The Recently Announced Revisions to the Home Affordable Modification Program (HAMP)

Written Testimony

of

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of the House Committee on Financial Services

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I. Introduction

Chairwoman Waters, Ranking Member Capito, and members of the Subcommittee, thank you for inviting me to testify today regarding the Making Home Affordable Program and its effect on foreclosures.

I am a staff attorney at the National Consumer Law Center (NCLC).[1] In my work at NCLC, I provide training and technical assistance to attorneys across the country representing homeowners who are facing foreclosure, and I also bring the concerns of those homeowners to policymakers in Washington. Prior to my work at the National Consumer Law Center, I focused on mortgage lending issues as an attorney at the Federal Trade Commission's consumer protection bureau, where I was involved in investigations and litigation regarding lending abuses. I testify here today on behalf of the National Consumer Law Center's low-income clients. On a daily basis, NCLC provides legal and technical assistance on consumer law issues to legal services, government and private attorneys representing low-income consumers across the country. I also testify here today on behalf of the National Association of Consumer Advocates.[2]

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[1] The **National Consumer Law Center, Inc.** (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending* (6th ed. 2007) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. This testimony was written by Alys Cohen, Staff Attorney, and Diane E. Thompson, Of Counsel.

[2] The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

Today's hearing is about the recently announced changes regarding the Home Affordable Modification Program (HAMP). While we applaud the Administration for acknowledging that no foreclosure prevention program can do its job without principal reduction, assistance for the unemployed, and stopping the foreclosure process while considering whether a loan modification is possible, even these enhanced measures threaten to be an empty promise without meaningful transparency, accountability, and enforcement. These changes, introduced more than a year into the program, are still inadequate to address the scale of the continuing foreclosure crisis. Until the program addresses servicers' incentives to foreclose rather than modify loans and mandates program compliance, new initiatives are unlikely to dampen the country's economic distress.

HAMP must be further revised to provide substantially increased transparency and accountability, as well as reformed program rules:

- **Increase HAMP transparency.**
    - **Make public the net present value ("NPV") test used by servicers.**
    - **Require that servicers issuing HAMP denials provide more detailed information**.
    - **Establish a formal appeals process**.
    - **Make loan-level data available to the public, including data for fair lending analysis.**
- **Change the terms of the trial modification program to mitigate adverse effects on homeowners.**
    - **Require that trial modification payments be applied to principal and interest as specified under the permanent modification.**

    - **Convert homeowners who make three on-time trial modification payments automatically to permanent modifications.**
    - **Allow homeowners who fail a trial modification an opportunity to pay back the arrears through regular monthly installments consistent with an affordable payment.**
    - **Ease credit reporting requirements so that homeowners who enter a trial modification as current and make all trial modification payments as agreed do not suffer adverse credit reporting.**
- **Designate Treasury official(s) available to assist with Court or other required mediation cases.**
- **Expand HAMP eligibility and coverage.**
    - **Provide additional modifications for homeowners who experience unforeseeable future drops in income.**
    - **Establish a revised analysis of affordability for homeowners with interest-only and option ARMs.**
    - **Provide modifications for homeowners with unaffordable payments, even when the first mortgage payment is 31% or less of current income.**

To overcome the misalignment of incentives between servicers and the other stakeholders—investors, homeowners, and communities—mortgage servicing needs to be further regulated by Congress. We also recommend that Congress take other additional steps to ensure that the current economic crisis is not repeated. We recommend that Congress:

- **Pass legislation to mandate loan modification offers to qualified homeowners prior to foreclosure where the modification is consistent with net present value.**
- **Fund quality foreclosure mediation.**

- **Allow bankruptcy judges to modify home loans in bankruptcy.**
- **Ensure that homeowners receiving mortgage modifications do not find their new financial security undermined with a burdensome income tax bill.**
- **Pass strong legislation prohibiting the abusive mortgage lending practices that precipitated today's economic crisis.**
- **Establish an independent Consumer Financial Protection Agency that can establish strong rules to govern the market.**

II. HAMP Is Still Hindered by Noncompliance and a Lack of Transparency and Accountability

The program announced by President Obama's administration on March 4, 2009, was a welcome attempt to overcome servicers' long-standing reluctance to perform large numbers of sustainable loan modifications. It sought to change the dynamic that leads servicers to refuse even loan modifications that would be in the investors' best interests by providing both servicers and investors with payments to support successful loan modifications.

Yet, an entire year into the Home Affordable Modification Program (HAMP), homeowners and their advocates still report a stunning degree of noncompliance, including wrongful denials, provision of unsustainable payment plans without proper HAMP review, conclusion of foreclosure sales prior to complete HAMP review, and general confusion among and misinformation from servicer personnel.

These problems are magnified by the program's continuing failure to establish basic transparency and accountability.[3] The core eligibility analysis under HAMP, which is the net present value analysis, is not available to the public, thus depriving homeowners of the ability to verify whether a servicer's analysis is accurate. Many servicers deny homeowners based on allegations of "investor non-participation," while refusing to identify the provisions of the contracts with investors that forbid participation. The escalation hotline sponsored by Treasury seldom offers beleaguered homeowners relief, usually offering homeowners nothing more than a restatement of the servicer's unsupported assertions. One year into the program, Treasury still has not announced whether and what type of penalty a servicer would suffer for noncompliance, and it is not clear whether any meaningful penalties for noncompliance could be imposed under the contracts Treasury drafted.

