The Implementation of the HOPE for Homeowners Program and a Review of Foreclosure Mitigation Efforts

Written Testimony
of

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I. Introduction.

Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for inviting me to testify at today's hearing on "The Implementation of the HOPE for Homeowners Program and a Review of Foreclosure Mitigation Efforts." I am an attorney, currently of counsel to the National Consumer Law Center (NCLC).[1] Prior to joining NCLC, I was a clinical instructor at Harvard Law School where my practice focused on foreclosure prevention in the low-income communities of Boston. I am also a co-investigator, along with Professor Katherine Porter from the University of Iowa, in the Mortgage Project, a national empirical study of mortgage claims in consumer bankruptcy cases.

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.

II. The Foreclosure Crisis Requires Substantial Action.

We are facing the greatest foreclosure crisis since the Great Depression. As we know, the statistics are grim. For the second quarter of 2008 foreclosure filings nationwide were up 121% over the second quarter of 2007.[2] In the same time period, nearly a quarter of a million properties were foreclosed.[3] As of July 2008, REO, or bank-owned, property

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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 seventeen 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.

[2] RealtyTrac, Inc., *Foreclosure Activity Up 14 Percent in Second Quarter* (July 25, 2008), *available at* *http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4891&accnt=64847*.

[3] *Id.* (reporting 222,391 REO properties for the quarter).

represented more than 16 percent of the inventory of existing homes for sale.[4] In some communities, bank-owned properties make up nearly 40 percent of existing inventory.[5]

The trouble is not behind us. Foreclosures have continued to surge in 2008.[6] In both the prime and subprime markets seriously delinquent[7] loans have continued to rise at an alarming rate, increasing three-fold since early 2006.[8] The figures for adjustable rate mortgages (ARMs) are more shocking. As the chart below demonstrates,[9] seriously delinquent ARMs have more than quadrupled in the past two and a half years. By mid-2008, nearly one-third of subprime ARMs were more than 90 days late or in foreclosure. Nationwide, it is estimated that 2.2 million households with subprime mortgage loans have lost or will lose their home to foreclosure over the next several years.[10]

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[4] RealtyTrac, Inc. has reported more than three quarters of a million properties are in its active REO database. *See* RealtyTrac, Inc., *Foreclosure Activity Increases 8 Percent in July* (Aug. 14, 2008), available at http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5041&accnt=64847; National Association of Realtors, *July Existing-Home Sales Show Gain* (Aug. 25, 2008)(reporting total housing inventory at the end of July at 4.67 million existing homes for sale), *available at* http://www.realtor.org/press_room/news_releases/2008/july_ehs_show_gain.

[5] Kelly Bennett, *Local Prices Down 30 Percent from Peak* (Aug. 27, 2008)(reporting 135 of 337 properties listed for sale on Aug. 21 and 22, 2008 in San Diego area were bank repossessions), available at http://www.voiceofsandiego.org/articles/2008/08/27/housing/869dataparty082708.txt.

[6] *See* Chris Reidy, *2008 could be even worse for local foreclosures*, Boston Globe (Mar. 28, 2008)(estimating 2008 foreclosures to be at least 15 to 25 percent higher than the historic highs reached in 2007), available at http://www.boston.com/business/ticker/2008/03/report_2008_wil.html#

[7] Seriously delinquent loans includes loans that are at least 90 days delinquent plus the loans in foreclosure inventory.

[8] The seriously delinquent rate for subprime loans, both fixed and adjustable in the first quarter of 2006, was 6.22%. By the second quarter of 2008 that number had grown to 17.85%. Similarly, in the prime market the number of seriously delinquent loans has climbed from .77% in the first quarter of 2006 to 2.35% in the second quarter of 2008.

[9] This chart contains data from the Mortgage Banker's Delinquency Survey for each of the quarters listed.

[10] Ellen Schlomer, et al., *Losing Ground, Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending (Dec. 2006) at 3.

YEAR	SERIOUSLY DELINQUENT ARMS: PRIME	SERIOUSLY DELINQUENT ARMS: SUBPRIME
2006	Q1: .82 Q2: .92 Q3: 1.14 Q4: 1.45	Q1: 6.28 Q2: 6.52 Q3: 7.72 Q4: 9.16
2007	Q1: 1.66 Q2: 2.02 Q3: 3.12 Q4: 4.22	Q1: 10.13 Q2: 12.40 Q3: 15.63 Q4: 20.43
2008	Q1: 5.43 Q2: 6.78	Q1: 24.11 Q2: 26.77

The consequences of this foreclosure crisis have not only ripped through Wall Street, they are taking a heavy toll on Main Street. Abuses in the subprime market have undermined the efforts of hardworking families to acquire and retain the dream of homeownership. Instead of building wealth, families are losing equity.[11] Worse yet, some foreclosed families are unable to find replacement shelter and become homeless.[12] Renters suffer, too, as lenders quickly evict tenants from foreclosed homes.[13] More and more Americans are being driven into bankruptcy.[14] And, neighborhoods are deteriorating as foreclosed homes are boarded

[11] *Id.* (estimating that foreclosures will cost homeowners as much as $164 billion, primarily in lost home equity).

