COMMENTS
to the
FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 360

Advance Notice of Proposed Rulemaking Regarding Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After March 31, 2010

by the **National Consumer Law Center**
on behalf of its low-income clients
and for
the **National Association of Consumer Advocates**

February 22, 2010

The National Consumer Law Center1 ("NCLC") submits the following comments on behalf of its low income clients, as well as the National Association of Consumer Advocates[2] ("NACA"), to the Federal Deposit Insurance Corporation. While the ANPR covers securitizations of all types of credit, in these comments we focus only on residential mortgage backed securities (RMBS).

We very much appreciate the FDIC's initiative and creativity evident in this and previous explorations of ways to improve the mortgage market. The FDIC's increased requirements for securitizations will be an extremely effective method of accomplishing significant changes in ways mortgages are originated, underwritten, serviced, and dealt with after default.

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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), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009), and *Foreclosures* (2nd 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 address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments were written by NCLC attorneys Margot Saunders and Diane E. Thompson and by **Professor Kurt Eggert of Chapman University Law School.**

[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.

These comments are in four parts:

1. Background on the Need for the FDIC's Rule on Securitizations
2. The Current Securitization System Incentivizes Risky Loans
3. Proposed Rules to Ensure Solid Origination Practices – Realigning Incentives
4. Necessary Rearrangements for Servicer Incentives

1. Background on the Need for the FDIC's Rule on Securitizations.

The FDIC's interests in strengthening securitizations of mortgage loans include both the protection of investors and consumers. The essential – and exquisitely correct – idea behind the ANPR is that, if incentives are realigned among all the parties, the system will work more successfully for everyone, including society in general. This goal of ensuring that all parties profit, not at the expense of others but through the success of others, will solve many of the problems in the mortgage market.

It is unfortunately necessary to use these circuitous means to regulate the extension of credit to homeowners. Stringent regulation of loan origination coupled with private enforcement (thereby enlisting an army of lawyers to enforce the rules) against both the originator and ultimate holders of the loan would be much simpler and more straight-forward. Servicers could be required to act in the best interests of both investors and homeowners, with clear public and private legal liability for failure to follow the rules.

Congress could require these standards, but this seems unlikely to occur in the near future. State legislation could mandate these requirements for entities they charter, but national banks, federal savings banks, and their subsidiaries would claim to be exempt from these requirements, leaving only a small portion of the marketplace covered.

The Federal Reserve Board does have the authority to impose all of these requirements on the originators, the lenders, the investors and the servicers of mortgage loans. The Federal Reserve Board has this authority under both its FTC authority to regulate against unfair practices by banks,[3] as well as the explicit authority provided in HOEPA.[4] Yet, the Board has only acted around the edges.[5]

That leaves the FDIC. The FDIC does not have direct rulemaking authority to cover all mortgage originations and servicing violations. Nonetheless, the FDIC has a legitimate interest in ensuring the stability of the institutions it insures. Changes along the lines

[3] Pursuant to Reg AA, 15 U.S.C.A. § 57a(f).

[4] 15 USC § 1639(l)(2)(a).

[5] The Federal Reserve Board has significantly improved some of the rules governing the extension of mortgage credit using its authority under § 1639(l)(2)(a), including the most important requirement that a borrower's ability to repay the loan be fully determined (Reg Z § 226.35(b)(1)). However, these rules only apply to a part of the mortgage market, and even these rules would not have prevented most of the payment option arm loans currently in default.

suggested by the FDIC in the ANPR should promote market strength and stability. The FDIC mandate of minimum standards for securitizations by banks will establish the new industry standard for RMBS. Once the FDIC acts, we would expect state and informal regulators – such as the American Securitization Forum – to adopt the FDIC standards as the minimum required for the entities they regulate or govern.

In the unlikely event that the FDIC's securitization standards were not adopted by other regulators, FDIC-insured banks would be in the enviable position of providing a better product, with logical, transparent, enforced rules. RMBS issued by non-bank actors in the marketplace would always be characterized as having considerably more risk. The risks of participating in alternative RMBS would flow from at least four different sources:

- risk resulting from default in the underlying mortgage loans;
- risk resulting from litigation costs incurred as the result of lawsuits from borrowers, investors, or other actors in the mortgage production channel;
- risk resulting from regulatory enforcement by a non-bank regulator protecting consumers or investors from violations of applicable law; or
- risk resulting from less full disclosure of relevant information about the value of the underlying assets of the securitization.

One immediate result of the FDIC's new securitization rules imposed on banks would be an increase in the value of securitizations subject to these stricter, more transparent standards. The risk to incursions into the Federal Deposit Insurance fund will be less likely. And homeowners will be offered much safer mortgages.

In the ANPR, the FDIC has identified the key problem that led to the current mortgage market problems: misaligned incentives. As the FDIC also implicitly recognizes, once mortgage lending starts again, there will be little to stop a repeat of the current problems. The marketplace has failed as a regulator. Traders and intermediaries were able to structure hundreds of millions of dollars in investments with the expectation that the RMBS in which they were invested would experience huge losses.[6] Those who issued credit enhancement on these deals—the credit enhancement that allowed, in part, the profit by a few from the failure of the pool—did so with their eyes open, knowing the pool was, at best, poorly underwritten.[7] So long as mortgage originators profit from making loans without regard to long-term sustainability, and investors believe they can protect themselves from shoddy underwriting and review practices through external credit support (known in other contexts as insurance) these marketplace participants will have no incentives to change the rules.

