). The numbers are not large enough to threaten the macroeconomy, but even a small rise in foreclosures could damage the prospects of millions of low- and moderate-income households.

The Role of House Prices

House prices play an ambiguous role in this story. When house prices rise at healthy rates, as they have until just recently, borrowers make capital gains on their homes and build wealth. If they get in trouble with their mortgages, they can just sell their houses, pay their prepayment penalties, and walk away from the whole problem. Or they can refinance their mortgages on favorable terms.

Yet, the rise in house prices, combined with slow growth in low-income wages, has led to significant gaps in the stock of affordable housing. Nearly half of all households in the bottom quarter of the income scale now spend more than 50 percent of their income on housing, and another quarter spend between 30 and 50 percent of their income (Joint Center 2006, table A.6, 36). With housing expenditures at this rate, households have little left to spend on other things, and whether they buy or rent, they are likely to experience financial difficulties.

Consequently, the latest slackening in house price appreciation rates could have ambiguous impacts. Foreclosure problems might worsen or, perhaps, shortages of affordable housing might become less serious.

What Caused the Changes?

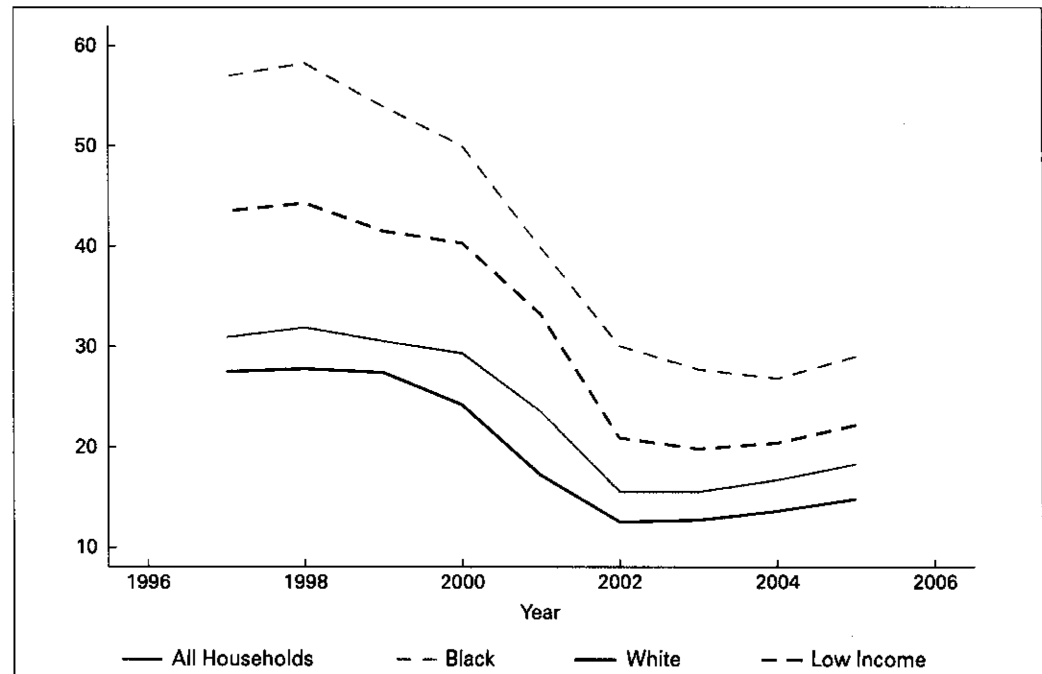
Several factors opened up housing markets. One clear factor is the disappearance of usury laws against unreasonable or excessively high interest rates. The Depository Institutions Deregulatory and Monetary Control Act of 1980 abolished usury laws on first mortgages, and states followed the federal lead and eliminated many of their own usury laws throughout the 1980s. Borrowers with inferior credit histories previously denied credit have become much more likely to qualify for subprime mortgage loans, perhaps even for prime mortgage loans. Reflecting this fact, mortgage denial rates, reported under the Home Mortgage Disclosure Act, have dropped noticeably (figure 4).

The reduction in usury laws has joined larger changes in credit markets. Lenders now rely much more on credit scoring and other such technologies to assess the risk of particular borrowers, and they have set up entities to compete for the new subprime business. Parallel developments have taken place in markets for auto finance and credit cards. Many new mortgage brokers and subprime lenders have emerged, as have many old-line lenders with subprime mortgage subsidiaries. Financial regulation of these new entities is a good deal less stringent than for the traditional banking sector.

Another regulatory change that facilitated these developments was the 1977 Community Reinvestment Act (CRA). Through the 1980s and 1990s, the CRA encouraged banks to make low- and moderate-income mortgage loans in redeveloping areas. To their surprise, banks often found these loans to be profitable. In effect, the CRA opened up new areas of business to lenders unaware of the profit possibilities in these low-income markets. Thus, lending has expanded significantly to low- and moderate-income households. A large share of the new loans has financed the new set of low- and moderate-income homeowners.

There are other changes as well. The scope and breadth of community-based organizations have expanded significantly, whether they operate on their own or are tied to national networks such as Neighborworks America or the Opportunity Finance Network. The Federal Housing Administration, which guarantees the

FIGURE 4. Denial Rates for Conventional Mortgages, 1997–2005 (percent)



Source: Home Mortgage Disclosure Act.

mortgages of many first-time homebuyers, has liberalized its rules. Giant secondary-market purchasers like Fannie Mae and Freddie Mac have expanded into lower-income mortgage markets to meet their new and more stringent housing goals.