[12] *See* Erlenbusch, et al., *Foreclosure to Homelessness: The Forgotten Victims of the Subprime Crisis*, National Coalition for the Homeless (Apr. 15, 2008).

[13] It is estimated that 18% of the foreclosure started in the third quarter 2007 were not occupied by the owners. *See* Brinkmann, *infra* note 30 at 10. *See also* Testimony of Sheila Crowley to the Financial Services Committee, U.S. House of Representatives (April 10, 2008)(discussing the affects of the foreclosure crisis on renters), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/crowley041008.pdf; John Leland, *As Owners Feel Mortgage Pain, So Do Renters, New York Times* (Nov. 18, 2007);

[14] The number of bankruptcy filings is projected to top more than one million filings for 2008—the highest number of filings since the 2005 amendments to the Bankruptcy Code. See Posting Robert Lawless on *Credit Slips* blog, Bankruptcy Filings Reach New High in August, http://www.creditslips.org/creditslips/2008/09/bankruptcy-fili.html#more (Sept. 2, 2008).

up and left vacant.[15] Crime in high-foreclosure neighborhoods is on the rise.[16] Overgrown lawns and trash-strewn yards symbolize growing community abandonment and disinvestment.[17]

To date the magnitude of the foreclosure crisis dwarfs the current response from the financial services industry and federal regulators. However, one of the few bright spots in the effort to stem the rising tide of foreclosures has been the enactment of the HOPE for Homeowners Act of 2008.

III. The Promises and Pitfalls of the HOPE for Homeowners Act of 2008.

In July 2008, the President signed into law a wide-ranging housing bill—the "Housing and Economic Recovery Act of 2008."[18] A key component of the law is the "HOPE for Homeowners Act of 2008."[19] The HOPE for Homeowners Act creates a new, temporary program authorizing FHA to refinance homeowners into 30-year fixed rate FHA mortgages. Under this program, the principal balance and/or interest rate for an eligible homeowner is reduced through refinancing into an affordable FHA-insured loan based on current property values. The goal is to convince existing mortgage holders that they are better off taking a short payoff rather than foreclosing. We appreciate the call by Chairman Frank and Committee members Waters, Watt and Miller to halt foreclosures until the program is up and running.

HOPE for Homeowners addresses important barriers to creating affordable, sustainable mortgage loans through a combination of loan modification and refinancing. First, the program specifically encourages principal writedowns, which have been virtually non-existent to date.[20] The amount of the principal obligation under the program must take into

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15 *See* Letter, Senator Dodd to Senator Reid (Jan. 22, 2008)(describing cycle of disinvestment, crime, falling property values and property tax collections resulting from foreclosures), *available at* http://dodd.senate.gov/multimedia/2008/012308_ReidLetter.pdf.; Brad Heath and Charisse Jones, *Mortgage defaults force Denver exodus*, USA Today (Apr. 1, 2008)(in some Denver neighborhoods as many as one-third of residents have lost their homes).

16 *See, e.g.,* J.W. Elphinstone, *After foreclosure, crime moves in*, Boston Globe (Nov. 18, 2007)(describing Atlanta neighborhood now plagued by house fires, prostitution, vandalism and burglaries).

17 *See* Daphne Sashin and Vicki Mcclure, *Foreclosure leave painful ripple effect*, Orlando Sentinel (Oct. 15, 2007)(describing a once safe neighborhood now dotted with empty homes and overgrown lawns).

18 Pub. L. No. 110-289 (2008).

19 Title IV, Pub. L. No. 110-289 (2008).

20 *See* Alan M. White, *Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports* (Aug. 2008) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538 (studying voluntary loan

account the ability of the borrower to make the new loan payments, and the loans must run for at least 30 years. The law acknowledges that prepayment penalties can be a significant barrier to refinancing for distressed borrowers and requires such penalties to be waived. Similarly, fees and penalties related to defaults and delinquency must be forgiven. The program mandates appraisal independence to prevent the deliberate overstatement of property values—a practice underlying a significant number of mortgage fraud cases.[21] It addresses the "subordinate mortgage problem" by providing that all holders of outstanding mortgage liens on the property eligible for a new insured loan must agree to accept the proceeds of the insured loan as payment in full, and all related encumbrances must be removed. Lastly, the act checks the potential for "tranche warfare"[22] by providing that, unless the contract between a servicer of securitized mortgages and an investor states otherwise, a servicer is considered acting in the best interests of all investors of the pooled mortgages if the servicer enters into a modification or workout plan, including a modification or refinancing plan under the HOPE program.