In recent reports, both the GAO and SIG TARP have identified numerous concerns. The GAO report[4] found inconsistencies in implementation as well as widespread instances where borrowers were given inaccurate program information by servicer personnel—including prominent misinformation on websites and other easily-managed public information channels. According to the GAO, servicers do not consistently track complaints or their resolution and few complaints are referred to the servicers' in-house escalation process. In general, only those homeowners lucky enough to have a contact at the highest levels of management can count on having their complaints resolved. The SIG TARP report[5] found similar problems in the provision of incorrect and

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[3] Additional HAMP policy issues include, among others, the structure and payment rules regarding trial modifications, failure to provide an independent appeals process for homeowners, failure to consider homeowners for additional modifications where circumstances changed beyond the homeowner's control, and limited assistance to homeowners with negative amortization loans. These are discussed further in Section IV, below.

[4] Government Accountability Office, Home Affordable Modification Program Continues to Face Implementation Challenges (Mar. 25, 2010), *available at* http://www.gao.gov/new.items/d10556t.pdf.

[5] Office of the Special Inspector General for the Troubled Asset Relief Program, Factors Affecting Implementation of the Home Affordable Modification Program (Mar. 25, 2010), available at http://www.sigtarp.gov/reports/audit/2010/Factors_Affecting_Implementation_of_the_Home_Affordable_Modification_Program.pdf.

inconsistent information to borrowers. Strikingly, SIG TARP reported inconsistencies between the code and the written parameters of the key eligibility test, the NPV test.

SIG TARP also pointed to a fundamental flaw in the Administration's current measurement of the program's success. As SIG TARP noted, only permanent modifications, not temporary modifications, are a legitimate measure of HAMP's success. Yet even temporary modifications are falling off.

By Treasury's estimates, 1.8 million homeowners should be eligible for permanent modifications under HAMP. This figure is probably too conservative and may reflect double-counting in determining ineligible borrowers (for example, the numbers depend on servicer self-reporting as to restrictions in investor documents and reduce eligible borrowers both for "jumbo" loans and investor property, which may overlap). This figure is also dramatically lower than Treasury's initial estimates of 3-4 million to be helped by the program. Worse, these numbers are wholly outsized by the magnitude of the crisis. One in seven homeowners is delinquent on their mortgage or already in foreclosure.[6] Projected foreclosure totals number anywhere between 8 and 13 million.[7] Over 2 million homes already have been lost to foreclosure, according to the Hope Now Alliance.[8]

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[6] MBA National Delinquency Survey, Feb. 19, 2010. The combined percentage of loans in foreclosure or at least one payment past due was over 15 percent on a non-seasonally adjusted basis, the highest ever recorded in the MBA delinquency survey.

[7] Rod Dubitsky, Larry Yang, Stevan Stevanovic and Thomas Suehr, *Foreclosure Update: over 8 million foreclosures expected,* Credit Suisse (Dec. 4, 2008) (projecting 10 million foreclosures by 2012 depending on current unemployment rates); Jan Hatzius and Michael A. Marschoun, *Home Prices and Credit Losses: Projections and Policy Options*, Goldman Sachs Global Economics Paper (Jan. 13, 2009) (projecting 13 million foreclosures by 2014) at 16.

[8] Hope Now Phase I National Data (Nov. 2009), *available at* https://www.hopenow.com/industrydata/Summary%20Charts%20Nov%202009%2020100104%20v2.pdf. (Approximately 2.1 million foreclosure sales have been completed between 2007 and November 2009.)

Yet even measured against these facially inadequate goals, HAMP is falling behind. A year into the program, only 170,000 homeowners had received permanent modifications[9]—less than 10% of Treasury's scaled back expectations of the number to be helped.

III. Recently Announced Changes to HAMP Do Not Alter Core Problems in Mortgage Servicing

On March 24 and 26, 2010, the Administration announced several new measures that will be adopted as part of its foreclosure prevention program. While the package of "enhancements" acknowledges the importance of certain keys issues to fighting foreclosures—helping the unemployed, providing for principal reductions, stopping the foreclosure process during loss mitigation, and offering modifications to homeowners in bankruptcy—none of these measures seems likely to effectively address the key issues. The Administration has not yet addressed servicers' fundamental unwillingness to modify loans, although this comes at the expense of investors, and seems unable or unwilling to address servicers' significant profit motivations to foreclose.

The unemployment measure offers only short-term payment relief without any debt relief and for a period far shorter than the current average period of unemployment. The principal reduction program is based on voluntary principal write-downs, an approach that heretofore has not produced significant results and that adds complexity without providing transparency or accountability. Indeed, homeowners are instructed in the Consumer FAQ's published by the Administration that they should not talk to their servicer with questions about the principal reduction program and that

[9] U.S. Dept. of Treasury, *Home Affordable Modification Program, Servicer Performance Report Through Feb. 2010.*

their servicer will contact them if they are eligible.[10] Even the most promising initiatives--the mandatory stopping of the foreclosure process and the access to HAMP for homeowners in bankruptcy—cannot succeed unless HAMP significantly increases transparency and accountability.

A. Foreclosure Stops and Access to HAMP for Homeowners in Bankruptcy

On March 24, 2010, the Administration released Supplemental Directive 10-02.[11] Effective June 1, 2010, servicers may not refer a loan to foreclosure until either the borrower's eligibility is determined or reasonable efforts at solicitation have failed. After the servicer sends a non-approval notice, there is an additional 30-day hold on the foreclosure sale unless the borrower is not approved because the property or mortgage is ineligible, the borrower withdraws, or the borrower failed to make payments under a trial or permanent HAMP modification. In addition, once a borrower is in a trial modification based on verified income as described in Supplemental Directive 10-01, all foreclosure activity in the case must cease, even if the loan had previously been referred to foreclosure. Foreclosure activity may resume if the borrower fails to make trial modification payments.