Benefits and Costs for the New Homeowners

The parallel growth of homeownership rates and the subprime market suggests that the new homeowners are drawn largely from groups formerly excluded from credit markets. A voluminous literature has tried to measure the basic benefits of homeownership. Essentially, these homeowners save more, build wealth, and act to improve their neighborhoods. The biggest problem with this literature is correcting for selection bias—are the new homeowners benefiting from owning a home, or would they have benefited anyway because of innate differences between them and renters? Did homeownership or the innate differences cause the gains? Earlier studies did not correct for this bias and generally found significant impacts of homeownership. Some of the newer studies in this area, beginning about 1990, have used panel data and other sources to correct for these biases (Dietz and Haurin 2003). While these new studies still find positive effects from homeownership, the impacts are not as large and are sometimes quite tenuous.

These post-1990 studies can be summarized briefly (Dietz and Haurin 2003). Homeowners might be expected to save more—and they seem to—since they have the self-control mechanism of having to make their monthly mortgage payments. Homeowners might also be expected to build more wealth, both because of any added saving and the relative rise in house prices. Here the empirical confirmation is stronger, especially in areas where house prices are rising rapidly. Homeowners might be expected to be less mobile, due to the higher transaction costs of owning a home. Here there is strong empirical confirmation. They might be expected to work harder, particularly if they have to stretch to make their mortgage payments. Here there seems to be strong evidence that at least women increase their labor supply. Homeowners might be expected to invest more in their home, neighborhood, community, and children, and to guard more against crime. There is confirmation of some of these relationships, though not all. There is also some empirical evidence of greater self-reported satisfaction (table 1).

The American Housing Survey permits a more careful look at those buying a home for the first time in the 1990s (Herbert and Belsky 2006). These new homebuyers seem to be satisfied with their homes and to have made reasonable purchases from a physical standpoint. Again, it is hard to verify significant neighborhood improvements. The new homebuyers have generally put very little money down on their mortgages, though their interest rates are only slightly higher than on conventional mortgages. The most troubling aspect is that many new buyers now face significant cost burdens, and while they are not actually going into foreclosure, a high

TABLE 1. Theoretical and Empirical Impact of Homeownership (Post-1990 articles)

Impact on	Theoretical Impact	Empirical Confirmation
Household saving	Weak positive	Weak
Wealth accumulation	Strong positive	Depends on house prices
Mobility	Strong negative	Strong
Labor supply	Weak positive	Reasonable, for women
Property improvements	Strong positive	Weak
Urban environment	Strong positive	Weak
Political activity	Strong positive	Reasonable, on voting
Crime	Strong negative	Weak
Child outcomes	Strong positive	Reasonable
Satisfaction	Weak positive	Reasonable

share sells their houses after only a few years.

On the cost side, delinquency and foreclosure are the dramatic risks. Studies of the foreclosure problem in the city of Chicago suggest significant costs all around (Home Ownership Preservation Initiative 2006). Homeowners can lose their property, their equity, and their chance to build wealth. Even the lenders do not often fare well, with a series of servicing costs. The city loses, particularly when the property remains vacant and entails continuing costs. And neighborhood values go to pot when surrounding homeowners lose significant value.

There are more subtle costs as well. Even though refinancing a subprime mortgage is costly, some homeowners refinance often, up to several times a year. A series of terms—loan flipping, equity stripping—have come into use to characterize conditions in these markets. Some of these problems can be attributed to predatory lending and some to the fact that borrowers may have lost jobs (and their ability to make their mortgage payments).

Policy Changes

The country has, in effect, performed a huge experiment in opening up housing and mortgage markets to new groups of homeowners with marginal credit records, presumably lower incomes, and a higher representation from racial or ethnic minority groups. The changes are so huge they are likely to be irreversible—the country will not likely go back to homeownership rates of a decade ago and the subprime mortgage market will not likely shrink.

From an overall standpoint, this change would appear to represent a net social improvement. There seem to be more gainers than losers, and unless the losers lose a lot more per household, the net gains would seem to outpace the losses. Hence the overall net social benefit tally should be positive. But this is not the best way to view the change. Rather than evaluate the overall change, it makes more sense to see if there are measures that could reduce the costs or enhance the benefits.

An obvious potential policy measure is improved lending counseling, now already used by various community groups such as Neighborworks America. Targeted programs such as these can require that clients enter lending counseling programs, making these clients more selective in taking on credit and more disciplined in making mortgage payments. The programs can give valuable advice when consumers want to refinance, provide legal help in disputes, and refinance loans on terms preferable to those privately available. But lending counseling might inherently have limited effectiveness. Mortgage contracts can be unfathomable even to those with advanced degrees in finance, and the notion of universal housing counseling may be hard to shove down prospective buyers' throats. Also, attempts to establish universal counseling may create an industry of phony consultants.

Product restrictions might play some role. Very often subprime, and even prime, borrowers exhibit what economists call myopia, where they are more aware of short-term than long-term costs. If consumer myopia is a general problem, it may make sense to ban balloon payments in this market, as the Home Ownership Equity Protection Act of 1994 (HOEPA) already does for very high cost mortgages. HOEPA also contains strictures against long-term prepayment penalties, another restriction that may be appropriate to lessen the costs of mistakes. Many states have adopted their own policies, often patterned after the 1994 law, and these can be extended as well.