The promise of HOPE for Homeowners is great. Set to begin on October 1, 2008, the program is authorized to insure up to $300 billion in mortgages and is expected to serve approximately 400,000 homeowners. Unfortunately, the pitfalls are also large.

Many anticipate that we will be well into 2009 before the program is operating at full speed. In the meantime, foreclosures will continue to run their course. In California alone, actual foreclosures auctions now average 700 per day.[23] Delay in full implementation means that hundreds of thousands of families who could have been helped will lose their homes. Additionally, while the act requires the establishment of "a reasonable limitation on origination fees" it remains unclear whether financially distressed homeowners will have the funds available to cover the costs, which average 2-3% of the loan amount, either directly or

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modifications and finding principal writedowns of more than 1% in only 62 (1.4%) of 4342 loan modifications within the sample).

[21] *See* FBI Press Release, *Mortgage Fraud Operation "Quick Flip*," (Dec. 14, 2005)(estimating that industry professionals engaged in fraud for profit make up 80% of the mortgage fraud cases and rely, in part, on inflated property values), available at http://www.fbi.gov/pressrel/pressrel05/quickflip121405.htm.

[22] "Tranche Warfare" is a term used to describe mismatched interests among the investors in any given loan pool. A typical securitization results in different classes of securities, called tranches. Loan modifications can have different effects on different tranches giving rise to a conflict of interest between investors. As a result, servicers may be reluctant to engage in significant loss mitigation for fear of being sued by disgruntled investors.

[23] *See* DataQuick, Information Systems, Inc., *Another Increase in California Foreclosure Activity* (July 22, 2008)(63,061 trustees' deeds recorded, evidencing actual loss of home to foreclosure, during second quarter 2008), available at http://www.dqnews.com/News/California/CA-Foreclosures/RRFor080722.aspx.

indirectly. The largest obstacle, however, to achieving the promise of HOPE for Homeowners is that participation in the program remains entirely voluntary.

For more than a year now, the financial services industry has been encouraged to meet this growing foreclosure crisis by scaling-up voluntary loan modifications efforts. In May 2007, Senate Banking Committee Chairman Dodd announced a set of servicing principles aimed at long-term affordability.[24] Those principles called, in part, for loan modifications that would "create a solution for the borrower to ensure that the loan is sustainable for the life of the loan."[25] In June 2007, Chairman Sheila Bair of the FDIC called for automatic loan modifications for borrowers with subprime ARMs.[26] Like Senator Dodd's servicing principles, Chairman Bair emphasized the importance of providing sustainable loan modifications. A report from the Joint Economic Committee also suggested that automatic loan modifications were needed.[27] In September 2007, the federal and state banking regulators issued a joint statement on loss mitigation strategies, referencing earlier guidance and encouraging use of loss mitigation authority available under pooling and servicing agreements.[28] In October 2007, Treasury Secretary Paulson sought voluntary commitments from servicers to contact borrowers and explore new loan modification approaches.[29] Then in December, 2007, Secretary Paulson announced a plan for "fast track" loan modifications.[30]

Despite widespread efforts to encourage voluntary loan modifications, it is clear that the financial services industry has failed to implement a loan modification strategy on a scale commensurate with the problem. As Chairman Bair recently acknowledged, "[w]hile voluntary loan modifications have shown significant progress, at this point, it must be

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[24] Senator Dodd Unifies Industry Members, Consumer Representatives to Help Preserve the American Dream of Homeownership (May 2, 2007), *available at* http://dodd.senate.gov/index.php?q=node/3863/print

[25] Homeownership Preservation Summit Statement of Principles (May 2, 2007), *available at* http://dodd.senate.gov/multimedia/2007/050207_Principles.pdf.

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

[27] *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here*, Report and Recommendations by the Majority Staff of the Joint Economic Committee (Oct. 2007)(one of the key policy recommendations put forth in the report was to direct servicers and lenders to make safe and sustainable loan modifications).

[28] Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages (Sept. 2007), *available at* http://www.occ.treas.gov/ftp/bulletin/2007-38a.pdf.

[29] Associated Press, *Paulson to Mortgage Industry: Help Curb Defaults* (Oct. 31, 2007), *available at* http://money.cnn.com/2007/10/31/real_estate/paulson_housing.ap/.

