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before the

House of Representatives
Committee on the Judiciary

Hearing on Foreclosed Justice: Causes and Effects of the Foreclosure Crisis

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Over the past several months there has arisen much concern over foreclosure practices and procedures and their effects on borrowers. The result of such concern has been to reveal to the general public the arcane system by which mortgage loans are bought and sold on secondary markets. As a result, while the recent revelations are new to many outside the industry, the system is just another example of how outdated laws, regulations, and recordkeeping systems continue to hamper financial market development.

It is important to remember, however, that the foreclosure process is just one element of the broader legal system that allows individuals and firms to borrow funds against collateral property that can be seized in lieu of repayment. Hence, the ability to foreclose against the secondary source of value in the loan is a key element of US economic growth. While in no event should unjustified foreclosures be allowed to proceed, policymakers should strive to improve the system to make property rights clear to all market participants and set forth a sound system of law by which parties may contract for credit.

In the following pages I first describe briefly the dimensions of the foreclosure problem not only in terms of the outdated contractual arrangements that have been tortured to fit 21st century financial market needs, but also in order to properly position the magnitude of the problem and the debate. In short, while the contractual difficulties are rife the proportion of affected loans is still very small. Moreover, the proportion of wrongly affected loans is much smaller, still.

I follow that introduction with a description of the likely effects of a foreclosure moratorium. Where foreclosures are lengthier, there is greater propensity for strategic default and commensurately higher borrowing costs. While secondary markets are not greatly affected by the slowdown, lengthier foreclosure times do result in greater losses on foreclosed loans, all things held equal. Moreover, all of those relationships are well researched in events since the Depression to today. Hence, we should not expect a foreclosure moratorium to have effects different from the effects they have demonstrated previously.

Last, I suggest some reforms that could be enacted with or without a moratorium. As seen in the Deepwater Horizon incident, a moratorium without a clear purpose can be tremendously destructive. Nonetheless, it is hard to imagine what a moratorium would contribute to the reforms described here, since the judicial system generally is keeping a vigilant eye on foreclosures with the cooperation of mortgage servicers, themselves, who have reported foreclosure problems voluntarily, to date.

1. Dimensions of the Problem: What's up (with the) Doc's?

A mortgage loan is a set of contracts evidencing a loan secured by real property. The contracts include (a) a "note" evidencing the borrower's promise to repay and (b) a "mortgage" or "deed of trust" representing a lien on the real property acting as collateral for the borrowing (herein referred to for convenience as a mortgage).

The key problem brought to light in the foreclosure "crisis" is that those two legal documents sometimes follow different paths of ownership through the life of a loan. The reason that occurs is because different sets of rules and laws govern the transferability of each instrument. State contract law and applicable portions of the Uniform Commercial Code (UCC) govern transfers of notes. State real estate law governs transfers of mortgages.

While the two do not conflict, per se, they do necessitate to different mechanisms working in tandem to support the transfer of mortgage loans, in contrast with – for instance – the simplified title mechanisms designed for the transfer of motor vehicles. The reason is simple: until recently, many people bought one or two homes in their entire lifetime. Today, people relocate much more readily and purchase and sell vacation and other second homes. In the speculative real estate environment of the latter half of the 2000s, home could be bought and sold several times before a buyer took up residence in the property (or it was even finished being built).

Clearly, therefore, the historical mechanisms for transferring title and ownership were stressed by the pressures of the 21st century marketplace. Nonetheless, general custom and practice continued (and continue) to support the marketplace.

First, where mortgages are sold into the secondary market there still exists a contract – such as a pooling and servicing agreement – which "…contains clear granting language that conveys ownership of all of the seller's "right, title and interest in and to" the mortgage loans to the trustee on behalf of the securitization trust. There is a schedule or exhibit to these documents that specifically identifies each loan sold under the agreement." (SNR Denton, *Commentary on Transfers of Mortgage Loans to RMBS Securitization Trusts*, October 18, 2010.)