Further, borrowers in an active chapter 7 or chapter 13 bankruptcy proceeding must be considered for HAMP if the borrower, borrower's counsel or bankruptcy trustee submits a request to the servicer. Servicers cannot object to confirmation of a chapter 13 plan, move for relief from the automatic stay, or move to dismiss the chapter 13 case on the basis that the borrower paid only the trial period plan payments rather than the scheduled mortgage payments. Borrowers in a chapter 13

[10] *See* Consumer FAQs, 2-3, *available at* http://makinghomeaffordable.gov/docs/Consumer%20FAQs%20032510%20FINAL.pdf.
[11] Supplemental Directive 10-02, Borrower Outreach and Communication, available at https://www.hmpadmin.com/portal/docs/hamp_servicer/sd1002.pdf.

case who are determined eligible for HAMP may be converted to a permanent modification without completing a trial period plan.

These changes will broaden access to HAMP, make it more likely that proper HAMP reviews are completed, and reduce the risk that a home is sold in foreclosure without a HAMP review. Most importantly, the new rules preventing foreclosure referrals before HAMP review for all HAMP servicer participants establishes the principle that evaluation for an appropriate loan modification is a proper prerequisite to foreclosure. Loan modifications provided prior to the commencement of foreclosure are more affordable to homeowners, because all foreclosure-related fees and costs would otherwise be capitalized into the loan principal for the modified loan, and they can save investors money as well. Moreover, homeowners trying to obtain modifications during foreclosure receive confusing, seemingly contradictory correspondence from the servicer and the foreclosure attorney, and in too many instances find that their home has been sold before the modification analysis has been completed, and hopefully these new measures will help prevent those situations from arising.

In November 2009, NCLC and NACA informally surveyed NACA members about the prevalence of foreclosure sales in violation of HAMP.[12] Almost 95% of the 113 consumer advocates[13] responding from over 24 states[14] represented homeowners in cases where the servicer attempted to proceed with a foreclosure sale without a completed HAMP review. Nearly 50% of the respondents represented 10 or more households in this situation.[15]

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[12] http://www.consumerlaw.org/issues/foreclosure/content/NCLC-NACA-Foreclosure-Sale-Survey-ResultsJan2010.pdf.
[13] 40% of the survey participants responded on behalf of an office; 60% responded on individual experience.
[14] AL, AZ, CA, CO, DC, FL, IL, IN, IA, LA, MD, MA, MI, MN, MS, MO, NV, NJ, NY, NC, OH, PA, SC, and VA.
[15] 113 NACA members from 24 states participated in the survey.

While homeowners already in foreclosure who are eligible to be evaluated for HAMP cannot avail themselves of a foreclosure stop during a HAMP review, those obtaining trial modifications based on verified income will be able to secure a stop to the entire foreclosure process. Nevertheless, over 2 million households currently face foreclosure[16] and many still will face the costs, confusion and potential wrongful sale of the family home prior to completion of the trial modification review.

This announcement also addresses the failure of servicers to provide HAMP modifications to homeowners in bankruptcy, despite their discretion to do so. The addition of a mandatory requirement to provide HAMP access to bankruptcy debtors highlights the limited utility of incentives. The evidence from HAMP to date, along with other information about the structure of the servicing market discussed below, strongly suggests that voluntary, incentive-based programs will not work. As the Administration has recognized with respect to borrowers in bankruptcy, servicers respond most effectively to mandates.

The additional guidance regarding borrower communication and communications between a servicer and a foreclosure attorney provided by Supplemental Directive 10-02 is welcome. To date, servicer outreach to homeowners has been inconsistent and often ineffective. Servicer communications with foreclosure attorneys are mostly computerized and often lack the level of detail and safeguards to ensure that homeowners have been reviewed for HAMP or any loss mitigation prior to foreclosure. Whether this guidance is sufficiently clear and enforceable to remedy these failures remains to be seen.

[16] Mortgage Bankers Association, National Delinquency Survey, Feb. 19, 2010.

B. Unemployed Homeowners

Unemployment figures remain high. According to the Bureau of Labor Statistics, the current rate of unemployment is 9.7%.[17] Historically, periods of very high unemployment were accompanied by essentially flat foreclosure figures, with only a modest increase in delinquency levels.[18] The combination of high rates of foreclosures and persistently high unemployment presents a challenge not seen since the Great Depression and requires similarly paradigm-shifting proposals.

The temporary assistance for unemployed homeowners announced on March 26 aims to reduce mortgage payments to 31 percent of current monthly income (such as unemployment insurance) or less through a forbearance plan for all borrowers otherwise eligible under HAMP. This plan, available to homeowners who seek assistance within the first 90 days of delinquency, will be available for at least three months and up to six months where available under investor agreements and regulatory guidelines. At the end of the assistance period, borrowers who are re-employed and whose mortgage payment is greater than 31 percent of their monthly income must be considered for HAMP. At that point, unemployment insurance no longer will be included in HAMP's qualification process. Homeowners who do not obtain re-employment at the end of the temporary assistance period will be routed to a path for surrendering homeownership under HAFA, where a short sale or deed in lieu of foreclosure may be available, along with minimal moving expenses.[19]

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[17] Press Release, The Employment Situation—March 2010, Bureau of Labor Statistic (Apr. 2, 2010), *available at* http://www.bls.gov/news.release/pdf/empsit.pdf.

[18] Testimony of Julia Gordon, Center for Responsible Lending, Before the U.S. House of Representatives, Committee on Oversight and Government Reform, Subcommittee on Domestic Policy, "*Foreclosures Continue: What Needs to Change in the Government Response?"* (Feb. 25, 2010) (citing statistics from the Mortgage Banker's Association National Delinquency Survey and the Bureau of Labor Statistics).