[30] American Securitization Forum, "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans", Executive Summary (Dec. 6, 2007), *available at* http://www.treas.gov/press/releases/hp706.htm.

acknowledged that the pace has not been sufficient to achieve the scale necessary to contain broader harm to communities and our economy."[31]

The data available thus far support the conclusion that little is being done by the financial services industry to help homeowners facing foreclosure. The HOPE NOW program issued its first data in early 2008.[32] Although touted as showing substantial improvement, the HOPE NOW report actually demonstrates that little progress has been made. The same can be said about the Mortgage Bankers Association's report on loan modifications issued in January 2008.[33] Both reports confirm that servicers are relying heavily on repayment plans rather than loan modifications. Repayment plans require homeowners to make increased monthly payments to cure arrears. They do not address payment affordability problems caused by high interest rates and resets. Most recently, a study by Professor Alan White of Valparaiso University School of Law supports the conclusion that the industry has not engaged in meaningful loan modifications.[34] Professor White analyzed loan level information from service remittance reports from July 2007 through June 2008. He concludes that:

> [W]hile the number of modification rose rapidly during the crisis, mortgage modifications in the aggregate are not reducing subprime mortgage debt. Mortgage modifications rarely if ever reduced principal debt, and in many cases increased the debt. Nor are modification agreements uniformly reducing payment burdens on households. About half of all loan modification resulted in a reduced monthly payment, while many modifications actually increased the monthly payment.

As Professor White notes, the result of mortgage modifications that do not reduce principal balances and in many cases do not even reduce monthly payments delay, is that they do not prevent large numbers of foreclosures.

We appreciate Congressional leadership on this issue and this Committee's continuing persistence in seeking solutions to the foreclosure crisis. While voluntary measures may be

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[31] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Using FHA for Housing Stabilization and Homeownership Retention, Testimony before the Committee on Financial Services, U.S. House of Representatives (Apr. 9, 2008).

[32] *See* HOPE NOW: Results in Helping Homeowners (Feb. 2008)(data covers 18 servicers representing 2/3 of the industry), *available at* http://www.fsround.org/hope_now/pdfs/JanuaryDataFS.pdf. The HOPE NOW data covers the period from July 1, 2007 to January 31, 2008. *See also* HOPE NOW Alliance Servicers, Prime and Subprime Residential Mortgages: 2007 Loss Mitigation Activities (February 2008), *available at* http://www.fsround.org/media/pdfs/NationaldataFeb.pdf.

[33] Jay Brinkmann, An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and other Loss Mitigation Activities in the Third Quarter of 2007, Mortgage Bankers Association (Jan. 2008), *available at* http://www.mortgagebankers.org/files/News/InternalResource/59454_ LoanModificationsSurvey.pdf.

[34] *See* White, *Rewriting Contracts, supra* at note 20.

able to help some borrowers, we believe that structural barriers inherent in the mortgage servicing industry will hamper the effectiveness of any voluntary programs, including the HOPE for Homeowners program. Accordingly, an essential component of any mortgage crisis solution involves enhanced obligations on the part of servicers to communicate with borrowers and seek reasonable loss mitigation prior to foreclosure.[35]

IV. The Servicing Industry Is Fundamentally Broken When It Comes To Meeting The Needs of Borrowers.

Mortgage servicers provide the critical link between mortgage borrowers and the mortgage owners. Since the 1990s, mortgage servicing has become an increasingly specialized and lucrative industry, driven in part by the need for one party to coordinate the distribution of mortgage revenues to the investors in securitized loans. The rights to service mortgage loans are routinely sold or transferred independently of the loans themselves. The servicers' goals in managing loans are generally two-fold: 1) to maximize its own profits and 2) to maximize the returns to the owner of the loan.

Servicers are generally responsible for account maintenance activities such as sending monthly statements, accepting payments, keeping track of account balances, handling escrow accounts, calculating interest rate adjustments on adjustable rate mortgages, reporting to national credit bureaus, and remitting monies to the owners of the loans. Servicers also are responsible for engaging in loss mitigation activities and prosecuting foreclosures.

Despite the important functions of mortgage servicers, borrowers have few market mechanisms to employ to ensure that their needs are met. While borrowers must be notified about any change in servicer,[36] they cannot choose the servicer that handles their loan or change servicers if they are dissatisfied. Recent headlines and court decisions around the country have called into question servicer and holder conduct with respect to borrowers in default.[37] For some time now homeowners and consumer advocates have struggled with

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[35] Recent efforts by the FDIC to engage in affordable loan modifications for delinquent Indymac borrowers demonstrate that reasonable loss mitigation programs on a large scale can be done. *See* Loan Modification Program for Distressed Indymac Mortgage Loans, *available at* http://www.fdic.gov/consumers/loans/modification/indymac.html.

[36] *See* 12 U.S.C. § 2605 (detailing transfer notice requirements).