Further evidencing the sale, the contract is accompanied by the physical delivery of the note to the purchaser. While endorsement is still required as a matter of technicality, "…because mortgage notes are generally "instruments" under the UCC, possession of the mortgage note by the purchaser in a valid sale is generally sufficient to establish that the purchaser's ownership rights are superior to the rights of any other person in the mortgage loan." Moreover, the physical note may be required to enforce on the loan in the event of a default and/or a foreclosure. (SNR Denton, *Commentary on Transfers of Mortgage Loans to RMBS Securitization Trusts*, October 18, 2010.)

The last evidence of a sale is the assignment of the mortgage in recordable form to the purchaser. Of course, the mortgage "follows the note", so that is secures the debt for the benefit of the note holder. Any other arrangement would be illogical. Hence, it is not necessarily the case that the mortgage needs to be recorded in the name of the purchaser. Nonetheless, it may still be necessary under certain state laws that the purchaser becomes the mortgagee of record in order to exercise enforcement and/or foreclosure rights. "Because every recording of an assignment of mortgage involves a filing fee and other expenses, it is not unusual for these assignments to remain unrecorded until such time as is needed in connection with a foreclosure of a specific defaulted loan." (SNR Denton, *Commentary on Transfers of Mortgage Loans to RMBS Securitization Trusts*, October 18, 2010.)

The three steps above are generally viewed as sufficient to establish ownership in loans transferred to securitization trusts and others. As described above, there may be other steps required to foreclose in individual states. Those additional steps, however, do nothing to convey ownership rights and therefore do not negate those rights. Hence, the foreclosure crisis is not about the rights of sale, per se, but about the individual foreclosure requirements in individual states and the ability of banks to execute according to those in the present environment.

Mortgage Foreclosures in Perspective

	Number Outstanding in Category	Number in Foreclosure in Category	Number in Foreclosure as Percent of all loans in Category	Number in Foreclosure as Percent of All Loans
All Loans	44,508,533	2,034,040	4.57%	4.57%
Prime Fixed Loans	27,471,873	648,336	2.36%	1.46%
Prime ARM Loans	4,613,443	468,726	10.16%	1.05%
FHA Fixed Loans	5,381,913	188,367	3.50%	0.42%
FHA ARM Loans	171,007	7,849	4.59%	0.02%
VA Loans	1,293,415	32,335	2.50%	0.07%
Subprime FRM Loans	2,676,386	238,198	8.90%	0.54%
Subprime ARM Loans	1,694,395	389,541	22.99%	0.88%

Source: Mortgage Bankers Association 2q2010 Delinquency Survey

Still, I would be remiss not to present even that problem in its proper perspective. The loans at issue are products known to have been used by high-risk borrowers. The breakdown of foreclosures provided by the Mortgage bankers Association shows that a preponderance of foreclosure activity – in terms of the number of loans in foreclosure as a percent of loans in the category – is in Prime ARM Loans and Subprime FMR and ARM loans.

Subprime loans are loans extended to less creditworthy borrowers. Such loans are typically low-balance loans on low-price homes, but are not high-LTV loans that are at risk of home price declines. Rather, subprime loans are more affected by employment and economic difficulties. Hence, it is not hard to understand why those loans are performing poorly and why foreclosures are necessary in an economy with almost ten percent unemployment.

The Prime ARM loans are those that were arbitraged most effectively by innovative mortgage products like Option ARM loans. Those loans were technically "Prime" at origination, but only by virtue of suppressing back-end debt to income ratios and LTV through negatively-amortizing teaser payments and piggyback second lien loans.

While both those categories of loans are certainly performing poorly and cause for concern, it is important to remember that while those categories account for only about twenty percent of mortgage loans, they account for almost half of all foreclosures. Hence, we need to be sure the rhetoric of the issue does not carry us away, but continue to deal with fundamentals.