The rules must change. Realigning the incentives between all the players requires real regulation of the process, including meaningful limitation on the terms of the loans and the servicing of loans.

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[6] *See* Gretchen Morgenson and Louise Story, *Quiet Conflict with Goldman Helped Push AIG to Precipice*, New York Times at A1, Feb., 7, 2010.

[7] *Id.* Timeline – "Feb. '06 – AIG stops writing insurance protection on securities containing subprime mortgage bonds, because of lax lending practices."

2. The Current Securitization System Incentivizes Risky Loans

In the ANPR, the FDIC correctly notes that the securitization process has caused a misalignment of incentives that led to the lowering of underwriting standards. As a result, default rates dramatically increased for both prime and subprime mortgage loans made after 2004.[8] Most of the blame for these lowered underwriting standards can be placed on the "Originate to Distribute" model whereby lenders shift the risk of loan default to the investors in mortgage-backed securities, and so lenders can make loans with little concern for the losses resulting from those loans.[9] This shedding of default risk drastically decreases the value of underwriting to loan originators, except when it actually helps them sell their loans.[10]

Other effects of securitization also increase the risk of bad lending, and it is important that the FDIC recognize all of these other dangers. Securitization works by splitting what had been the work of a single entity into parceled tasks to various market participants. One entity will make the individual loans, another will collect the payments, another will package the loans into a mortgage pool, another rate the resulting securities, and yet another entity will own the beneficial interest in the loan. As a result, another serious hazard of securitization is that too many of the participants in the chain of actions are paid not for the quality of loans but for the quantity. Payment for the quantity of loans made, rather than their quality rewards entities who maximize the number of loans made and securitized, without regard for the default risk of those loans.

Securitization also causes lenders to change how they underwrite mortgages and encourages them to rely on "hard" mortgage underwriting, using objective data such as FICO scores or loan-to-value ratios that can be easily communicated to third parties and plugged into computerized risk models by rating agencies. Securitization discourages lenders from engaging in "soft" mortgage underwriting, which depends on direct, often difficult to quantify "soft" information about the individual borrower or the property, and may include listening to and analyzing the borrower's explanation for past difficulties in making credit payments and determining whether the hard numbers for the borrower or property make sense given what a loan agent can perceive about them. Both "soft" and "hard" underwriting have strength and weaknesses, with "hard" underwriting limiting red-lining and "soft" underwriting better at reacting to changing mortgage conditions or new mortgage products. Lenders who securitize their loans tend to jettison "soft" underwriting because it

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[8] Gene Amromin & Anna L. Paulson, *Comparing Patterns of Default Among Prime and Subprime Mortgages,* 33 Econ. Perspectives (May 18, 2009), *available at* SSRN: http://ssrn.com/abstract=1406594 at 18.

[9] Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904661 at 550–51.

[10] For a discussion of this point, and of how securitization helped cause the subprime collapse, *see* Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 Connecticut L. Rev. 1257 (2009). Available at SSRN: http://ssrn.com/abstract=1434691.

is difficult to communicate the information garnered by and the benefits of such underwriting to secondary market participants.[11]

Lenders and Wall Street came to rely almost exclusively on "hard" objective underwriting criteria. As more loans are securitized, the rates of mortgage loans for borrowers with similar hard credit criteria converge, which shows that lenders were foregoing "soft" underwriting and instead focusing more exclusively on hard information.[12] One study of underwriting standards concluded that there was a weakening of "soft" underwriting standards after 2004, relatively hidden from the secondary market, even though FICO scores and loan to value ratios stayed relatively stable. These weakened underwriting standards were blamed by for *half* of the recent surge of foreclosures, with the rest caused by weakened economic conditions.[13]

One real weakness of using objective underwriting exclusively is that market participants can game the system and are thus encouraged to push each loan to the limits that the objective system will tolerate. Loans with third party originators, such as brokers, default at a higher rate than loans made directly by lenders.[14] Brokers pushed borrowers to obtain the maximum loan possible, the use of yield spread premiums encouraged brokers to entice borrowers into paying higher interest rates, and lenders pushed rating agencies and investment banks to securitize the most risky loans their mathematical models would tolerate.[15] In this way, securitization made the financial system more fragile by encouraging the creation of loans at the margins of what was tolerated.

Securitization also encourages a boom and bust model of subprime lending, whereby subprime lenders grow rapidly by immediately selling their loans by securitizing them, then relending the money. In the years before the subprime meltdown, many subprime lenders expanded rapidly, only to go bust when the subprime securitization pipeline went dry. New Century Financial Corporation, for example, increased its loan origination volume from $14

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[11] Uday Rajan et al., *The Failure of Models That Predict Failure: Distance, Incentives and Defaults* 3 (Chi. Graduate Sch. Bus., Research Paper No. 08-19, 2008), *available at* http://ssrn.com/abstract=1296982.

[12] *Id*., at 25–26.

[13] Charles D. Anderson, et al., Deconstructing the Subprime Debacle Using New Indices of Underwriting Quality and Economic Conditions: A First Look 3 (July 15, 2008) (unpublished working paper), *available at* http://ssrn.com/abstract=1160073, at 32. Another study found that for two loan portfolios of similar credit quality, where one portfolio is more likely to be securitized, it has a higher default rate than the other portfolio less likely to be securitized, and the authors of the study attribute this difference in default risk to lenders' greater incentive to screen loans they are more likely to hold rather than sell. Benjamin J. Keys et al., Did *Securitization Lead to Lax Screening? Evidence from Subprime Loans 2–3* (unpublished manuscript, 2008), *available at* http://ssrn.com/abstract=1093137.