[19] This testimony focuses on the announced measures that aim to save homes. Short-sales and deeds-in-lieu are often touted as providing a "soft" landing for homeowners. Even under the Administration's enhanced payment standards, short sales and deeds-in-lieu continue to offer more benefit to investors—who save significantly on foreclosure costs—than homeowners, who suffer loss of their home, impaired credit, and, under the Administration's plan, are required to

While the proposal recognizes the importance of unemployment to the current rate of foreclosures, it is unlikely to provide adequate assistance to many unemployed homeowners. For most, it will not cover their likely period of unemployment. The median length of unemployment in March 2010 was 20 weeks,[20] eight weeks longer than the baseline time frame for the Administration's program. Half of all unemployed workers are unemployed for even longer before they re-gain employment. While some of these homeowners might benefit from six months of forbearance, that amount of coverage is not mandated and is dependent on investor approval. Servicers routinely use investor non-participation as the basis for denying HAMP participation to borrowers without providing any supporting documentation whatsoever; nothing in the current proposal encourages servicers to be more straightforward and careful in determining investor restrictions under this new proposal.[21]

The program's forbearance approach also does not reflect the financial reality of many who are unemployed. The forbearance itself will raise a homeowner's debt during this period of assistance. The difference between the homeowner's reduced monthly payment and regular monthly payment during the forbearance period will be immediately capitalized at the end of the assistance period, thus increasing the homeowner's debt and decreasing the chances that a homeowner will qualify for a HAMP modification, even if the homeowner has re-gained employment.

While a three month forbearance, or six month forbearance, will help some homeowners stay in their homes, many will need more assistance. The Administration has announced grants totaling no more than $2.1 billion that will be targeted to state-designed programs to relieve foreclosures in 10

continue making mortgage payments while the servicer negotiates the terms of the short sale or deed-in-lieu. Many homeowners would be able to achieve a softer landing for themselves by saving their mortgage payments for the duration of the foreclosure and then moving than agreeing to one of the Administration's foreclosure alternatives.

[20] Economic News Release, Table A-12: Unemployed persons by duration of unemployment, Bureau of Labor Statistics (Apr. 2, 2010), *available at* http://www.bls.gov/news.release/empsit.t12.htm.

[21] While Supplemental Directive 10-02 requires servicers to turn over investor participation information for compliance purposes, it does not require any information to be shared with homeowners.

states.[22] Even though these grants will help some unemployed homeowners facing foreclosure, many states and whole regions are not eligible for the targeted grants, nor is it clear that the funds allotted will cover the need in the targeted states.

Historically, the most successful assistance for unemployed homeowners has been a bridge loan program. The program most often discussed is the Homeowners' Emergency Mortgage Assistance Program in Pennsylvania. The program provides up to two years of assistance with mortgage payments or a maximum of $60,000.00, whichever comes first. When unemployment averages 6.5% or above for three months, assistance may be extended to three years. HEMAP loan recipients pay at least $25 a month and up to 40 percent of their net monthly income, as determined by HEMAP, towards their total housing expense. The difference between the regular monthly payment and the payments made by the homeowner accrue in an interest-free loan. Homeowners are obligated to make payments on their loan once their monthly income rises such that their housing expenses are less than 40 percent of their income, at which time interest will begin accruing on the loan. Upon sale or refinancing of the home, the entire loan must be paid in full. During HEMAP's existence, the amount repaid, with interest, has exceeded appropriations.

The Administration should promote similar bridge loan-style programs, both through the existing state grants and through the use of TARP money. The Administration could use TARP money to establish its own bridge loan program, where a person pays 31% of their income, as under HAMP, and the loan pays the rest for up to two years. The loan would be paid back when the mortgage is paid off, as is done with HUD partial claims.

[22] Press Release, U.S. Dept. of Treasury, Making Home Affordable, Administration Announces Second Round of Assistance for Hardest-Hit Housing Markets (Mar. 29, 2010), *available at* http://www.makinghomeaffordable.gov/pr_03292010.html.

C. Principal Reduction

The Administration's proposal to promote principal reductions has two components, one within HAMP and the other through FHA, discussed below. Under HAMP, servicers will be required to consider (although they will not be required to provide) principal reductions to HAMP-eligible borrowers who owe more than 115 percent of the current value of the home. Servicers will be required to run two NPV tests: the standard waterfall model; and one that places principal reduction first in the waterfall. If the NPV is higher under the alternative approach, servicers will have the option of using it as the basis for a loan modification.

The program starts by assuming principal forbearance, not reduction. The forborne amount then would be written down in three equal portions over three years, as long as the borrower remains current on modified payments. Furthermore, no principal reduction would be available at all unless second lien principal reductions are provided in conjunction with the first lien adjustments (Treasury is increasing incentive payments for its second lien program in an effort to promote such action). Second liens that are greater than six months delinquent, regardless of loan-to-value ratio ("LTV"), will be paid at the rate of six cents on the dollar; others will be paid in a range between ten and 21 cents on the dollar, depending on LTV.[23] For borrowers who are current on permanent or trial modifications at the time this new program becomes operational, servicers will be required to re-run the NPV analysis, using the new two-step framework. Servicers will not, however, be required to offer principal reduction, regardless of the results of the NPV analysis.

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[23] Addressing second liens is a critical piece of the puzzle in promoting affordable modifications. There is limited transparency and participation in the HAMP second lien program, which undermines its effectiveness. Moreover, eligibility needs to be expanded for modifications where the first and second lien payments together are greater than 31% of the borrower's income.

Servicers may choose to offer a principal reduction, as indeed servicers have been authorized to do from the beginning of HAMP. Potentially, the new two-step NPV analysis may produce more positive results than the earlier one-step NPV analysis. However, program experience to date and the general structure of the servicing industry give little cause for optimism that the voluntary, two-step procedure will result in greater use of principal reductions, even with modest servicer payments for doing so.