2. What would a moratorium look like?

Economic research has given us a good idea what economic effects a foreclosure moratorium would entail. There is little good to be had from such an alternative. Moratoria tend to increase the option value of default for borrowers leading to more defaults, even if those are only temporary. Moreover, while a moratorium would only delay recoveries on loans for secondary market investors, an ill-crafted policy adverse to such investors could very well shut down the secondary markets and securitization conduits that provide considerable funding for the mortgage and other consumer credit sectors. Last, a moratorium could have deleterious effects on home prices. When the moratorium is lifted – as it must eventually be – the increased number of homes proffered for sale at that time could pressure home prices to overshoot downward, lengthening the crisis and recovery.

a. Longer foreclosure times generate additional free rent for borrowers

Debt is a necessary, but not sufficient, condition for default. Other conditions, like job losses and earnings may stress income, given a constant level of debt. Nonetheless, outside conditions like divorce, accidents, illnesses, and addictive behaviors typically cause defaults and bankruptcies. (See, for instance, Joseph R. Mason, "Demographics and Personal Bankruptcies." *Research in Banking and Finance*, November 2000 (1:1), pp. 229-257.)

Still, growing stress on individuals' ability to service debt creates a pattern to defaults that progresses according to borrower expectations, incentives, and preferences. Specifically, Kelley Pace and Shuang Zhu in a recent working paper show that "…borrowers that expect fewer repercussions from default (longer time to foreclosure) have a higher propensity to default." ("The Influence of Foreclosure Delays on Future Default, Loan Losses, and Contract Rates," Louisiana State University Working Paper, 2010.)

The reason, explained by Pace and Zhu, is that default without immediate implications a form of "easy financing." Individuals facing financial difficulties often have few available credit resources. In the past, such individuals might have borrowed more heavily from credit cards. However, credit card issuers now use more sophisticated risk management tools to preemptively reduce card limits, cancel cards, and raise rates preemptively on the basis of early indicators of default contained in spending patterns and other behaviors.

In addition, recent bankruptcy reforms have reduced the payoff from trying to discharge credit card debt if the "bid for resurrection" does not work out. We may yet see the effects of some of the changes to personal bankruptcy requirements enacted in BAPCA of 2005 play out in the crisis. In total, however, it is safe to say that consumer incentives have changed in ways that seem foreign to us in present foreclosure patterns, but make absolute sense to the borrowers.

Borrowers typically don't think of skimping on their automobile loan or lease payment because the lender will repossess the car. Similarly, renters don't typically think of skimping on their rent payment or they will be evicted. But as cheap mortgage rates and new types of loans turned less financially stable individuals from renters into mortgage borrowers, those consumers discovered that – unlike automobile repossession or even eviction – foreclosure takes a long time.

Moreover, since a mortgage (or rent) is typically the largest consumer payment, the skipped payments can amount may constitute a significant source of funds that can be used to maintain payments on items such as automobiles and cell phones, both of which are valuable if the consumer is searching for employment.

Recent research shows patterns suggestive of such behavior. In recent periods, many more individuals than before are defaulting temporarily on mortgages and later becoming current. Adelino et al. (Adelino, M., K. S. Gerardi, and P. Willen, Why don't lenders renegotiate more home mortgages? redefaults, self-cures and securitization. SSRN eLibrary, 2009.) estimate that about 30 percent of borrowers come back to current after slipping as far as sixty or more days delinquent. Of course, longer foreclosure delays increase borrowers' expected benefits from default, since serious effects such as eviction are postponed while borrowers save on payments – borrowers live rent-free.

Pace and Zhu show that a one standard deviation increase in foreclosure delays increases default risk by 7.91%. They also report subsample regression results for both low and high credit score borrowers, and show that both groups increase their default risk in response to longer foreclosure times. Similarly, foreclosure delays similarly increase default rates for both non-traditional loans and fully amortized FRMs.