[14] William P. Alexander, et al., *Some Loans Are More Equal than Others: Third-Party Originations and Defaults in the Subprime Mortgage Industry*, 30 REAL ESTATE ECON. 667, 668 (2002).

[15] *Hearings Before the H. Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 111th Cong. 3 (2009), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/gordon_testimony_3-11-09_final.pdf, (testimony of Julia Gordon, Center for Responsible Lending).

billion in 2002 to $60 billion just four years later, only to declare bankruptcy when its funding sources were cut off.[16] Subprime securitization has proved to be an unreliable funding supply and this instability itself discourages careful underwriting. Subprime lenders that know they may go bust soon when the money supply dries up have less incentive to engage in good underwriting for the long haul and instead are encouraged to make as many loans as they can while they have a funding source, whether those loans are are likely to default or not.

Private label securitization depends on rating agencies to rate the securities. Yet rating agencies have an essential conflict of interest: they are paid by the issuers they are supposed to police rather than the investors they are supposed to protect.[17] The issuers have been able to shop around for the rating agency that would provide the best set of ratings for their proposed loan pool. Lenders punished cautious agency ratings by taking their business elsewhere. This encouraged the rating agencies to engage in a race to the bottom to bestow AAA ratings on the greatest proportion of securities backed by risky subprime loans. One rating agency internal memo noted –

> The real problem is not that the market . . . .underweights ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating.[18]

Rating agencies regularly rated securities backed by pools of new, exotic loan products without the record of payment histories by which the rating agency could actually judge the likely future performance of the new loan pool. Rating agencies should not have rated securities backed by loans with no real historical record of default rates, because the ratings are supposed be based on just such a record. However, rating these subprime-backed mortgage securities was so profitable that the rating agencies rated them anyway. The lack of necessary records was counter-balanced by the fact that this was occurring during a period of growing housing prices with few defaults. By the mid 2000s, the ratings for subprime securities became increasingly unreliable as rating agencies continued to underestimate the

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[16] William M. VanDenburgh & Philip J. Harmelink, *Accounting Implications of the Subprime Meltdown: The Peril of Forgetting the Fundamentals*, CPA J. 24, 24–25 (Dec. 2008) (citing *In re* New Century TRS Holdings, Inc., No. 07-10416, 2008 WL 850030 (Bankr. D. Del. Feb. 29, 2008) (Final Report of Michael J. Missal, Bankr. Court Exam'r)). In 1998, the Russian debt crisis and the related collapse of the private hedge fund LTCM caused investors to rush to safety, and they abandoned securities issued by subprime lenders, moving instead to U.S. Treasury securities. Many subprime lenders went out of business. Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: Not Again!*, AM. BANKR. INST. J., Sept. 2007, at 1.

[17] Joseph R. Mason & Joshua Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions 58 (May 3, 2007) (unpublished working paper), *available at* http://ssrn.com/abstract=1027475.

[18] *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. On Oversight and Gov't Reform*, 110th Cong. (2008), *available at* http://oversight.house.gov/documents/20081022124926.pdf (confidential presentation to Moody's Board of Directors), *available at* http://oversight.house.gov/documents/20081022111050.pdf.

default risk for residential mortgages.[19] The significantly over-rated securities – issued by agencies which are still respected, active market participants – have defaulted at rates far, far higher than predicted.

Investors have been among the big losers in the mortgage meltdown, as the value of their mortgage-backed securities has decreased significantly. One question is why some of the most sophisticated investors purchased these securities, and why they believed in the AAA ratings given to securities backed by risky loans. The investors' failure to assess accurately the risk of these securities can be ascribed to several factors. Investors were drawn to the higher returns that the AAA rated securities of CDOs and subprime-backed RMBS achieved, compared to government or corporate bonds, a higher return that was achieved by the rating agencies underrating the risk of those securities.[20] Many institutional investors, such as pension funds, are permitted to purchase only AAA-rated or investment grade assets, which gives a premium to securities receiving that high rating.[21] Normally, risk and return go hand in hand, but by undervaluing the risk of RMBS, rating agencies made the return for supposedly safe investments seem highly attractive.

Investors were also hampered by the complexity of the securitization structures and the lack of good disclosure regarding the underlying loans that backed the securities, both of which made it difficult for investors to discover the real risk in the securities. This forced the investors to depend excessively on the ratings agencies' analysis and ratings. Investment houses should have been reporting to rating agencies and investors all relevant information they had on the value and risk of the underlying loans. Instead, they failed to report the results of their own due diligence reviews of the underlying mortgages, and also failed to inform rating agencies and investors how many mortgages in the pools did not fit the stated underwriting criteria of the lender but were made pursuant to exceptions to those criteria, a practice that was growing in the run-up to the subprime meltdown.[22] The investors were given inadequate disclosures. Even with good faith efforts, adequate disclosure of the default risks would have been difficult given the complex structure of the subprime securitizations and resecuritization of the resulting RMBS into CDOs, as the investors would have had to track back from the CDO securities through a maze of securitization to a collection of pools of subprime loans. This complexity made it extremely difficult to assess

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[19] Uday Rajan et al., *The Failure of Models That Predict Failure: Distance, Incentives and Defaults* 3 (Chi. Graduate Sch. Bus., Research Paper No. 08-19, 2008), *available at* http://ssrn.com/abstract=1296982, at 28 (stating: "However, when incentive effects lead to a change in the underlying regime, the coefficients from a statistical model estimated on past data have no validity going forward . . . Importantly, collecting historical data over a longer time period is likely to exacerbate the problem by aggregating data from different regimes.").