First, even the simpler, one-step NPV analysis currently in use has been the subject of criticism for lack of transparency by SIG TARP, servicers, and consumer advocates. Homeowners, attorneys and counselors nationwide report widespread failure to use the NPV model correctly, ranging from not running the NPV analysis at all to inputting incorrect information, including income, property location, and amount of the unpaid principal balance into the NPV model. SIG TARP, in its recent report, details multiple problems with implementation of the existing model, including widespread confusion among servicers as to how to use the model and problems with the underlying code in the model.

Second, these implementation challenges are magnified by the lack of transparency and accountability endemic in the HAMP program. The NPV test remains unavailable to the public. This means both that the entire model is immune from review by outside evaluators and those homeowners seeking modifications are unable to verify that the NPV model was applied correctly. While certain NPV inputs are available to homeowners who ask for them after a HAMP denial, this system is inefficient, time-consuming and less likely to lead to the proper flow of information due to the burden on the homeowner and the short timeline involved. Moreover, significant inputs, including home valuation, are not automatically made available to homeowners under Treasury's guidance, which means that only homeowners already embroiled in litigation with their servicers are able to ascertain and correct those errors in the servicer's inputs.

Third, the new program assumes that principal reductions that provide for higher NPV values will result in servicers voluntarily opting to adopt the forbearance/reduction modification model (and accept incentives for doing so). Yet, servicers previously had the option to providing NPV-positive modifications to homeowners in bankruptcy and to be paid for doing so, and generally they did not pursue this path. As discussed below, servicers do not necessarily profit more from providing NPV-positive modifications over pursuing foreclosure. Indeed, because a principal reduction will result in a hit to the servicer's largest source of income, the monthly servicing fee, servicers have a strong incentive to avoid principal reductions. Modest incentives are unlikely to change this picture.

Servicers have not heretofore been willing to make NPV-positive modifications—modifications that, by definition, should return more to investors than pursuing a foreclosure. Nor have investors heretofore shown much, if any, interest, in forcing servicers to pursue NPV-positive modifications. Investors have little direct authority over servicers, receive virtually no usable data on modifications, and suffer from their own competing interests, as between different investor classes and as between a modification with reduced payments or a foreclosure with certain costs.

The new principal reduction approach (which will not even be implemented until close to the end of this calendar year) is unlikely to coax many servicers into reducing principal. Where servicers do adopt this approach, lack of transparency will make it impossible for homeowners to advocate for principal reduction opportunities on their own loans and indeed Treasury has, so far, actively discouraged homeowners from doing so.

D. FHA Program Option

The recently announced FHA-based program provides further options for homeowners who are current on their mortgage but who owe more on their loan than the home is worth. Qualifying refinancings will reduce the amount owed on the first lien by at least 10 percent to an LTV of no more than 97.75 percent, while limiting all mortgage debt to no more than 115 percent of the current value of the home, thus requiring write-downs of many second liens. Because this option is only available for homeowners who are current on their mortgage, homeowners with unsustainable mortgage payments will receive no assistance.

This new program improves upon the FHA's Hope for Homeowners program by permitting lower FICO score, taking a more streamlined approach to paying down second liens, and by avoiding the complexities and mixed incentives of shared appreciation. Yet the new program still suffers from the same fatal flaw: a misguided belief that servicers will voluntarily do the right thing and agree to principal reductions. Moreover, in the existing credit climate, it is not clear that there will be new lenders willing to refinance these high LTV loans.

IV. Servicers' Lack of Alignment with the Interests of Investors or Homeowners Contributes to the Failure to Do More Loan Modifications.

Servicers' interests often do not align with those of investors or homeowners. Servicers, unlike investors or homeowners, do not necessarily lose money on a foreclosure. Nor do the large servicers currently have any difficulty replacing servicing rights lost to foreclosure at attractive prices.[24] The result is that servicers are often indifferent at best as to whether a delinquency ends in a modification or foreclosure. Until this situation is addressed more directly, loss mitigation will favor the interests of servicers over those of homeowners and investors.

A. Servicers Have Different Interests Than Investors.

Servicers are not investors. Investors hold the note, or a beneficial interest in it, and are, in general, entitled to repayment of the interest and principal. Servicers collect the payments from the homeowners on behalf of the investors. The bulk of their income comes from a percentage payment on the outstanding principal balance in the pool; the bulk of their net worth is tied to the value of the mortgage servicing rights they purchased. A servicer may or may not lose money—or lose it in the same amounts or on the same scale—when an investor loses money. And it is servicers, not investors, who are making the day-to-day, on the ground, decisions as to whether or not to modify any given loan.

Investors do stand to lose money, at least collectively, when there is a foreclosure. The available data suggests that investors lose ten times more on foreclosures than they do on modifications.[25] In particular, leading investor groups have advocated broader use of principal reductions as part of the anti-foreclosure arsenal, but only a handful of servicers have obliged.[26]

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[24] Jeff Horwitz, *Mortgage Sellers Are Fed Up with Megaservicers' Oligopoly*, Am. Banker, Apr. 9, 2010.

[25] "Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes?" Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary, 111th Cong. (2009) (testimony of Alan M. White).

[26] "Preserving Homeownership: Progress Needed to Prevent Foreclosures," Hearing Before the Senate Comm. on Banking, Housing & Urban Affairs, 111th Cong. (July 16, 2009) (testimony of Curtis Glovier, on behalf of the Mortgage Investors Coalition).