Measures could also be taken to reduce market inefficiencies. The U.S. Department of Housing and Urban Development (HUD) has promoted the idea of folding all closing costs into one amount and of informing the consumer of this total amount in advance. Such a plan would provide better market information to consumers, and also give consumers a chance to shop around, as they do in other areas of the economy. Secondary-market purchasers such as Fannie Mae and Freddie Mac could also use their considerable leverage to lessen market distortions and standardize and clarify loan terms.

Financial lenders in this market could also be more closely regulated. Prime mortgage lenders are subject to arduous bank examinations every three years, examinations that monitor lending practices, verify borrowers' incomes, and assess repayment probabilities. Similar regulations could be extended to the affiliates of these prime lenders, and perhaps even to independent lending companies, the source of most allegations about predatory lending. There may also be ways to regulate mortgage brokers, who are placing ever-growing shares of subprime mortgages.

There are also ways to encourage homeownership on better terms. HUD has been doing some experimental programs under which tenants' rent payments are partially devoted to escrow accounts, to permit the tenants to become owners. These tenants have to satisfy difficult conditions to become owners, but the early experience is that once they do that, foreclosure rates are much lower (Lubell 2006). The lesson again seems to be that some coaching on homeownership may pay big dividends.

Conclusion

Wittingly or unwittingly, the United States has passed through an era of enormous social change in housing markets. The mortgage market has been opened up to millions of potential new homeowners, and the implications are huge, for both owners

and renters. There has been much research on particular aspects of these changes but very little in the way of overall assessment. There has also been little evaluation of potential policy changes. It is now time to begin that process.

References

Dietz, Robert D., and Donald R. Haurin. 2003. "The Social and Private Micro-Level Consequences of Homeownership." *Journal of Urban Economics* 54: 401–50.

Herbert, Christopher E., and Eric S. Belsky. 2006. *The Homeowner Experience of Low-Income and Minority Families: A Review and Synthesis of the Literature.* Report to the U.S. Department of Housing and Urban Development, February. Washington, DC: U.S. Department of Housing and Urban Development.

Home Ownership Preservation Initiative. 2006. *Partnership Lessons and Results.* Three Year Final Report, July 17. Chicago: Neighborhood Housing Services.

Joint Center for Housing Studies of Harvard University. 2006. *The State of the Nation's Housing: 2006.* Cambridge, MA: President and Fellows of Harvard College.

Lubell, Jeffery. 2006. "Strengthening Resident Opportunities for Self-Sufficiency and Homeownership through Rent Reform Linked to Asset Building." Washington, DC: Center for Housing Policy.

Schloemer, Ellen, Wei Li, Keith Ernst, and Kathleen Keest. 2006. *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners.* Research Report, December. Durham, NC: Center for Responsible Lending.

About the Author

Edward M. Gramlich is a senior fellow at the Urban Institute. He developed expertise in housing while serving as a member of the Board of Governors of the Federal Reserve System, from 1997 to 2005. Dr. Gramlich spent his academic career at the University of Michigan, serving as provost and dean of the Public Policy school. From 1994 to 1996, Dr. Gramlich was chair of the Quadrennial Advisory Council on Social Security. In 1986–1987, he was first deputy and then acting director of the Congressional Budget Office. He also served as director of the Policy Research Division at the Office of Economic Opportunity (1971–1973), as senior fellow at the Brookings Institution (1973–1976), and in the Research Division at the Federal Reserve Board (1965–1970). Dr. Gramlich also was the staff director for the Economic Study Commission of Major League Baseball. He is author of a popular text on benefit-cost analysis, and has authored several other books and many articles on topics such as macroeconomics, social security, budget policy, income redistribution, and fiscal federalism.

THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037

Nonprofit Org.
U.S. Postage
PAID
Permit No. 8098
Ridgely, MD

Address Service Requested

For more information,
call Public Affairs:
202-261-5709
or visit our web site,
http://www.urban.org.
To order additional copies
of this publication, call
202-261-5687
or visit our online bookstore,
http://www.uipress.org.

Given the chance, many low-income families can acquire assets and become more financially secure. Conservatives and liberals increasingly agree that government's role in this transition requires going beyond traditional antipoverty programs to encourage savings, homeownership, private pensions, and microenterprise. The Urban Institute's *Opportunity and Ownership Project* policy brief series presents some of our findings, analyses, and recommendations. The authors are grateful to the Ford Foundation and the Annie E. Casey Foundation for funding the policy briefs.

THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037
Copyright © 2007
Phone: 202-833-7200
Fax: 202-293-1918
E-mail: pubs@ui.urban.org

The views expressed are those of the author and do not necessarily reflect those of the Urban Institute, its board, its sponsors, or other authors in the series.

Permission is granted for reproduction of this document, with attribution to the Urban Institute.

Five Questions With Edward Gramlich

Author(s): Edward Gramlich
Other Availability: Printer-Friendly Page
Posted to Web: February 01, 2007
Permanent Link: http://www.urban.org/url.cfm?ID=901039

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

Edward Gramlich, a former member of the Federal Reserve System's Board of Governors (1997-2005), recently became the Urban Institute's first Richard B. Fisher Senior Fellow. An expert in macroeconomics and public finance, he got involved in affordable housing issues at the Federal Reserve. He has written America's Second Housing Boom, a new brief on the benefits and risks of the subprime mortgages offered to lower-income buyers.