[20] *U.S. Subprime RMBS in Structured Finance CDOs*, FITCH REPORTS, 4 Aug. 21, 2006, *available at* www.fitchreports.com.

[21] Michel G. Crouhy et al., The Subprime Credit Crisis of 07 9 (July 9, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1112467.

[22] Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at 1, *available at* LEXIS, News Library, NYT File.

the risk carried by the new securities.[23] Worse yet, investors were not provided the kind of loan-level information necessary to fully assess the values of the securities backed by those loans.

It is clear that securitization itself has led to the degradation of underwriting for home mortgages, and that this effect is hard-wired into the structure of securitization. Because of this hard-wiring, the FDIC should not succumb to industry arguments that it should change little and that the market itself will find a solution to these problems. For securitizing mortgage loans to work, investors have to be confident that problems in the securitization system have been fixed. While the financial industry will argue that possible reforms would put regulated lenders at a competitive disadvantage, the current sorry state of private label securitization indicates that these rules will give such lenders a competitive advantage: the better rules will attract investors too gun-shy to invest in other mortgage-backed securities.

3. Proposed Rules to Ensure Solid Origination Practices – Realigning Incentives

As the FDIC recognizes, the key is to ensure a system in which all players share incentives to support sustainable credit. The mortgage market has collapsed on itself in part because the base of the securitization pyramid – the actual mortgage loans – were not sustainable.

Currently, the origination process itself is the major source of profit to the mortgage broker, the lender, the closing agent and the title insurance company. The originators generally receive substantial up-front fees (almost always paid for from the consumer's home equity) at the origination of the mortgage. In the current structure, neither brokers nor lenders depend on the payment stream to recover either their costs associated with making the loan, or for their profit. There are two critical problems with this system:

- It encourages loan churning – making new loans to homeowners over and over – because the making of the loan is what generates the business and the profits in this market.
- It discourages a real affordability analysis. Not only are the originator's profits unaffected by whether the loan performs, but unaffordable payments may actually benefit the originator, by driving the homeowner back to the originator for a new loan with more affordable payments, thus creating more opportunities for profit.

As the FDIC has recognized, the originator must have incentives to ensure that the loan is affordable and sustainable.[24] Affordability and sustainability are related, yet different. A full affordability analysis includes at least three separate components:

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[23] *See* John D.Martin, A Primer on the Role of Securitization in the Credit Market Crisis of 2007 (January 7, 2009). Available at SSRN: http://ssrn.com/abstract=1324349, at 11.

[24] Another consideration is the price of the loan. Even if the payments are affordable, if they are either more than what is fair under all the circumstances, or the loan includes exorbitant fees or confusing terms, the homeowner's resentment will undermine the efforts to maintain the mortgage payments.

- All scheduled payments due under the terms of the loan, including any potential increases in the interest rate or principal, must be found to be affordable, that is, the loan must be underwritten for the maximum contractually-required payment on the loan.
- All other housing debt, as well as monthly contribution requirements for property insurance and taxes, must be included in the sum of housing debt.
- All income must be verified through independent means, either using wage statements, bank account and deposit records, tax information, or equivalent documentation.

In recent years, the mortgage industry has violated all of these basic precepts of sound underwriting and facilitated completely unaffordable loans by permitting loans for which there has been 1) no verification of income and 2) no determination of whether even verified income would sustain the higher payments actually called for on the mortgages.[25]

Loan sustainability incorporates affordability but also goes to the homeowner's larger ability to sustain the mortgage. When homeowners owe more on their mortgages than their homes are worth, they have difficulty sustaining those mortgages. This is not just a matter of "strategic default." A homeowner who owes more than the home is worth cannot refinance out of a minor delinquency, the most common way to cure a default. Nor can such a homeowner refinance to smooth out unexpected adverse life events, whether a divorce, a lost job, or needed major structural repair to the home. Initial high loan-to-value ratios coupled with declining home values guarantee a high rate of default among even homeowners for whom the loan was otherwise properly underwritten.

True sustainability requires that the originator fully evaluate the homeowner's ability to afford the highest contractually-required payment under the loan and allow for the accumulation of an equity cushion. Originators who do so should be rewarded for making better, safer loans to borrowers.

The complexity of loans originated in recent years stresses any system, whether the borrower's, the lender's, or the regulator's, for determining the affordability and sustainability of loans. Determining the maximum payment on a payment option ARM, for example, is not a trivial matter, depending as it does on the interplay of the remaining term of the loan, the amount of negative amortization accumulated when a payment resets, and interest rates throughout the loan's life. All parties would benefit from a gold standard mortgage, whose terms could be evaluated and compared, and whose risks are relatively well understood.

[25] Both the Guidance on Non-Traditional Mortgages and the Statement on Sub-prime Mortgages permitted originators to continue to make loans without fully verifying income. Both issuances also permitted originators to evaluate that stated income against payments that are substantially less than will actually be required on some loans, because the fully indexed rate is used as the benchmark, rather the maximum possible rate, and the fully amortized term is used, rather than the shortened term called for after the reset in interest only and payment option arm loans. (Statement on Sub-prime Mortgages, 72 Fed. Reg. 37,569 (July 10, 2007)) and the Interagency Guidance on Nontraditional Mortgage Product Risks, (71 Fed. Reg. 58,609 (Oct. 4, 2006)).