Pace and Zhu summarize the effects by showing that the effect of a six month increase in foreclosure delay is equivalent to a 6.54% decrease in housing price expectations, a 3.65% increase in loan-to-value ratio, a 17.71 point lower FICO score, or a 0.82% increase in mortgage rates. The results indicate that various proposals such as the broad foreclosure moratoria may materially increase default probabilities, which may lead to an even worse housing market conditions.

The effects for non-traditional mortgage products are even more dire. For exotic AMR loans, the default risk increases another 41.97%, equivalent to a 16.18% decrease in housing price expectations, a 9.04% increase in LTV ratio, a 43.79 point lower FICO score, or a 2.02% increase in the contract rate. Moreover, only non-traditional loans are sensitive to housing price movements, not fully amortized FRMs.

Longer foreclosure times also equate with higher loan losses to lenders. During delinquency, servicers still pay for taxes, insurance, and maintenance, which add up over time. Many industry numbers are available, and Pace and Zhu confirm the range of those estimates, showing that in their own sample each additional month of foreclosure delay increases losses by approximately $7,280.

Many studies have measured the effects of increased foreclosure times on mortgage rates. Again, Pace and Zhu estimate that an increased average six-month foreclosure delay by region increases contract rates about 0.1 percent.

In summary, longer foreclosure periods increase borrowers' incentive to default. Additionally, longer periods in foreclosure are associated with higher losses for lenders/investors. Last, lenders seem to pass the higher costs to prospective borrowers by increasing the mortgage rates.

b. Secondary market interruptions

As long as the contracting environment with respect to ownership remains constant, the foreclosure crisis is expected to have little effect on secondary markets overall. Nonetheless, it is important to be aware of the caveat in that statement. The foreclosure crisis is already lengthening liquidation times and therefore imposing costs on investors and lenders. Adding to those delays will add to investor and lender costs, in many cases unnecessarily.

Simple math elucidates the point. At $7,280 per month per loan, a six-month foreclosure moratorium will increase industry costs by a magnitude just shy of $100 billion. About half of that cost will be incurred for foreclosures of non-traditional mortgage products that were used by borrowers to take the biggest real estate risks. Since in many of those cases the non-traditional mortgage products were used as a means of increasing affordability, it is not likely that borrowers will be able to afford the home with an amortizing product available in the current marketplace, even at half the principal value.

In short, therefore, it is not clear what good can come of a foreclosure moratorium.

3. What is the role for Judiciary?

With or without a foreclosure moratorium, I am of the opinion that the Committee on the Judiciary can have a calming influence on markets and the economy by working toward rational solutions that can help borrowers, investors, and lenders, alike. In particular, the Committee can make it clear to market participants that REMIC provisions are not threatened and that work will be undertaken to provide a more robust title transfer mechanism that is capable of supporting 21st century mortgage markets. Additionally, as I have said from the beginning of the crisis, borrowers and lenders alike will benefit from properly classifying modifications as new loans or refinancings, which will imbue the processes behind them with clear recordkeeping and underwriting standards and processes that can answer many of the questions regarding the status of such transactions that are before us.

Of course, many of those improvements will not help sloppy securitizers, nor should they. For them, the cleanup will just take time. Although the standard procedures described above make it "…highly unlikely that there has been any widespread failure to deliver the mortgage notes that simply went undetected." (SNR Denton, *Commentary on Transfers of Mortgage Loans to RMBS Securitization Trusts*, October 18, 2010.)

a. Create a robust document clearing and settlement mechanism (MERS)

MERS presents two main risks in the current marketplace. The first regards whether MERS has legal standing to foreclose in its own name. The second is whether loans recorded in MERS can be foreclosed at all. While the former risk is easy to deal with, the latter – while technically not an issue – may require clarification for the judiciary and therefore legislation.

In practice, MERS need not ever really foreclose on any property in its own name. In fact, most private label RMBS trusts have loans assigned into their own name prior to foreclosure, anyway, and earlier this year Fannie Mae required its servicers to do likewise. In any event, many states have already affirmed MERS' right to foreclose in its own name as nominee for RMBS trusts, obviating the need for further clarification. (Yehudah Forster, "Putting the Foreclosure Issues in Perspective," *Moody's ResiLandscape*, November 10, 2010.)