---

1. What are your priorities after a decade in government?

Asset building and ownership, for one. In the past, people zeroed in on how much incomes figure into welfare. That's great. But asset building matters too because that's the way that people develop wealth.

My first project on housing fits right in because low- and moderate-income people generally build wealth through owning a house. Housing is a predominate form of wealth for all families, even into the top echelon.

The housing situation is complicated greatly by a serious debt-burden problem. Families with high debt levels are in a risky position already, and many of them took out even more debt to buy their house. There's evidence that the foreclosure rate may jump, causing big social problems as families lose homes and plunge more into debt.

With some assets, like IRAs [Individual Retirement Accounts], you just put money in and that's it. If you miss a few payments, it just means that there's less money in the account. With housing, it doesn't work that way—if you miss too many payments and get foreclosed on your house, you lose virtually all of the equity you had accumulated in the house.

The stakes are much higher for housing. The foreclosure problem, and where that may lead, is what got me interested in this issue at the Federal Reserve.

I also may do a project for the World Bank on urbanization for emerging market countries. Workers earn more in the cities than in the country. That sets up a very difficult social problem because, without careful planning, the population will flood to the cities and have trouble getting housing and jobs. It puts a strain on the social services. Not that you want to keep people down on the farm, where they don't make any money.

2. How will affordable housing play out in this year's budget?

Rent subsidy programs will probably be level funded, so that won't help much or hurt much. The fundamental problem is that these programs aren't structured very well.

The other problem with housing is the subprime mortgages. Many of them have been taken out under very risky circumstances. The subprime mortgage of choice is an adjustable rate mortgage. Short-term rates have been very low. So adjustable rate mortgages on very good terms have been available. But that period is over.

The short rates have gone up and a lot of these mortgages are in for a big payment shock. Many people have borrowed to the end of their resources. Groups studying this issue are projecting pretty significant increases in foreclosures. There's not too much the federal budget has historically done about that. It really is a question of restructuring personal debt.

Now I do have some ideas on changing the rules of the game of subprime credit markets. It's very important and I hope Congress will get interested. [House Financial Services Chairman] Barney Frank already plans to hold hearings.

3. What should people watch as the budget process unfolds?

There are several critical issues to watch. One is the deficit. The deficit problem is not one of imminent financial collapse. It is one of long-term appropriate macroeconomic management. Everyone here would love to see Congress get the deficit under control, particularly over the long run. But I'm a bit dubious that it will happen.

There is always the entitlement problem. Short-term, there is going to be a war of numbers. If you want a guide on this war of numbers, you have to keep your eye on two things. One is whether the military costs are fully priced in. The administration funds Iraq on a series of supplemental spending bills, so it's hard to see the real costs.

The other thing is the alternative minimum tax [AMT]. If you leave it alone, it brings in a huge amount of revenue. But the AMT affects millions of people. This is a very large tax bill. Congress has typically indexed it so it brings in about the same amount of revenue as it did the previous year. It's often not counted in the budget, so you have to be careful about how it's treated.

In terms of whether anyone is serious about budget change, you have to just wait and see. But in terms of honest budgeting, I'd keep my eye on the AMT.

4. What big-ticket items might be tackled in the next two years?

We may not be far from thinking about national health insurance. We've got 47 million people without insurance. Of course, they really are covered. If they go into hospitals, they get treated. Then it gets loaded onto everyone else in a very inefficient way. Our health system is breaking down in some fundamental sense.

What's happening is that states like Massachusetts and California are starting to establish universal health care. The last thing we need is to have 50 different state programs. We aren't that far away from the time that we really have to confront this as a nation.

It will be costly. Whether the aggregate costs go up is not that clear. It will bring costs out into the open, and will certainly seem costly.

But the country can't go on much longer without confronting health care. Every year we sweep it under the rug. At some point, we can no longer do that.

With Medicare and the prescription drug program, it's certainly possible to do some fine-tuning. But I'm pessimistic about doing anything in Social Security. I do think that President Bush poisoned that debate a couple years ago with his push for private accounts.

A lot of people would accept individual accounts if they came on top of regular Social Security benefits. But if you carve them out of Social Security, no Democrat will support the plan.

Solving Social Security needs presidential leadership and the Democrats and Republicans in a room—and you have to get them to agree to hold their noses and come out with something. That was done in 1983, and it can be done again.

The preconditions don't strike me as being there right now for a compromise. Social Security is a wonderful issue to demagogue your opponent with. Somehow you have to change the dynamics. Frankly, I think the next president will have a better chance.

5. What's your advice for the new Congress?

I would love to see them do something about the budget. I would love to see them work toward honest budgeting—on the AMT and military. I would love to see them go to some pay-go rules so if there is some measure that busts the budget, attention gets paid to financing. And I would really love to see them make some reforms in entitlement spending.

The most we can hope for is that we get back some fiscal responsibility. I'm a little skeptical, but I would love to see it.

I also think Congress is going to have to confront health insurance—some sort of universal benefits plan. We can't keep letting all the states do it without at some point thinking that the national government should do this. It will happen, not because anyone wants it to happen, but because the issue is forced by rising health care costs and state action.

Health care may not necessarily get done in the next couple years, however, because Congress is facing such highly divisive issues as Iraq. It may not be the time to get together and compromise on things like health insurance or Social Security.