This mortgage – which we call the "Plain Vanilla Mortgage[26]" – would have the following features:

- Fixed rate for life of the loan
- 30 year term
- Fully amortizing payments
- No up-front fees (other than to bona fide third party closing process providers and for governmental recording and tax functions)
- No prepayment penalties
- Fully verified income
- Determination that the homeowner's ability to pay the mortgage, plus all other housing costs, is no greater than 32% of gross income
- Loan-to-value ratio of no more than 80%

This is the mortgage that most people can understand. It has only one moving part – the interest rate. This type of mortgage would allow homeowners who are shopping for a mortgage to know exactly what they are getting, and what the costs and the risks are. Shoppers can call up multiple originators and ask one question to determine the various options available – "What is the interest rate for a Plain Vanilla Mortgage for me?"

The FDIC need not mandate Plain Vanilla Mortgages, it need only create a system that rewards the originators of Plain Vanilla Mortgages. The reward system would simply be based on the recognition that there is considerably less risk when making a Plain Vanilla Mortgage. The reduced risk of making or owning these loans flows from a number of important factors:

1. The mandated, verified nature of the underwriting
2. The static nature of the borrower's obligations: the payments will not change, the homeowner's equity will continue to grow
3. The fact that neither the broker, the lender, or the investor will recover any proceeds or profit from the loan until and unless the borrower makes the payments – meaning that all of these parties have tremendous incentives to make sure that the borrower does indeed have the ability and the desire to continue to make the mortgage payments.
4. The simplicity of this mortgage facilitates the homeowner's involvement in the mortgage process, providing a way for the homeowner to more meaningfully protect herself when shopping for the loan secured by the family home.
5. Moreover, the fact that no prepayment penalties are included provides the additional, important incentive to make the interest rate for the loan as low as possible. Because, the borrower will have the ability to refinance into a lower price loan whenever that becomes available – the incentive is created in the marketplace to offer the borrower the lowest available rate the first time around.

[26] Our use of the term "Plain Vanilla" to refer to our preferred mortgages is not intended to slight other favorites. While our favorite ice cream flavors include Chocolate-Chocolate Chip and Chunky Monkey, we felt the description "Plain Vanilla" best conjured up the type of simple, but high quality, mortgages we advocate for these securitization rules to favor.

Plain Vanilla Mortgages can be encouraged and facilitated in the mortgage marketplace through the seasoning process. Because Plain Vanilla Mortgages are so much safer than any other type of mortgage, the FDIC should require a seasoning requirement of at least two years for other mortgages and only one year for the Plain Vanilla Mortgages.

Seasoning requirements for mortgage loans have several advantages:

1. The riskiest loans often default early, and these would be left in the lenders' portfolios, for the lenders to deal directly with the distressed borrowers. Lenders would be considerably less likely to make risky loans if the loan performance reflects on the lenders' bottom line. The lenders making the loans will make sure that the loan is affordable and sustainable.
2. Secondly, this policy, if extended to lenders generally, would go far to end the boom and bust cycle of lenders and help borrowers when lenders do go bust. Lenders of riskier loans would not grow as rapidly if they had to season their loans for two years before selling them. They would also have to find more forms of financing more stable than securitization, at least for short term financing. And when these risky loan lenders do go bust, they will do so with more assets, so that defrauded borrowers and other creditors would have more assets to go after.
3. Requiring two-year seasoning for non-uniform loans would also tend to reverse the current steering problem. Borrowers have been steered to loans with higher interest rates or other risky terms, so that brokers can collect yield-spread premiums or lenders can sell the loans for more. However, if lenders had to hold these non-uniform loans twice as long as fixed-rate Plain Vanilla loans, that would encourage lenders to steer borrowers toward safer, lower-cost fixed-rate prime loans.

In order to ensure that originators truly have some skin in the game, the seasoning period on non-Plain Vanilla Mortgages should extend until the homeowner is scheduled to be making a fully-amortizing, fully-indexed payment. For many hybrid ARMs, that will be two years. For more complex products, the time might be extended longer – but this result is appropriate in the face of products whose risks are poorly understood even by sophisticated market participants.[27]

It seems likely that once the FDIC establishes different seasoning requirements for Plain Vanilla and other types of loans, that the marketplace would so favor the Plain Vanilla loans, that other loans might be priced out of favor. Alternatively, buyers of non-Plain Vanilla Mortgages would know to be cautious about the credit quality and the risks inherent in these loans.

[27] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,616 (Oct. 4, 2006) (lenders "should recognize that their limited performance history with [nontraditional mortgages] ... increases performance uncertainty").

4. Servicer Incentives Should Be Aligned to Favor Loan Modifications Over Foreclosures When Investors' Interests Would Be Served.

The FDIC seeks input on how to improve servicer authority to make loan modifications through changes to the RMBS agreements, including changes to the particular requirements of servicing advances on delinquent mortgages.

This is an important issue.[28] Servicers have failed to modify loans even when doing so would be in the interests of investors.[29] With loss severities approaching 65 percent on many portfolios,[30] market stability is jeopardized by servicers' ongoing failure to consider loan modifications. Millions of homeowners are slated to lose their homes[31] at the same time investors are losing eye-popping sums. Homeowners, investors, and society at large have been injured by servicers' failure to modify loans.