Servicers, on the other hand, are entitled to repayment of all their expenses off the top when there is a foreclosure,[27] while recovery of their costs in a modification is much less clear.[28] Worse, performing large numbers of loan modifications would cost servicers upfront money in fixed overhead costs, including staffing and physical infrastructure. Creating affordable and sustainable loan modifications for distressed homeowners on a loan-by-loan basis is labor intensive.[29] Under many current pooling and servicing agreements, additional labor costs incurred by servicers engaged in this process are not compensated by the loan owner. By contrast, servicers' costs in pursuing a foreclosure are compensated. Under this cost and incentive structure, it is no surprise that servicers continue to push homeowners into less labor-intensive repayment plans, non-HAMP loan modifications, or foreclosure.

B. Servicers' Business Model Involves As Little Service As Possible.

As with all businesses, servicers add more to their bottom line to the extent that they can cut costs.[30] Servicers have cut costs by relying more on voicemail systems and less on people to assist homeowners, by refusing to respond to homeowners' inquires, and by failing to resolve borrower disputes. Servicers sometimes actively discourage homeowners from attempting to resolve matters.

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27 *See, e.g.,* Ocwen Fin. Corp., Annual Report (Form 10-K), at 4 (Mar. 17, 2008) (advances are "top of the waterfall" in a foreclosure and get paid first); Wen Hsu, Christine Yan, Roelof Slump, FitchRatings, U.S. Residential Mortgage Servicer Advance Receivables Securitization Rating Criteria 1 (Sep. 10, 2009) (same.

28 American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 1 (June 18, 2009).

29 Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 7(Oct. 3, 2007), *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.

30 *See* Joseph R. Mason, Servicer Reporting Can Do More for Modification than Government Subsidies 17 (Mar. 16, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331(noting that "servicers' contribution to corporate profits is often . . . tied to their ability to keep operating costs low").

As one attorney in Michigan attempting to arrange a short sale with Litton reported, the voice mail warned, "If you leave more than one message, you will be put at the end of the list of people we call back."

Servicers, despite their name, are not set up to perform or to provide services.[31] They are set up to accept payments from the borrower and distribute those payments—to the insurance company or taxing authority, in case of escrow payments, or to a trustee for distribution to investors, in the case of principal and interest payments. The receipt and distribution of payments is largely automated, with accounting functions delegated to software programs.[32] In general, interaction with borrowers is minimal and discouraged.

Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate.[33] As a result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead homeowners are being pushed into short-term modifications and unaffordable repayment plans.

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[31] *Cf.* Joe Nocera, *Talking Business; From Treasury to Banks, An Ultimatum on Mortgage Relief,* N.Y. Times, July 11, 2009 (characterizing work of servicers as "relatively simple" whose default servicing consisted largely of either "prodd[ing] people" to pay or "initiat[ing] foreclosure").

[32] *See In re* Taylor, 407 B.R. 618 (Bankr. E.D. Pa. 2009) (describing the extreme reliance on a computer system to perform the servicing, to the point that the computer system was personified by the actual living employees of the servicer).

[33] Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities* 9-10 (Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs Working Paper No. 2008-46); State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance, Data Report No. 3 at 8 (2008), http://www.csbs.org/Content/NavigationMenu/Home/SFPWGReport3.pdf; Preston DuFauchard, California Department of Corporations, Loss Mitigation Survey Results 4 (Dec. 11, 2007); *cf.* Aashish Marfatia, Moody's, U.S. Subprime Market Update November 2007 at 3 (2008) (expressing concern as to servicers' abilities to meet staffing needs).

C. Servicers Maximize Income in Ways that Hurt Both Homeowners and Investors.

In the interest of maximizing profits, servicers have engaged in a laundry list of bad behaviors, which have considerably exacerbated foreclosure rates, to the detriment of both investors and homeowners.[34]

Most pooling and servicing agreements permit servicers to retain fees charged to delinquent homeowners and to collect those fees post-foreclosure before the investors receive any recovery.[35] Examples of these fees include late fees[36] and fees for "default management" such as property inspections.[37]

The profitability of these fees can be significant.[38] Late fees alone constitute a significant fraction of many subprime servicers' total income and profit.[39] Worse, the very presence of these fees may later

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[34] *See* National Consumer Law Center, Foreclosures, Ch. 6 (2d ed. 2007 & Supp.) (describing the most common mortgage servicing abuses).

[35] See, e.g., Prospectus Supplement, Chase Funding Loan Acquisition Trust, Mortgage Loan Asset-Backed Certificates, Series 2004-AQ1, at 34, (June 24, 2004), available at http://www.sec.gov/Archives/edgar/data/825309/000095011604003012/four24b5.txt ("[T]he Servicer will be entitled to deduct from related liquidation proceeds all expenses reasonably incurred in attempting to recover amounts due on defaulted loans and not yet repaid, including payments to senior lienholders, legal fees and costs of legal action, real estate taxes and maintenance and preservation expenses.").

[36] See, e.g., Prospectus, CWALT, INC., Depositor, Countrywide Home Loans, Seller, Countrywide Home Loans Servicing L.P., Master Servicer, Alternative Loan Trust 2005-J12, Issuer 56 (Oct. 25, 2005) ("In addition, generally the master servicer or a sub-servicer will retain all prepayment charges, assumption fees and late payment charges, to the extent collected from mortgagors).

[37] See, e.g., ., Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at S-73 (June 27, 2007):

> **Default Management Services**
>
> In connection with the servicing of defaulted Mortgage Loans, the Servicer may perform certain default management and other similar services (including, but not limited to, appraisal services) and may act as a broker in the sale of mortgaged properties related to those Mortgage Loans. The Servicer will be entitled to reasonable compensation for providing those services, in addition to the servicing compensation described in this prospectus supplement.

[38] *See In re Stewart*, 391 B.R. 327, 343, n.34 (Bankr. E.D. La. 2008) ("While a $15.00 inspection charge might be minor in an individual case, if the 7.7 million home mortgage loans Wells Fargo services are inspected just once per year, the revenue generated will exceed $115,000,000.00."), *aff'd,* 2009 WL 2448054 (E.D. La. Aug. 7, 2009).