Congress might be able to help with housing. I could see measures against predatory lending and perhaps payment shocks in subprime mortgages passing without huge budget implications. But these issues definitely are not center stage.

Monetary policy is one thing in pretty good hands. After a century of working at it, I think the Fed is operating well. Of all the problems that we have, there is one that we

don't have—inflation. We've actually gotten that under control.

Related Research

- A Perfect Opportunity for Health Reform >>
- Access Gaps among Uninsured Children in Los Angeles County >>
- Assessing Community-Based Outreach and Enrollment Activities and Outcomes Relative to Need in Los Angeles County >>

Browse by Topics

- Health/Healthcare >>
- Housing >>

Other Publications by Authors

- Edward Gramlich >>

Disclaimer:

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

Terms and Conditions for use of this website:

Copyright of the written materials contained within the Urban Institute website is owned or controlled by the Urban Institute. This information may be used, with appropriate acknowledgment, for research, academic, policy or other non-commercial purposes. Proper attribution is required. Posting UI research papers on other websites is permitted provided the poster first gains approval from the Urban Institute. For approval, please contact us.

Source: http://www.urban.org | © 2005 The Urban Institute

American Securitization Forum

Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans

June 2007

I. Introduction

The American Securitization Forum (ASF)[1] is publishing this Statement as part of its overall efforts to inform its members and promulgate relevant securitization industry guidance in light of the widespread challenges currently confronting the subprime residential mortgage markets.

Current subprime residential mortgage market conditions include a number of attributes of concern that impact securitization transactions and the broader environment for subprime mortgage finance: an increase in delinquency, default and foreclosure rates; a decline in home price appreciation rates; a prevalence of loans with a reduced introductory rate that will soon adjust to a higher rate; and a reduced availability of subprime mortgage lending for refinancing purposes. In light of these concerns, the ASF is of the view that loan modifications, for subprime mortgage loans that are in default or for which default is reasonably foreseeable, are an important servicing tool that can both help borrowers avoid foreclosure and minimize losses to securitization investors.

Moreover, the ASF recognizes that it is an important goal to minimize foreclosure and preserve homeownership wherever possible. Higher than normal rates of foreclosure may harm borrowers and their communities, and may adversely affect housing values and therefore collateral values on both performing and non-performing loans. Accordingly, the ASF recommends the use of loan modifications under appropriate circumstances as described in this Statement.

The overall purpose of this Statement is to provide guidance for servicers modifying subprime residential mortgage loans that are included in a securitization. It is our hope that publication of these principles, recommendations and guidelines will help to establish a

[1] The American Securitization Forum is a broad-based professional forum of over 350 organizations that are active participants in the U.S. securitization market. Among other roles, ASF members act as insurers, investors, financial intermediaries and professional advisers working on securitization transactions. ASF's mission includes building consensus, pursuing advocacy and delivering education on behalf of the securitization markets and its participants. This statement was developed principally in consultation with ASF's Subprime Mortgage Finance Task Force and Loan Modifications Working Group, with input from other ASF members and committees. Additional information about the ASF, its members and activities may be found at ASF's internet website, located at www.americansecuritization.com. ASF is an independent, adjunct forum of the Securities Industry and Financial Markets Association.

360 Madison Avenue, 17th Fl. • New York, NY 10017-7111 • P: 646.637.9211 • F: 646.637.9124
1399 New York Avenue, NW • Washington, DC 20005-4711 • P: 202.434.8400 • F: 202.434.8456
www.americansecuritization.com

common framework relating to the structure and interpretation of loan modification provisions in securitization transactions, thereby promoting greater uniformity, clarity and certainty of application of these provisions throughout the industry. As a consequence, ASF hopes that this guidance will facilitate wider and more effective use of loan modifications in appropriate circumstances.

While this Statement addresses certain legal, regulatory and accounting matters, it does not constitute and should not be viewed as providing legal or accounting advice.

This Statement is focused on modifications of first lien subprime residential mortgage loans. Many of the principles reflected in this Statement would also apply to modifications of other types of residential mortgage loans. This Statement does not address modifications of second lien residential mortgage loans.

II. Overview of Typical Securitization Document Modification Provisions

Servicing of subprime residential mortgage loans included in a securitization is generally governed by either a pooling and servicing agreement or servicing agreement. These agreements typically employ a general servicing practice standard. Typical provisions require the related servicer to follow accepted servicing practices and procedures as it would employ "in its good faith business judgment" and which are "normal and usual in its general mortgage servicing activities" and/or certain procedures that such servicer would employ for loans held for its own account.

Most subprime transactions authorize the servicer to modify loans that are either in default, or for which default is either imminent or reasonably foreseeable. Generally, permitted modifications include changing the interest rate on a prospective basis, forgiving principal, capitalizing arrearages, and extending the maturity date. The "reasonably foreseeable" default standard derives from and is permitted by the restrictions imposed by the REMIC sections of the Internal Revenue Code of 1986 (the "REMIC Code") on modifying loans included in a securitization for which a REMIC election is made. Most market participants interpret the two standards of future default – imminent and reasonably foreseeable – to be substantially the same.

The modification provisions that govern loans that are in default or reasonably foreseeable default typically also require that the modifications be in the best interests of the securityholders or not materially adverse to the interests of the securityholders, and that the modifications not result in a violation of the REMIC status of the securitization trust.