Clear guidance in RMBS contracts as to the scope of servicers' authority to modify and mandated modifications where doing so would benefit all investors would be an improvement. The FDIC should go further. The RMBS contracts should clearly authorize the most sustainable forms of modifications, principal reductions.[32] Moreover, the near-universal requirement that foreclosures proceed at the same time loan modifications do is a far more serious impediment to performing successful and sustainable loan modifications currently than any purported lack of authority by servicers in the contracts. The vast majority of existing RMBS contracts already permit modifications, if with insufficient

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[28] The relationship between securitization agreements, servicer advances, and servicer compensation more generally and the failure of servicers to perform modifications is developed more fully in this paper: Diane E. Thompson, National Consumer Law Center, Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and Its Consequences (Oct. 2009), *available at* http://www.consumerlaw.org/issues/mortgage_servicing/content/Servicer-Report1009.pdf.

[29] Kurt Eggert, Comment: What Prevents Loan Modifications?. Housing Policy Debate, Vol. 18, No. 2, 2007. Available at SSRN: http://ssrn.com/abstract=1081479.

[30] Alan M. White, Nov. 26, 2009 Columbia Collateral Summary Statistics 1, http://www.valpo.edu/law/faculty/awhite/data/nov09_summary.pdf.

[31] Center for Responsible Lending, Soaring Spillover 1 (May 2009), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf (projecting 9 million foreclosures between 2009 and 2012); Goldman Sachs Global ECS Research, *Home Prices and Credit Losses: Projections and Policy Options* (Jan. 13, 2009), at 16 (projecting 13 million foreclosure starts by 2014); Rod Dubitsky, Larry Yang, Stevan Stevanovic & Thomas Suehr, Credit Suisse Fixed Income Research, *Foreclosure Update: Over 8 Million Foreclosures Expected* 1 (Dec. 4, 2008) (predicting 9 million foreclosures for the period 2009-2012).

[32] Roberto G. Quercia, Lei Ding, Janneke Ratcliffe, Center for Community Capital, Loan Modifications and Redefault Risk: An Examination of Short-Term Impact (Mar. 2009), *available at* http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf; Diane Pendley & Thomas Crowe, FitchRatings, U.S. RMBS Servicers' Loss Mitigation and Modification Efforts 2, 10-11 (May 26, 2009) (modifications with principal reductions greater than 20% perform better than any other category of modifications).

clarity.[33] On the other hand, few, if any, RMBS agreements, actually prioritize modifications over foreclosures.

The FDIC also proposes to limit servicers' requirements to make advances on delinquent loans to three months. Limiting advances to three months should make investors care more about loan performance and will ease the financing pressure on servicers facing large numbers of defaults. By itself, however, limiting advances is unlikely to encourage more modifications. Lifting the burden of advances will give servicers more time to pursue a modification, should they chose to do so, but still does not ensure that servicers will evaluate loans for modifications.

Servicers profit from default-related fees, both pre- and post-foreclosure.[34] Given reported mark-ups in these fees of over 100%,[35] default fees likely lure more servicers to foreclose than do the burden of advances. Moreover, since the RMBS contracts generally allow for the recovery of these fees before the investors are paid in the event of a foreclosure[36] but fail

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[33] Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, Fed. Reserve Bank of Boston, Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization 28 (Public Pol'y Paper No. 09-4, July 6, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf (summarizing several different studies finding no meaningful PSA restrictions in a majority of securitizations reviewed); John P. Hunt, Berkeley Ctr. for Law, Business, and the Economy, *What Do Subprime Securitization Contracts Actually Say About Loan Modification: Preliminary Results and Implications* 6 (Mar. 35, 2009), *available at* http://www.law.berkeley.edu/files/bclbe/Subprime_Securitization_Contracts_3.25.09.pdf (reporting that the PSAs of 90% of subprime loans surveyed generally permitted modifications); Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, The Incentives of Mortgage Servicers: Myths and Realities 22 (Working Paper No. 2008-46) (reporting that of 500 different PSAs under which a large servicer operated, 48% had no limitations on modifications other than that they maximize investor return; only 7.5% of the PSAs had meaningful limits on the types of modifications a servicer could authorize); Credit Suisse, The Day After Tomorrow: Payment Shock and Loan Modifications (2007), *available at* http://www.credit-suisee.com/researchandanalytics (finding that 65% of survey PSAs contain no meaningful restrictions on ability to modify loans); American Securitization Forum, Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans 2 (June 2007) ("Most subprime transactions authorize the servicer to modify loans that are either in default or for which default is either imminent or reasonably foreseeable.").

[34] *See, e.g.,* Ocwen Fin. Corp., Annual Report (Form 10-K) (Mar. 12, 2009) (reporting that 11% of all Ocwen Asset Management's 2008 servicing fees were "process management fees," or property valuation, REO sale, and title service fees, primarily, while 18% of Ocwen Asset Management's non-process management servicing fees were default fees, such as late fees).

[35] *See In re* Stewart, 391 B.R. 327, 346 (Bankr. E.D. La. 2008), *aff'd,* 2009 WL 2448054 (E.D. La. Aug. 7, 2009) (reporting that a servicer marked up a property valuation fee from $50 to $125).

[36] Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, The Incentives of Mortgage Servicers: Myths and Realities 22 (Working Paper No. 2008-46); Ocwen Fin. Corp., Annual Report (Form 10-K), at 4 (Mar. 17, 2008) (advances are "top of the waterfall" 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); Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at 71 (June 27, 2007) (servicers repaid all advances when foreclosure is concluded).

to define or limit the recovery in the event of a modification,[37] servicers are discouraged from pursuing modifications, even if a modification would be less costly for the investor than a foreclosure. The FDIC should restrict servicers' ability to profit from default-related fees and require that legitimate fees are entitled to the same recovery in a modification as in a foreclosure.