[39] *See, e.g.*, Ocwen Fin. Corp., Annual Report (Form 10-K), at 34 (Mar. 12, 2009). (revenue from late charges reported as $46 million in 2008 and made up almost 18% of Ocwen's 2008 servicing income); Gretchen Morgenson,

make a modification unaffordable to the homeowner.[40] Neither homeowners nor investors profit from the imposition of these fees, but servicers do.

D. Servicers Have Disincentives to Perform Principal Reductions, Even When Doing So Would Benefit the Trust

Some servicers, notably Ocwen, have made some principal reductions. But other servicers—including those who are also major lenders—have not. In part, this represents nothing more than experience: Ocwen has more experience modifying loans than many other servicers. In part, it reflects the varying incentives servicers have weighing against loan modifications.

Of key importance is whether or not the loss of a principal reduction is recognized immediately or if it is delayed. Most PSAs are silent on the treatment of principal reductions or forbearance.[41] If recognition of the loss is immediate, servicers face reduced income in two ways, their monthly servicing fee and income from any subordinate tranches. Because recognition of the loss is not delayed, servicers are unlikely to be neutral or even positive towards principal reductions.[42] This

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Dubious Fees Hit Borrowers in Foreclosures (Nov. 6, 2007) (reporting that Countrywide received $285 million in revenue from late fees in 2006).

40 *See* Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims,* 87 Tex. L. Rev. 121 (2008) (reporting that servicers appear to be imposing often improper default-related fees on borrowers in bankruptcy proceedings). Under the Department of the Treasury's Home Affordable Modification Program, servicers are required to waive unpaid late fees for eligible borrowers, but all other foreclosure related fees, including, presumably, paid late fees, remain recoverable and are capitalized as part of the new principal amount of the modified loan. *See* Home Affordable Modification Program, Supplemental Directive 09-01 (Apr. 6, 2009).

41 *See* American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 1 (June 18, 2009), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf.

42 *See generally* American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions (June 18, 2009), available at http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf (discussing impact of accounting for principal forbearance).

accounting nicety accounts, in part, some industry analysts believe, for the high rate of loan modifications with principal reductions performed by Ocwen in 2007.[43]

Worse, servicer's largest source of income is the monthly servicing fee. The monthly servicing fee is set as a percentage of the outstanding loan principal balance in the pool. Once a principal write down is recognized, the outstanding principal balance of the pool declines and so does the servicer's monthly fee, permanently.

Servicers will also take a hit against their residual income if the loss is recognized immediately. Commonly, servicers also derive some income from the lowest level investment interests in the pool, called residuals.[44] Residuals represent payment of the surplus income after the senior certificate holders have been paid. If the pool shrinks, through foreclosure, prepayment, or principal reduction, or the interest rate drops on the loans in the pool due to modifications, there will be less of a surplus, and the servicer will suffer a loss. Once a pool suffers a certain level of loss, further payments out of residual income are cut off. If the loss is recognized immediately, the subordinate tranches in most cases bear the entire cost.[45] Since industry practice, despite the silence in the PSAs,

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[43] Ocwen was apparently not recognizing the loss immediately, and thus shifting more of the pain to senior bond holders and away from the subordinate tranches. Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 7-8 (2008).

[44] *See, e.g.,* Ocwen Fin. Corp., Annual Report (Form 10-K), at 20 (Mar. 17, 2008); Joseph R. Mason, Mortgage Loan Modification: Promises and Pitfalls 8 (Oct. 2007) (servicers who own residual interests always lose money when loans are modified). In some cases, the servicer may even bet against itself, by purchasing a credit default swap on the pool, in which case it makes money if there is a foreclosure. *See* Patricia A. McCoy & Elizabeth Renuart, The Legal Infrastructure of Subprime and Nontraditional Home Mortgages 36 (2008), *available at* http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit

[45] *See* American Securitization Forum, Discussion Paper on the Impact of Forborne Principal on RMBS Transactions 3-6 (June 18, 2009), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Principal_Forbearance_Paper.pdf.

has now moved towards recognizing the principal write down as an immediate loss, many servicers may be doubly reluctant to write down principal, regardless of the investors' desires.[46]

V. The Core HAMP Program Still Needs Substantial Revision

While the Administration has taken laudable steps to standardize loan modification procedures, HAMP still needs substantial program improvements. We recommend the following changes to HAMP:

1. Increase HAMP Transparency. Servicers routinely deny HAMP modifications for what appear to be arbitrary or unfounded reasons. Recent guidance requiring notice to borrowers is some progress, but does not provide sufficient detail to enable homeowners to evaluate the legitimacy of denials. Some servicers consistently disregard existing notice rules. Fundamentally, the HAMP program itself wholly lacks accountability for servicers; servicers routinely assert that they are not required to follow HAMP guidelines or offer HAMP modifications, even to qualified borrowers. It is essential that the Administration:

a. Make public the net present value ("NPV") test used by servicers. The NPV model must be accessible to homeowners and advocates in order to determine whether the servicer used the test accurately in denying a HAMP modification. Without access to the NPV analysis, including all inputs used by the servicer, homeowners are entirely reliant on the servicer's good faith.

b. Require that servicers issuing HAMP denials provide more detailed information. When the basis of denial is a failure of the NPV test, all NPV inputs and outputs must be provided as part of the initial denial letter. Key investor information should be provided where that is the basis of the

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[46] *See* Rod Dubitsky, Larry Yang, Stevan Stevanovic, Thomas Suer, Credit Suisse, Subprime Loan Modifications Update 7-8 (2008).