In addition to the authority to modify the loan terms, most subprime pooling and servicing agreements and servicing agreements permit other loss mitigation techniques, including forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owing but extend the time for payment. In addition, these agreements typically

permit loss mitigation through non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs.

Beyond the general provisions described above, numerous variations exist with respect to loan modification provisions. Some agreement provisions are very broad and do not have any limitations or specific types of modifications mentioned. Other provisions specify certain types of permitted modifications and/or impose certain limitations or qualifications on the ability to modify loans. For example, some agreement provisions limit the frequency with which any given loan may be modified. In some cases, there is a minimum interest rate below which a loan's rate cannot be modified. Other agreement provisions may limit the total number of loans that may be modified to a specified percentage (typically, 5% where this provision is used) of the initial pool aggregate balance. For agreements that have this provision: i) in most cases the 5% cap can be waived if consent of the NIM insurer (or other credit enhancer) is obtained, ii) in a few cases the 5% cap can be waived with the consent of the rating agencies, and iii) in all other cases, in order to waive the 5% cap, consent of the rating agencies and/or investors would be required. It appears that these types of restrictions appear only in a minority of transactions. It does not appear that any securitization requires investor consent to a loan modification that is otherwise authorized under the operative documents.

III. Loan Modification Principles

Based upon extensive consultation with its members and other securitization market participants, ASF believes that the following principles articulate widely-accepted industry views regarding the use of loan modifications in connection with securitized subprime residential mortgage loans:

1. For subprime mortgage loans that are in default or where default is reasonably foreseeable, loan modifications are an important loss mitigation tool that should be used in the circumstances described in this Statement. Modifications may include changing the interest rate on a prospective basis, forgiving principal, capitalizing arrearages and extending the maturity date. Other loss mitigation alternatives include forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owing, and also non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs. Unlike other loss mitigation alternatives, loan modifications have the additional advantage that they can be used prior to default, where default is reasonably foreseeable.

2. Establishing early contact with borrowers is a critically important factor in the success of any loss mitigation initiative. Servicers should be permitted and encouraged to reach out affirmatively and proactively to borrowers for whom default is more likely, determine whether default is reasonably foreseeable, and

then explore modification possibilities. In particular, such outreach should be permitted and encouraged prior to an upcoming first adjustment date on a hybrid ARM loan.

3. Loan modifications should be considered and made on a loan-by-loan basis, taking into account the unique combination of circumstances for each loan and borrower, including the borrower's current ability to pay. The ASF is opposed to any across-the-board approach to loan modifications, and to any approach that would have all modifications structured in a particular manner. The ASF is also opposed to any proposals that would provide an across-the-board moratorium or delay period on foreclosures.

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;

    d. In a manner that, insofar as possible, avoids materially adverse tax or accounting consequences to the servicer and, to the extent known, to the securitization sponsor or investors;

    e. Where the loan is either in default or default is reasonably foreseeable, and if the latter, where there is a reasonable basis for the servicer determining that the borrower is unlikely to be able to make scheduled payments on the loan in the foreseeable future;

    f. Where there is a reasonable basis for the servicer concluding that the borrower will be able to make the scheduled payments as modified; and

    g. In a manner that is designed to provide sustainable and long-term solutions, but does not reduce the required payments beyond the magnitude required to return the loan to performing status, or beyond the anticipated period of borrower need.

5. 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.

6. In considering loss mitigation alternatives that reduce the interest rate prospectively, servicers should consider whether to make the rate reduction temporary (such as a relatively short term extension of the initial fixed period on a hybrid ARM), or permanent, based on the anticipated period of borrower need. For temporary rate reductions, servicers should re-evaluate the borrower's ability to pay, and the continued need for a rate reduction, at the end of the temporary period.

7. Any loan modification that reduces otherwise lawful, contractually required payments of principal or interest must be understood to be a financial concession by the securitization investors. There is no basis for requiring such concessions from investors unless the modification is determined to be in the best interests of the investors collectively. Loan modifications should seek to preserve the originally required contractual payments as far as possible.

8. Reasonable determinations made by servicers with respect to loan modifications, where made in good faith and in accordance with generally applicable servicing standards and the applicable securitization operative documents, should not expose the servicer to liability to investors and should not be subject to regulatory or enforcement actions.

IV. Loan Modification Interpretive Guidance

The ASF endorses the following interpretive positions on specific issues arising in connection with loan modifications:

1. The ASF believes, based on prevailing existing practice, that standard and customary servicing procedures for servicing subprime mortgage loans included in a securitization, as typically used as an overarching servicing standard in securitization operative documents, should be interpreted to allow the servicer to: a) permit loan modifications (including prospective interest rate reductions which may be either temporary or permanent, forgiveness of principal, capitalizing arrearages, or maturity extension not beyond the securitization maturity date) for loans that are in default or for which default is reasonably foreseeable, so long as the modification is in the best interests of investors in the aggregate, and b) engage in other loss mitigation alternatives including forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owing, and also non-foreclosure alternatives to terminating a loan, such as short sales and short payoffs. The ASF believes that existing securitization pooling and servicing agreements should be interpreted, to the maximum extent possible, to authorize the servicer to take the actions referenced above.

2. With respect to existing pooling and servicing or other operative agreements that expressly prohibit or restrict the servicer from taking the actions referenced above, the ASF believes that amendments to those agreements authorizing such actions should be approved by all parties required to consent to such amendments, as and when requested to do so.