With loss severities at historical highs, there is no question but that investors would benefit from more and deeper loan modifications. But investors do not currently have the tools at hand to police servicer behavior in this regard.[38] In most instances, investors are unable to compare the costs and benefits of modifications with foreclosures.[39] As a result, investors have in some instances preferred the certainty of foreclosure to the risk of a modification. Yet investors would benefit from RMBS contracts that aligned servicers' interests clearly with their own, in performing modifications that saved the pool as a whole money and limited opportunities for servicer chicanery. Investors would also benefit from curtailment of servicers' excessive default-related fees, which get stripped from the loan collateral before investors are paid. Investors need transparency and certainty: the FDIC is in a position to provide both.

A. RMBS contracts should provide servicers with clear authority to make loan modifications and specify recovery of expenses post-modification.

While few RMBS agreements bar all loan modifications, the governing documents provide little guidance for servicers.[40] Servicers are given little-to-no direction as to what types of loan modifications are permissible or desirable or how (or if) their expenses in performing a loan modification may be recovered. Blanket authority to servicers to perform loan modifications in the RMBS contracts, as proposed by the FDIC, would ease servicers' concerns and address the anomalous cases where RMBS agreements deny servicers that authority. Similarly, requiring that all modifications be made in the interest of the pool as a whole, and not any individual class of investors, would conform industry practice to what is currently the generally articulated understanding in the investment community.[41] Greater

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[37] 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.

[38] *See, e.g.,* Joseph R. Mason, Servicer Reporting Can Do More for Modification than Government Subsidies 14 (Mar. 16, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361331; Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Troubled Loans,* N.Y. Times, July 30, 2009 (investors largely do not know the extent of the fees taken off the top in a foreclosure by a servicer).

[39] *See* Complaint at 6, Carrington Asset Holding Co., L.L.C. v. American Home Mortgage Servicing, Inc., No. FST-CV 09-5012095-S (Conn. Super. Ct., Stamford, Feb. 9, 2009) (noting that information on the disposition of foreclosed property was available to junior investor only because of "special rights" bargained for by institutional investor).

[40] *See* Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, & Eileen Mauskopf, Fed. Reserve Bd. Fin. & Econ. Discussion Series Div. Research & Statistical Affairs, The Incentives of Mortgage Servicers: Myths and Realities 18 (Working Paper No. 2008-46) (reporting that servicers of private label securitizations receive little guidance from investors regarding loss mitigation)

clarity in these matters could encourage more modifications without changing existing investor expectations.

The FDIC should promote greater specificity regarding the types of loan modifications permissible. In particular, authority to perform loan modifications involving principal forbearance or principal reduction is seldom mentioned in RMBS agreements.[42] Even though principal reductions are likely the most sustainable and most economically rational modification in conforming the value of the note to the value of the collateral, they are seldom performed, in part because of servicer uncertainty over their permissibility and accounting nuances.[43] Both homeowners and investors would benefit if principal reduction modifications were offered more often. Homeowners would be able to retain their homes and perhaps have the prospect of building equity. Investors would avoid the losses suffered at foreclosure. Moreover, principal reductions, unlike other forms of loan modification, provide investors with solid information as to the real value of the assets held. Principal reductions offer a softer version of the hard truth of a foreclosure: both require recognition of the losses suffered to date, but in doing so, a principal reduction promotes market confidence. Explicit authority to perform these vital forms of loan modifications – principal forbearance and principal reduction -- would encourage their use.

Additionally, the RMBS documents must be changed to allow servicers to recover advances and other costs of servicing delinquent loans, including the costs of performing loan modifications, at the pool level. Such a move has already been endorsed, at least in part, by leading investor-advocacy groups.[44] Under the current system, servicers may recover all of their costs from the pool after a foreclosure but are restricted to the excess interest payments made by the borrower, or sometimes payments of principal on other loans (but not interest) for recovery of costs in a modification, if the borrower is not able to come up with the funds out of pocket. This scheme encourages servicers to pursue foreclosure, at the expense of both investors (who suffer greater losses post-foreclosure as a result) and homeowners who are needlessly foreclosed because they are barred from a modification at sustainable terms.

In order for any revision to the RMBS agreements encouraging modifications to work, the FDIC must ensure that the method used by servicers to evaluate the feasibility of loan modifications is objective and transparent. Without transparency, investors are unlikely to trust that servicers are, in fact, performing those modifications that save investors money and not using modifications solely as a tool for delay. The test used to evaluate loan modifications should be publicly available, to permit homeowners and investors to review

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41 *See, e.g.,* American Securitization Forum, Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans 4 (June 2007).

42 Investor Committee of the American Securitization Forum, Mortgage Investors Endorse Treasury Department's Guidance on Accounting Treatment of Forborne Principal 2 (Aug. 13, 2009).

43 Letter from Charles E. Schumer, U.S. Senator, to Daniel Mudd, CEO of Fannie Mae, and Richard Syron, CEO of Freddie Mac (Feb. 6, 2008).

44 American Securitization Forum, Operational Guidelines for Reimbursement of Counseling Expenses in Residential Mortgage-Backed Securitizations (May 20, 2008), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Counseling_Funding_Guidelines%20_5%20_20_08.pdf (stating that payments of $150 for housing counseling for borrowers in default or at imminent risk of default should be treated as servicing advances and recoverable from the general securitization proceeds).

the standards employed by any given servicer. The FDIC's publicly available Excel spreadsheet, the "Loan Mod-in-a-Box," is an important step in that direction. All servicers should be required to make their assumptions as transparent and accessible, in order to permit both investors and homeowners to ascertain that servicers are making loan modifications where appropriate. The servicer's test should be required to be an optimization model, so that the maximum number of loan modifications be performed, where doing so would be in the investors' best interests. Investors have long insisted that servicers use a "net present value test" to evaluate the benefit to investors of loan modification,[45] but experience shows that servicers have seldom applied such a test consistently or in investors' best interests.