Under the "fatal flaw" theory, splitting the note and mortgage irreconcilably results in no one party having the right to foreclose. While logic suggests that putting the two back together again should reconcile any problem, some maintain that MERS does not have the standing to assign the note to the holder of the mortgage, so the two can never be reassembled.

According to Moody's, "To support the fatal flaw theory, some have cited old cases in which courts held that when one party held the note and a different party held the mortgage, the mortgage became a nullity since you cannot split the mortgage from the note. In those cases, the parties owning the note and mortgage had or potentially had different economic interests. The same rationale should not apply to MERS, who is a nominee for, and has no different economic interests than, the note holder." (Yehudah Forster, "Putting the Foreclosure Issues in Perspective," *Moody's ResiLandscape*, November 10, 2010.)

Here, the judiciary or legislatures will most likely provide relief. Courts, especially appellate courts, are unlikely to uphold the reasoning involved in the fatal flaw approach. Moreover, where a state's court did accept the theory, the ramifications on mortgage lending in the state are though to be sufficient impetus to spur state legislatures to action to resolve the inequity.

Moody's cites the case of Kansas, where the "In August 2009, the Kansas Supreme Court ruled against MERS on the issue of whether MERS had the right to vacate a final foreclosure judgment on the grounds that MERS was not served with notice of the action even though it was listed as the nominee for the lender in the county land records. The court held that the trial court did not abuse its discretion in not granting MERS request since MERS was only a nominee and not a necessary party to the foreclosure. In 2010, the Kansas legislature enacted a law that would require parties to join nominees of record to such actions going forward." (Yehudah Forster, "Putting the Foreclosure Issues in Perspective," *Moody's ResiLandscape*, November 10, 2010.)

While issues of real estate law can be expected to remain state-specific, Federal authorities may find it useful to promulgate guidance in these areas to urge states to unify around one or several key approaches to promote market stability. In the current environment, such clarification would help to calm markets and consumers, alike, and therefore reduce unnecessary foreclosure delays and personal legal costs arising from foreclosure challenges that have little or no standing.

b. Ensure REMIC stability

Most RMBS deals obtain favorable tax treatment by qualifying as Real Estate Mortgage Investment Conduits (REMICs). The REMIC rules exempt a qualifying trust from the obligation to pay federal and state income taxes on net income realized by the mortgages it owns. Failure to meet the REMIC requirements could, in theory, obligate the trust to pay taxes like an investment company, reducing the amount of cash available to pay bondholders.

Some claim that the chain of documentation above confers ownership of the loans to the REMIC only at assignment in foreclosure, therefore violating REMIC provisions that require the trust to receive ownership within 90 days of closing. Nonetheless, as discussed above the sales contracts for the loans (the pooling and servicing agreement and related documents) itemize the specific loans transferred and reflect the passing of economic interest to the loans to the trust in exchange for consideration.

Even to the extent that REMIC rules require assets to be "principally secured by an interest in real estate," and some loans may be found to be in violation of that stricture, some are of the opinion that REMIC rules permit the sponsor to rely on its "reasonable belief" that the asset is eligible until proven otherwise. Moreover, even if the asset is proven *not* to be principally secured by real estate, the REMIC rules give the trust 90 days to sell the asset before it becomes ineligible for the REMIC. It is hard to imagine that such a sale or put back would not be supported under securitization representations and warranties and the offending loans replaced at the request of REMIC investors.