3. The ASF believes that securitization operative documents should not impose numerical limitations on loan modifications, such as limits based on the percentage of the pool that may be modified.

4. The modification standards "default is imminent" and "default is reasonably foreseeable" should be interpreted to have the same meaning.

5. The modification standard "default is reasonably foreseeable" should be deemed to be met where there has been direct contact between the servicer and the borrower, where the servicer has evaluated the current ability to pay of the borrower, and has a reasonable basis for determining that the borrower is unlikely to be able to make scheduled payments on the loan in the foreseeable future. (This interpretation is intended to provide guidance only as to a set of circumstances where the standard would generally be viewed to be met, and not to reflect any view that the standard would not be met in other circumstances.)

6. In evaluating whether a proposed loan modification will maximize recoveries to the investors, the servicer should compare the anticipated recovery under the loan modification to the anticipated recovery through foreclosure on a net present value basis. Whichever action is determined by the servicer to maximize recovery should be deemed to be in the best interests of the investors.

7. The standards "in the best interests of" or "not materially adverse to the interests of" investors or securityholders in any securitization should be interpreted by reference to the investors in that securitization in the aggregate, without regard to the specific impact on any particular class of investors, and in a manner that is neutral as to the effect on the cash flow waterfall or any particular class of securities.

V. Loan Modification Recommendations

The ASF recommends the following further actions in respect of loan modifications:

A. Existing and future securitizations:

1. The ASF endorses and encourages the adoption of the position articulated in the Mortgage Bankers Association position paper titled "FAS 140

Implications of Restructurings of Certain Securitized Mortgage Loans", dated May [24], 2007 (the "MBA Position Paper").

2. Servicers should maintain policies, procedures and guidelines that are reasonably designed to identify and manage any actual or perceived conflicts of interest that may arise in connection with their loan modification activities and decision making. Such policies, procedures and guidelines should address, among other topics, situations in which a servicer (a) has an ownership interest in one or more classes of bonds supported by principal and/or interest collections on subprime mortgage loans that it services; (b) receives servicing fees or other compensation that is tied to various attributes of subprime mortgage loans that it services (e.g., outstanding principal balance, delinquency/default status); and (c) is not reimbursed for the costs of loan modifications from collections on subprime mortgage loans that it services.

3. Securitization operative documents should clearly state, for purposes of "delinquency triggers" or "cumulative loss triggers" which control whether excess cash flow may be released to the residual, the following: (a) whether and under what conditions a modified loan is to be considered "current", and (b) whether and how any interest rate reduction or forgiveness of principal resulting from a loan modification should be treated as a realized loss.

4. As an urgent, high priority matter, the ASF should develop guidelines under which delinquency triggers and cumulative loss triggers in securitization operative documents, which control whether excess cash flow may be released to the residual, should be interpreted in a manner consistent with the parties' intent and in a manner that appropriately reflects any loan modifications that have occurred. It is the sense of investors that (a) any partial forgiveness of principal should be treated as a loss for purposes of cumulative loss triggers, and (b) a modified loan performing in accordance with its modified terms should be treated as delinquent for purposes of delinquency triggers for some appropriate period of time.

5. Greater clarity, transparency and consistency should be established regarding how any interest rate reduction or forgiveness of principal resulting from a loan modification should be reflected for purposes of investor reporting, and for purposes of allocating payments for the cash flow waterfall.

6. Consistent with the foregoing recommendations, servicers should not make decisions to use or not use loan modifications for the purpose of

manipulating the application of delinquency triggers or cumulative loss triggers which control whether excess cash flow may be released to the residual.

7. The ASF will conduct a survey of typical document provisions and interpretations, on the question of whether and under what conditions a modified loan is to be considered current for purposes of investor reporting, and for purposes of delinquency triggers and cumulative loss triggers which control whether excess cash flow may be released to the residual. Additional guidelines should be developed and recommendations should be made and evaluated regarding amendments to securitization transactional documents, based on the results of this survey.

B. Future securitizations:

1. The ASF will develop standard, uniform model contractual provisions governing the servicer's ability to provide loan modifications for use in future securitizations. Such provisions should expressly authorize the actions referenced in Loan Modification Interpretive Guidance point 1 above.

2. Use of an increased or supplemental servicing fee should be considered for loans that have been modified to defray the additional costs of administering modifications.

3. The ASF will develop standard, uniform model contractual provisions, both as to timing and priority, to govern the servicer's ability to obtain reimbursement for P&I advances and servicing advances made in respect of loans where there has been a loan modification, or where other types of loss mitigation have been used.

Thacher
Proffitt

Memorandum

TO: ASF Loan Modification Working Group

FROM: Mason L. Crocker and Stefano Taverna

DATE: May 16, 2007

RE: Cancellation of Indebtness Income in Conjunction with Typical Subprime Loan Modification Provisions

This memorandum highlights some of the federal tax consequences that result from certain loan modification provisions with respect to loans provided to individuals who purchased homes for primary or secondary residence and not for their trade or business (each, a "mortgagor"). Examples of loan modifications include: (1) capitalizing any amounts owed on a mortgage loan by adding such amount to the outstanding principal balance of the mortgage loan, (2) deferring amounts owed to a later date or to the final payment date of a mortgage loan, (3) extending the maturity of any such mortgage loan, (4) amending the related mortgage note to reduce the related mortgage rate with respect to any mortgage loan, (5) converting the mortgage rate on any mortgage loan from a fixed rate to an adjustable rate or vice versa, (6) with respect to a mortgage loan with an initial fixed rate period followed by an adjustable rate period, extending the fixed period and reduce the adjustable rate period, (7) forgiving the amount of any principal owed by the related mortgagor, and/or (8) forgiving the amount of any interest owed by the related mortgagor.