B. The FDIC must require loans in default to be evaluated for a loan modification before a foreclosure is initiated.

The FDIC does not address one of the largest hurdles to performing sustainable loan modifications: the ubiquitous requirement that loan modifications and foreclosures proceed simultaneously. Until modifications are processed before foreclosures, servicers will continue to push through unnecessary and costly foreclosures.

This dual-track system results in unnecessary foreclosures because the divisions of the servicer handling the loan modification and the foreclosure often do not talk to each other. In many cases, the servicer outsources the foreclosure to an entirely different legal entity, who may not have access to all of the servicer's records and may be paid a flat fee based on the number of foreclosures completed. Servicers have few incentives under the current scheme to make sure loan modifications are processed in a timely way, since they are guaranteed recovery of all their costs post-foreclosure and can usually generate more income servicing default loans than performing loans.

Evaluation for loan modifications must be required before initiation of a foreclosure. A foreclosure, once started, develops its own momentum, which is difficult to stop. The fees added during the pendency of a foreclosure can make a modification prohibitively expensive for homeowners. Investors lose money when loans, which could have been modified, are foreclosed. The only party that ultimately profits from the dual track system is the servicer.

Investors have sometimes insisted on the dual-track system in order to curtail the servicer's delay in the foreclosure process. But a standardized review for a loan modification should take a matter of hours and days, not weeks or months. Servicers' failure to process loan modifications costs more than the potential delay.

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[45] *See, e.g.,* American Securitization Forum, Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans 4 (June 2007).

C. The FDIC must require a servicer compensation system that rewards loan modifications, including reining in default and process management fees retained by servicers, in order to encourage modifications before a foreclosure.

The FDIC's proposal to limit servicer advances to three months should limit servicers' financing costs and may buy servicers time to perform a modification, should they choose to do so. It also shifts the financing cost of serious delinquency from the time of default to the time of the foreclosure sale from the servicer to the investors. This should introduce more rationality in the system.

Investors' reliance on advances shields them from full awareness of the defaults in the pool. Since investors know that their payments will continue in a steady stream until the foreclosure sale is completed, investors have little incentive to investigate or insist on assurances as to the credit-worthiness of the loans in the trust. Instead, investors are encouraged to condone asset-based lending and rely on the servicer's credit rating as a guarantee of steady payments.

Limiting servicers' advances to three months will remove this bubble wrap from investors. But it does not shift the ultimate risk of loss or fundamentally alter the dynamic encouraging foreclosure. Servicers are, after all, repaid all of their advances at the conclusion of a foreclosure. If their advances exceed the value of the property, they may even be able to recover from other loans in the pool or the trust's bank account.[46] Investors have always been, ultimately, on the hook for loans headed for foreclosure. The three-month limit allows investors to continue to benefit from income-smoothing – short-term delinquencies will not affect the investor's cash stream. But serious delinquencies, which delinquencies greater than three months are by definition, will be more apparent to investors. Reducing the requirement to make advances to three months should encourage investors to promote loan modifications for seriously delinquent loans, where feasible. Since investors, not servicers, are always ultimately on the hook for serious delinquencies, a three month limit on advances is rational and should reduce distortions caused by extended advances.

Other aspects of servicer compensation must also be addressed, however, if servicers are to perform loan modifications where doing so would benefit the securitization pool as a whole. Many servicers continue to profit from default fees and what some servicers denominate "process management fees" – fees related to the foreclosure and subsequent sale of property. Unless those fees are reined in, servicers will continue to have a perverse incentive to foreclose even when the trust would benefit from a modification.

Servicer retention of these fees is not in investors' interests in the current marketplace. Since servicers receive all fees related to property preservation and sale as well as all default fees

[46] *See, e.g.,* Prospectus Supplement, IndyMac, MBS, Depositor, IndyMac INDX Mortgage Loan Trust 2007-FLX5, at 71 (June 27, 2007) (permitting principal and interest advances to be recovered from the trust's bank account); Prospectus, CWALT, INC., Depositor, Countrywide Home Loans, Seller, Countrywide Home Loans Servicing L.P., Master Servicer, Alternative Loan Trust 2005-J12, Issuer 47 (Oct. 25, 2005) (right of reimbursement from trust account " to amounts received representing late recoveries of the payments for which the advances were made").

from any ultimate sale of the property, before investors receive any funds, servicers have no incentive to keep these costs low. Investors have no way currently to police these fees; these costs are poorly disclosed to investors and usually only after the fact. The absolute right of servicers to retain these fees encourages servicers to gouge both investors and homeowners.

Conclusion

The FDIC's adoption of clearer, better, safer standards for the securitizations offered by banks will set the new standard in the industry. The securitizations offered by banks will be the most valuable, the most sought after, and the safest of investments. The loans included in these securitizations will likewise be considered safer and less risky for homeowners. Lenders other than banks will seek to compete with the banks' securitizations by making even safer, less risky loans. The FDIC securitization rules will turn the current system on its head – and make it right side up finally. Everyone in the mortgage pipeline will be better off if the FDIC issues these securitization requirements: homeowners will have safer, more transparent mortgages, lenders will have clearer rules, investors will have more reliable investments, and the American public will no longer be threatened with a repeat of the disaster of these past few years caused by predatory mortgage lending.