[37] *See, e.g.,* Gretchen Morgensen, *Dubious Fees Hit Borrowers in Foreclosures,* New York Times (Nov. 6, 2007); Porter, Katherine M., *Misbehavior and Mistake in Bankruptcy Mortgage Claims* (November 6, 2007). University of Iowa College of Law Legal Studies Research Paper Series Available at SSRN: http://ssrn.com/abstract=1027961 (describing the systematic failure of mortgage servicers to comply with bankruptcy law and fees and charges that are poorly identified and do not appear to be reasonable); *In re Foreclosure Cases*, 2007 WL 3232430 (October 31, 2007)(dismissing 14 foreclosure

servicers who have no interest in helping families stay in their homes. Rather, in the interest of maximizing profits servicers have engaged in a laundry list of bad behavior and exacerbated foreclosure rates.[38] The most common abuses in loan servicing include misapplication of payments, use of suspense accounts, failure to make timely escrow disbursements, and cascading fees imposed upon homeowners in default.[39] These abuses exist because there are market incentives rather than deterrents for this type of behavior.[40]

Cutting Cost, Cutting Service. As with all businesses, servicers add more to their bottom line to the extent that they can cut costs. Servicers have cut costs by relying more on voicemail systems and less on people to assist borrowers, by refusing to respond to borrowers' inquires and by failing to resolve borrower disputes. Recent industry efforts to "staff-up" loss mitigation departments have been woefully inadequate. As a result, servicers remain unable to provide affordable and sustainable loan modifications on the scale needed to address the current foreclosure crisis. Instead borrowers are being pushed into short-term modifications and unaffordable repayment plans. These "kick the can" approaches to solving the foreclosure crisis do not provide real solutions for those affected borrowers. Instead, they merely postpones the day of reckoning.[41]

Obtaining Timely, Accurate and Consistent Information Is Difficult. The widespread use of automated voice response systems and the decline in "live" assistance for borrowers may improve the servicers' profits, but it is enormously frustrating to borrowers in need of help. From the homeowner's perspective one of the biggest obstacles to loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions. Stories abound of exasperated homeowners attempting to navigate vast voice mail systems, being bounced around from one department to another, and receiving contradictory information from different servicer representatives.[42] For example, an October 2007 survey from the Neighborhood Housing

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cases because purported holder could not demonstrate ownership of the loan at the time the foreclosure action were filed).

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

[39] *Id.*

[40] *See* Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good Business and Affordable Homeownership Policy": What Prevents Loan Modifications?,* 18 Housing Pol'y Debate 279 (2007).

[41] *See* Brinkmann, *supra* note 33 (Tables 2 and 3 showing that a large number of foreclosures result from failed repayment plans).

[42] *See, e.g.,* Gretchen Morgensen, *Can These Mortgages Be Saved?,* New York Times (Sept. 30, 2007)(describing one homeowner who identified 670 calls relating to her home foreclosure in the previous three months and who received nine different answers about how best to proceed from 14 different people at the company); *Miller v. McCalla*, Raymer, 214 F.3d 872, 875 (7th Cir.

Services of Chicago found that "countless counselors shared stories of having a client in the office ready to begin dealing with long-deferred financial problems, but then having to wait 30 minutes or more in order to talk to an appropriate loss mitigation staff person."[43] Unfortunately, things have not improved in recent months as servicers struggle to keep up with the increased workload caused by the foreclosure crisis.[44]

Servicers' claims that the lack of loan modifications is cause by unresponsive borrowers[45] are belied by the success of some industry players. For example, in July of this year, Mary Coffin, Executive Vice President of Wells Fargo Home Mortgage Servicing, testified to this Committee that Wells Fargo connected with 94 percent of its customers that were 60 or more days past due, but not in bankruptcy or foreclosure.[46] Wells Fargo's apparent success in reaching their delinquent customers, begs the question of what they are doing that other mortgage servicers are not? (Of course, what happens after the servicer connects with the borrower also is of great importance.)

Finding a Decision Maker Is Not Straightforward. Even if borrowers can get through to a servicer representative, there may be no one within the servicer operation who has the authority to negotiate a loan modification. In a response to FDIC Chairwoman Bair's call for automated loan modifications, the Consumer Mortgage Coalition described a structure devoid of decision-makers.[47] For private securitizations, the CMC complained that there is simply no active manager the servicer can call to get approval on a loan modification or a waiver of restrictions on modifications found in the pooling and servicing agreements (PSAs). The CMC stated: "While this passive structure may appear to give the servicer more discretion, in fact, because of the lack of an active decision-maker from which the servicer could obtain waivers of the usual requirements, no entity exists with the authority to grant

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2000)(describing the process of trying to get through to an 800 number as a "vexing and protracted undertaking").

43 Neighborhood Housing Services of Chicago, Inc., *Lessons from the Front Lines: Counselor Perspectives on Default Intervention*, p.6 (Oct. 29, 2007).

44 *See* Kate Berry, *The Trouble with Loan Repayment Agreements*, American Banker (Jan. 9, 2008)(noting that servicers push repayment plans instead of modifications because they "need twice the staff, and in part they can't manage the volume").

45 See Testimony of Michalea Albon, Washington Mutual, before the United States House of Representatives, Subcommittee on Housing and Community Opportunity (Nov. 30, 2007)("Perhaps our biggest challenge, however, is simply reaching the borrowers who are most in need. If we can't reach them directly or indirectly such as through community organizations, we cannot help them).