Again while there does not appear to be any fatal shortcoming in REMIC tax provisions, it may be useful for the Committee to revisit some of these issues and provide clarification or revision where necessary. Such action may potentially smooth mortgage market functions at a time of considerable uncertainty.

c. Treat Mods as new loans

One last element of concern arising from the foreclosure crisis is the claim by some borrowers that foreclosures are proceeding while they have been awaiting modification decisions. I have commented many times on such problems and warned early on in Congressional testimony that failure to classify modifications as new loans or otherwise give them official standing will create such difficulties. My October 2007 paper, "Mortgage Modification: Promises and Pitfalls," concluded:

> *Servicing is costly, and increasing loan modifications increases the costs of servicing. While the practice of modifying loans shows promise, the practice is highly risky, both to the consumer and the lender, and substantially unproven. Moreover, there are currently no industry standards for modification and financial reporting, and no consumer safeguards to monitor or prohibit predatory practices.*
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> *Modification will not be suited to helping avoid the massive defaults expected as a result of ARM interest rate resets, which account for the majority of the industries problems into 2008. Legislative pushes to mis-apply the practice to those ends will substantially worsen industry performance.*
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> *One of the key reasons loan modification has grown has been to skew financial reporting of delinquencies, modifying loans to help borrowers make a few payments and then aggressively reaging the accounts to classify them as "current," instead of "delinquent." Such practices appear to have been a key mechanism in supporting the paper earnings of many failed subprime lenders prior to bankruptcy.*
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> *Regulators can already require modified loans to be reported as material considerations under Sarbanes-Oxley with standardized reporting practices promulgated by the Financial Accounting Standards Board and Regulation AB. Without applying even existing regulations toward regulatory oversight or transparency in loan modification practices, however, it is hard to imagine long- term positive benefits for borrowers.*
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> *It does not make sense, therefore, to push a broad unmonitored application of loan modification onto the industry or the public without serious consideration. Doing so runs a substantial risk of consumers being used to prop up the mortgage industry in the short term by keeping financially-strapped consumers in homes they cannot hope to afford.*
>
> *It does make sense, however, to apply limited modification programs to appropriately-selected consumers while helping to smooth the transition to smaller homes or rentals for others. Regulators need to be aware that appropriately selecting borrowers for modification is an underwriting decision, which needs to be monitored for safe and sound underwriting practices. Regulators can monitor modification programs for predatory behavior and abuse by simply classifying a modification as a new loan, which subjects the practice to all the disclosure and record-collection requirements for other new loans. Hence, regulators can use existing regulations to monitor modification outcomes so that lenders who use modification for short-term gain solely at the expense of consumers can be identified and censured.*
>
> *With no regulatory authority to oversee modification and reaging policies and little transparency with respect to those arrangements, however, there is a distinct possibility that extensive modification will hurt consumers and investors alike. Again.*

Those words are as important today as they were three years ago and still provide a clear path for reform.

4. Summary and Conclusions

In conclusion, a foreclosure moratorium will not alleviate borrower credit and economic conditions that are the root cause of the foreclosure tsunami. The loans with which we are concerned have already been in default for some time now. It should not come as a surprise to anyone watching the delinquencies age and become foreclosures that we would eventually have to face the final stages of disposing of the properties that borrower could not and cannot afford. At this stage of the crisis, we have to let markets work where they are already doing so and clarify what those markets do for the benefit of the 95% of borrowers who bought within their means and wonder why they should continue paying their mortgages when borrowers who made poor choices are getting all the press.

Of course, where markets are not working correctly we can advocate reform. Mortgage modification remains a problem, since Dodd-Frank and other legislation passed it by. If modification is to become a best practice in the industry, it will have to be monitored to make sure the borrowers and investors alike are served equitably. Nonetheless, after three years the issue remains unresolved.

It is silly at this stage of the crisis to try to deny problem: people tried to buy homes they could not afford. Simple estimates show it would take principal modifications of the magnitude of 50%-60% to make loans affordable to option ARM borrowers. Such drastic action is not an alternative. Hence, foreclosures are inevitable. But on the bright side, foreclosures are one of the last stages of reallocating the properties from those who could not afford them to those that can. Beyond this stage, economic growth beckons.