Summary

Generally, a mortgagor will recognize income upon:

- forgiveness of principal;
- a short sale or short payoff; and
- forgiveness of past accrued and unpaid interest, to the extent that interest would not have been deductible by the mortgagor.

In addition, a mortgagor may recognize income if the rate on the mortgage loan is reduced prospectively to a below-market rate, defined herein as the AFR.

Analysis

If any principal amount of a mortgage loan is forgiven, as in Example 7 above, subject to certain exceptions for bankruptcy or insolvency, a mortgagor is treated as recognizing income to the extent of the amount of principal forgiven ("COD Income"). In addition, if a cash basis mortgagor is forgiven accrued but unpaid interest, as in Example 8 above, the mortgagor would not have to recognize COD Income in the amount of such interest, to the extent that its payment would have given rise to a deduction by the mortgagor. Thus, in Example 8 above, a loan-by-loan determination would be appropriate.

In the event a mortgagor recognizes COD Income, banks and other financial entities that discharge a debt of $600 or more must furnish a statement to the mortgagor by January 31 of the year following the year of discharge and file a Form 1099-C, *Cancellation of Debt,* by February 28 of the year following the year of discharge. A copy of Form 1099-C can be found on the website of the Internal Revenue Service (the "IRS") at http://www.irs.gov/pub/irs-pdf/f1099c.pdf.

When the mortgage loan's principal is not forgiven and the rate on a modified mortgage loan is above the AFR (as defined below), the terms of a mortgage loan may be modified by changing the amortization of principal or the type and amount of interest rate charged on the loan, as in Examples 1 through 6 above, without causing recognition of income to the mortgagors at the time of modification. For federal income tax purposes, if the terms of a mortgage loan, whether recourse or non-recourse in nature, are significantly modified that loan is treated as being exchanged for a "new" mortgage loan. Treas. Reg. §1.1001-3. The economic result of a significant modification is equivalent to the refinancing of the underlying indebtedness, and to the extent that the principal amount of the "new" loan is the same as the principal amount of the refinanced loan, a mortgagor does not recognize any income and the loan retains the same characteristics and limitations as the original mortgage loan (e.g., a mortgagor remains entitled to deduct the interest on the mortgage loan as qualified residence interest, to the extent the loan was so treated prior to the modifications).

Independently of whether a loan's modifications are significant, in Examples 1 through 6, a mortgagor may be treated as having to recognize income if the modified loan bears a rate that is less than the AFR (a "below-market loan"). IRC §7872. Generally, when a loan is treated as a below-market loan, the lender is presumed to forego interest in an amount equal to the difference between the rate on the loan and the AFR. Assuming the lender and the mortgagor are unrelated third-parties, the mortgagor is deemed to (i) receive a payment (and thus recognize income) in an amount equal to the amount of foregone interest and (ii) make an interest payment in the same amount, the deductibility of which is subject to the same restrictions as the interest actually due on the loan. Although Treasury Regulations contemplate an exception from the below-market loan regime for loans that are available to the general public on the same terms and conditions and which are consistent with the lender's customary business practice, it is not clear the extent of the availability of this exception to subprime lenders in the event of distress situations as those presented at this time.

The applicable federal rate ("AFR") is the federal short-, mid-, long-term or blended rate that is determined and published by the IRS monthly. The AFR is based on the yield of marketable U.S. Treasury obligations of similar maturities outstanding during the one-month period ending on the 14th day of each month prior to the month for which the rates are applicable. For purposes of ascertaining whether a loan is a below-market loan, a mortgagor must use the appropriate AFR depending on the terms of the loan, including length, compounding periods, and type of rates charged. The chart below provides an example of the AFRs for May 2007, as published in Rev. Rul. 2007-29.

AFR (term of loan)	Compounding Period			
	Annual	Semiannual	Quarterly	Monthly
Short-term AFR (3 years or less)	4.85%	4.79%	4.76%	4.74%
Mid-term AFR (over 3 years but not over 9 years)	4.62%	4.57%	4.54%	4.53%
Long-term AFR (over 9 years)	4.90%	4.84%	4.81%	4.79%

Lastly, in conjunction with the securitization of the mortgage loans, in addition to the authority to modify the loan terms, most subprime pooling and servicing agreements and servicing agreements permit loss mitigation techniques, including short sales and short payoffs. Since these loss mitigation techniques effectively allow for a reduction of principal amount on the underlying loans, they would result in COD Income to the mortgagors.

The information in this memorandum is provided as background information for discussion purposes only, and does not constitute and should not be construed as substantive legal advice. To ensure compliance with requirements imposed by the U.S. Internal Revenue Service, any U.S. federal tax advice contained herein, as to which each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor, (i) is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code and (ii) is written in connection with the promotion or marketing of the transaction or matters addressed herein.

*****

If you have any questions or comments on any of the issues discussed in this memorandum, please contact Mason L. Crocker at (212) 912-7867 or mcrocker@tpw.com or Stefano Taverna at (212) 912-8244 or staverna@tpw.com.