46 Testimony of Mary Coffin, Executive Vice President, Wells Fargo Home Mortgage Servicing, before the United States House of Representatives, Committee on Financial Services (July 25, 2008) at 3.

47 Sam Garcia, *Group Warns on Large Scale Modifications: Consumer Mortgage Coalition sends letters to the FDIC*, Mortgage Daily News (Oct. 9, 2007).

waivers." An industry structure that provides no decision maker to deal with loan modifications is of little value to financially distressed borrowers trying to save their homes from foreclosure.

Unanswered Requests and Unresolved Disputes Are the Norm. Additionally, responding to borrower's written requests for information or written disputes is also time-consuming and costly for servicers. Currently, the Real Estate Settlement Procedures Act requires servicers to respond to such requests within 60 days.[48] However, it appears that the cost of compliance outweighs the cost of non-compliance. As a result, many borrowers requests simply go unanswered.[49] Borrowers' remedies for the servicers' disregard are limited. In fact, under current law, even if borrowers dispute the servicers' loan accounting, servicers may nevertheless continue a foreclosure proceeding without resolving the dispute.[50]

Getting to Affordable Loan Modifications Takes Work. Creating affordable and sustainable loan modifications for distressed borrowers is labor intensive.[51] The borrower's financial circumstances must be evaluated. Property valuations and debt service levels must be considered. In many respects, reaching affordable results requires servicers to reunderwrite the loan.[52] Under many pooling and servicing agreements, additional labor costs incurred by servicer's engaged this process are not compensated by the loan owner. By contrast, most servicers are paid a fee to foreclose on a borrower. Under this cost and incentive structure, it is no surprise that servicers continue to push borrowers into less labor-intensive repayment plans or towards foreclosure. As Moody's has noted "[i]t is not advantageous to modify a loan without knowing if the borrower can afford the modified obligations. If they can't, it may simply serve to postpone an eventual foreclosure and increase, rather than decrease, the ultimate loss on the loan."[53] Despite this obvious proposition, the financial services industry continues to oppose a duty to consider affordable alternatives to foreclosure.

Maximizing Income is a Servicer's Main Goal.

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[48] 12 U.S.C. § 2605(e).
[49] *See, e.g.*, Maxwell v. Fairbanks Capital Corp., 281 B.R. 101 (Bankr. D. Mass. 2002).
[50] Reg. X, 24 C.F.R. § 3500.21(e)(4)(ii)(servicer not prohibited from pursuing collection activities during 60-day response period).
[51] Joseph R. Mason, *Mortgage Loan Modification: Promises and Pitfalls*, at 7(Oct. 3, 2007), *available from SSRN at* papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470.
[52] Moody's, *U.S. Subprime Mortgage Market Update* (Apr. 2007), *available at* http://www.americansecuritization.com/uploadedFiles/US%20Subprime%20Mortgage%20Market%20Update%20%20April%202007.pdf
[53] *Id.* at 3.

Unpaid Principal Loan Balance Is the Key to Servicer Income. Customarily, the servicer collects a monthly fee in return for the services provided to the trust (or investors). The servicing fee provides the largest income stream for servicers. The fee is based on the unpaid principal loan balance and typically ranges from 25 basis points (prime loans) to 50 basis points (subprime loans). A PSA with a 50 basis point servicing fee and a principal balance of $2 billion would result in a servicing fee of just over $9.5 million per year. With the most significant portion of a servicer's income derived from the outstanding principal loan balance, it is not surprising that servicers have not engaged in large-scale principal writedowns. Indeed, to do so would cut directly into their profits.

Unreasonable and Unearned Fees Boost Servicer Income. Ancillary fees are imposed on borrowers to compensate servicers for the occurrence of particular events. The most common ancillary fee is a late fee, although a variety of other "servicer" fees exist. Such fees are a crucial part of the servicers' income because servicers are typically permitted under PSAs to retain such fees. Ocwen Financial Corporation reported that in 2007 nearly 12% (just over $40 million) of its servicing income was derived from late fees and other loan collection fees.[54] In 2006, Countrywide reported $285 million in revenue from late fees alone.[55] Because servicers are permitted to retain these ancillary fees, they have a perverse incentive to charge borrowers as much in fees as they can. Just one improper late fee of $15 on each loan in one average size loan pool (3500 loans) would generate an additional $52,500 in income for the servicer. The profit potential of retained fee income gives servicers a financial incentive to overreach in imposing ancillary fees and to load up accounts with such fees even when doing so may lower the ultimate return to investors.