turndown. Basic information including the investor or guarantor's name, identification of the controlling documents, and a summary of efforts taken to secure investor approval for the proposed loan modification specifically and participation in HAMP generally should be provided in each relevant denial notice.

c. Establish a formal appeals process. Homeowners need recourse beyond the servicer. The Administration must institute a formal appeals process by an independent government entity for borrowers who believe their HAMP application was not handled properly. The current Freddie Mac compliance process does not effectively address individual complaints; the escalation process available through either the HOPE hotline or escalations@hmpadmin.com provides little more, in our experience, than a restatement of the initial denial. In order for HAMP to be effective, homeowners must be able to seek and obtain redress when a servicer has failed to comply with the Supplemental Directives.

d. Make loan level data available to the public, including data for fair lending analysis. A core component of any government program is public accountability. To date, no raw data has been made available for independent analysis. The availability of such information will allow researchers to review the reach and affects of the program, and will give community advocates a means to examine the role of HAMP in their areas. No analysis of this sort is complete without a fair lending analysis; it is essential that the Administration ensure that the program is subject to robust review.

2. Change the terms of the trial modification program to mitigate adverse effects on homeowners. Homeowners are left worse off after entering into a trial modification. The reporting of payments under trial modifications means that even homeowners who are current upon entering a trial modification and make every trial modification payment in full and on time, still emerge with a negative mark against their credit, which can result in lost jobs and rental housing, as well as higher-priced credit. Moreover, since the trial modification payments are by definition less than the full contract payment under the mortgage, and the terms of the mortgage are not altered during the trial modification, homeowners finish a trial modification owing more on their homes than when they started. We have seen servicers use these arrears, accumulated during the trial modification, as the basis for initiating a foreclosure against a homeowner, post-trial modification. The Administration should:

a. Require that trial modification payments be applied to principal and interest as specified under the permanent modification. Treasury has already recognized the harm that can be done by servicer delay in requiring any arrearages accumulated between the official end of the trial modification and the beginning of the permanent modification to be treated as principal forbearance. Treasury should go further and specify that all payments made during the duration of the trial modification be applied, retroactively if necessary, to principal and interest as specified under the terms of the permanent modification.

b. Convert homeowners who make three on-time trial modification payments automatically to permanent modifications. Servicer delays in converting trial modifications to permanent modifications are unacceptable. They increase costs to homeowners and create significant periods of uncertainty. An automatic conversion would address those problems.

c. Allow homeowners who fail a trial modification an opportunity to pay back the arrears through regular monthly installments consistent with an affordable payment. No lump sum payment should be required.

3. Designate Treasury official(s) for assistance with Court or other required mediation cases. Court-supervised mortgage mediation programs help borrowers and servicers find outcomes that benefit homeowners, communities and investors. Servicers, however, often do not negotiate in good faith, even with a mediator present. For example, representatives of servicers often attend mediations without the necessary authority to provide a modification, without any information about the matter at all and without any consideration of HAMP. Moreover, many judges and mediators often have questions regarding HAMP and seek input from counsel. For those communities with mediation programs, Treasury should designate an official or officials to provide assistance to mediators to ensure that HAMP is properly considered in mediation sessions, answer questions, and serve as a point of contact for escalated disputes. Designating a Treasury Department contact for such inquiries would substantially assist public officials seeking to interpret HAMP.

4. Expand HAMP eligibility and coverage. HAMP must recognize the realities of re-default and the limits of its program and revise its guidelines accordingly. The Administration should:

a. Provide additional modifications for certain homeowners with unforeseeable future drops in income. Many homeowners who receive HAMP loan modifications will suffer subsequent drops in income through no fault of their own. Under current HAMP policy, these homeowners are precluded from applying for a new loan modification. This policy should be changed for borrowers with involuntary reductions in income, such as unemployment, divorce or death of a co-borrower, or increases in expenses such as medical debt.

b. Establish a revised analysis of affordability for homeowners with interest-only and option ARMs. For interest-only and option ARMs, current payments do not reflect the long-term affordability of the loan. An evaluation should be made using a fully amortizing payment, calculated at the interest rate currently being assessed on the mortgage loan, regardless of when the payments will reset under the loan terms. Determination of affordability should not be made on the basis of a negatively amortizing, minimum payment.

c. Provide modifications for homeowners with unaffordable payments, even when the first mortgage payment is 31% or less of current income. Second mortgages or high medical debt can render a first mortgage payment of 31% or less unaffordable. Homeowners' actual, reasonable living expenses may mean that 31% is not, in fact, a sustainable and affordable payment when the total dollars available are quite low. Treasury should require and subsidize modifications below 31% where the homeowner has low residual income or high fixed expenses.

VI. Conclusion

Thank you for the opportunity to testify before the Subcommittee today. The foreclosure crisis is continuing to grow. Despite recently announced enhancements to the HAMP program, the program still lacks fundamental transparency and accountability. Further program changes also are needed to enable the program to reach many more homeowners who can benefit from the program. In addition, it is clear that HAMP can not do the job on its own and thus additional steps that do not rely on voluntary measures by the mortgage industry are in order.

Congress should pass legislation to mandate loan modification offers to qualified homeowners prior to foreclosure where the modification is consistent with net present value, and also should allow bankruptcy judges to modify home loans in bankruptcy. Congress also should ensure that homeowners receiving mortgage debt forgiveness or modifications do not find their new financial security undermined with a burdensome tax bill and should fund qualify mediation programs. Further, it should pursue further reform of the servicing industry and pass strong legislation prohibiting the abusive mortgage lending practices that precipitated today's economic crisis. Finally, Congress should establish an independent Consumer Financial Protection Agency that can establish strong rules to govern the market. We appreciate the Committee's interest in these pressing matters and look forward to working with you to address the challenges that face our nation's communities.