While we know that servicer costs increase during times of high defaults, we also know that those higher costs are likely to be fully offset by other fees and costs charged to the borrower and recouped by the servicer upon foreclosure. For example, in a 2007 third quarter earnings call for the nation's largest servicer at the time, Countrywide Financial Corp., we learn that servicers generally are not concerned that high defaults will negatively impact their bottom line:

> "Now, we are frequently asked what the impact on our servicing costs and earnings will be from increased delinquencies and loss mitigation efforts, and what happens to costs. And what we point out is, as I will now, is that increased operating expenses in times like this tend to be fully offset by increases in ancillary income in our servicing operation, greater fee income from items like late charges, and importantly from in-sourced vendor functions that represent part of our diversification strategy, a

[54] Ocwen Financial Corporation, Form 10-K (March 13, 2008), at 27 available at http://www.sec.gov/Archives/edgar/data/873860/000101905608000419/ocn_10k07.htm
[55] *See* Gretchen Morgenson, *Dubious Fees Hit Borrowers in Foreclosures*, New York Times (Nov. 6, 2007).

> counter-cyclical diversification strategy such as our businesses involved in foreclosure trustee and default title services and property inspection services."[56]

A recent bankruptcy case from Louisiana shows us how servicers can profit from unearned or illegal fees.[57] The case involves an elderly borrower and widow fighting to save her home in bankruptcy. Because inspections are automatically generated by the servicer's computer system, the servicer inspected the property on average every 54 days. However, upon closer examination of the servicer's records, the court found that some of those inspections were performed on other people's property and two were allegedly conducted at a time when Jefferson Parish, where the home was located, was under an evacuation order because of Hurricane Katrina. The court found that the penalty to the borrower for missing one $554.11 payment was $465.36 in late fees and other charges. The fees and charges almost equaled the amount of her one missed payment.

V. What more can be done?

Because of systemic problems in the mortgage servicing industry, voluntary, large-scale, affordable loan modifications are an aspiration rather than a reality. NCLC recommends several additional steps that Congress can take to address the still growing foreclosure crisis.

1. The now government-controlled GSEs should freeze foreclosures and modify loans.
2. Congress should enact H.R. 5679 that aligns mortgage servicers' interest with those of homeowners.
3. Congress should allow bankruptcy courts to modify home mortgage loans just as they can do for virtually every other kind of secured and unsecured debt.

A. The GSEs Should Freeze Foreclosures and Modify Loans

The GSEs should freeze foreclosures for a substantial period of time on all whole loans in their portfolios to allow for modification. Additionally, the GSEs should aggressively remove troubled loans from their securitized pools, without waiting for the loan to become delinquent, and place them in their portfolios so they can be subsequently modified. FHFA, along with Treasury and Congress, should design a modification process to avoid any negative tax consequences for homeowners. Principal reductions, which the GSEs have

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[56] Statement of David Sambol, President, Chief Operating Officer, Director, Countrywide Financial Corporation, Q3 2007 Earning Call (transcript on file with T. Twomey).

[57] *In re Stewart,* 391 B.R. 327 (Bankr. E.D. La. 2008) (awarding damages and legal fees and sanctioning Wells Fargo for the abusive and negligent imposition of fees, and moreover, ordering Wells Fargo to conduct an audit of every proof of claim filed on its behalf in cases pending in the district on or after April 13, 2007).

refused to do, interest rate reductions, and term extensions must all be used to create affordability. In the past, the GSEs have refused to pull loans from their securitized loans or modify delinquent loans aggressively. With the U.S. government now backing the GSEs, any barriers to changing these policies should be removed. To do otherwise would continue to undermine housing markets, create needless stress and disruption to beleaguered homeowners, and increase the number of foreclosed homes across the country. Secretary Paulson was recently quoted as saying that the regulators would work with financial institutions that own considerable GSE preferred stock to restore their capital positions. The same should be done for American homeowners. Moreover, the GSEs are substantial investors in subprime mortgage-backed securities, including in pools with loans originated by major subprime originators. The GSEs, as investors in senior tranches, should be playing a role in the decisions made by the servicers of these loans and moving the servicers toward more loan modifications, including principal writedowns, rather than mass movement toward foreclosures without reasonable loss mitigation.

B. Congress should enact H.R. 5679 that aligns mortgage servicers' interest with those of homeowners.

Congresswoman Waters has introduced a bill that recognizes the shortcomings of the mortgage servicing industry and would align mortgage servicer interests with those of homeowners trying to save their homes.

Mandating Borrower Access to a Decision Maker. From the homeowner's perspective one of the biggest obstacles to loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions. H.R. 5679, section 2(a) requires mortgage servicers to provide borrowers with contract information for a real person "with the information and authority to answer questions and fully resolve issues related to loss mitigation activities for the loan."

Requiring Information and Dispute Resolution Prior to Foreclosure. While the Real Estate Settlement Procedures Act currently requires servicers to respond to borrowers' request for information and disputes within 60 days, in practice many such inquires go unanswered. Despite this failure to respond, servicers are still permitted to proceed to collection activities, including foreclosure. H.R. 5679 ensures that borrowers facing foreclosure are no longer at the mercy of their servicer. Section 2(c) provides transparency to the servicing process by allowing the homeowner to obtain key information about the loan and its servicing history. The section also prohibits servicers from initiating or continuing a foreclosure proceeding during the period in which and outstanding request for information or dispute is pending.

Getting to Affordable Loan Modifications Takes Work. Creating affordable and sustainable loan modifications for distressed borrowers is labor intensive. It is no surprise, then, that servicers continue to push borrowers into less costly repayment plans and short-term modifications. H.R. 5679 would align mortgage servicer incentives with those of the homeowner seeking to prevent a foreclosure. Section 2(a) of the bill creates a duty to provide reasonable loss mitigation prior to any foreclosure and prioritizes "home-saving" loss mitigation options over those that result in loss of the home. Any loss mitigation must be based on an affordability analysis that considers the borrowers debt to income ratio and residual income—to ensure enough actual dollars for non-housing expenses—as well inclusion of the borrower's full debt profile, including junior liens on the property.

Curbing Opportunities for Abuse. Loan modification or forbearance agreements often contain a waiver of claims provision that purports to release the servicer and holder from any past or future claims that the borrower may have. Broad release language potentially cuts off all claims the borrower may have related to the origination or servicing of the loan and is inappropriate in the context of a loan modification or forbearance agreement. H.R. 5679, Section 2(a) nips this pernicious practice in the bud by banning such waiver of rights in loan modification or forbearance agreements. The section also prohibits the equally abusive practice of forcing borrowers to arbitrate any disputes with the lender or servicer.

C. Congress should allow bankruptcy courts to modify home mortgage loans just as they can do for virtually every other kind of secured and unsecured debt.

To help families save their homes from foreclosure, we propose an amendment to the Bankruptcy Code to give bankruptcy courts the same authority to modify home mortgage loans as they have for virtually every other kind of secured and unsecured debt. Our recommendation does not attempt to revisit the changes to the Code made by the 2005 amendments. Rather, it addresses the limitations in current Chapter 13 based on the special protection afforded to home mortgage lenders by the 1978 Bankruptcy Code.

A fundamental goal of chapter 13 has always been to provide an opportunity for consumers to repay their obligations. Unfortunately, this has become exceedingly difficult in recent years because our bankruptcy laws have not kept pace with the enormous changes in the mortgage marketplace that have occurred since those laws were first enacted. New non-traditional loan products have challenged the ability of hard-working families who have fallen on difficult times to effectively use chapter 13 to save their homes.[58]

Generally, section 1322(b)(2) of the Bankruptcy Code permits debtors to modify the rights

[58] *See* John Eggum, Katherine Porter and Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 Utah L. Rev. __ (forthcoming September 2008).

of secured and unsecured creditors. Some of the ways that secured claims may be modified include altering the payment schedule, reducing the contract interest rate, or "stripping down" the amount of the claim.[59] These modifications can be applied to loans secured by cars, boats, second homes and vacation homes. However, an exception to this general rule restricts modification of "a claim secured only by a security interest in real property that is the debtor's principal residence."[60] This limitation can make it nearly impossible for debtors with unaffordable mortgage payments to save their homes from foreclosure through the bankruptcy process.[61] To bring the treatment of family homes in line with the provisions applicable to cars, boats and vacation homes we recommend the following:

Repeal Special Protection for Home Mortgages in Section 1322. This change will permit some borrowers who were provided unaffordable loans to lower their monthly payment to an amount they can pay and to keep that payment amount permanent by converting their ARM to a fixed rate mortgage. It will help borrowers blunt the devastating effect of future rate adjustments which were often not properly considered by lenders when assessing ability to repay at the time the loans were made. For high LTV loans made based on the lender's careless underwriting decisions and inflated or fraudulent appraisals, and which have prevented borrowers from refinancing out of unaffordable loans, borrowers who file Chapter 13 to deal with a foreclosure would have the right to reduce the mortgage claim to the value of the property. This change will extend to low- and middle-income consumers the same protections that are afforded family farmers, corporations, and wealthy individuals who own investment properties.

Amend Section 1322 to Permit Reamortization. Permitting modification by itself does not fully address the problem based on the current structure of the Code. This is because modified secured claims in Chapter 13 must be paid in full during the three to five years of the plan. For home mortgages with large outstanding balances, this is impossible for most borrowers and they would not benefit from the change permitting modification. To address this, we propose a solution which Congress has already provided for family farmers in

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59 "Stripping down" or bifurcating a secured creditor's claim means to divide the claim into two parts: the secured portion, which is equal to the value of the collateral, and the unsecured portion represented by any amount owed over the value of the collateral. 11 U.S.C. § 506(a). Through this process, the secured creditor's rights in the collateral are preserved, but its rights to the debtor's property other than the collateral are limited and no greater than those of other creditors. Thus, the Code prevents the secured creditor from obtaining an unfair advantage in the bankruptcy case over the unsecured creditors out of proportion to the true value of its security interest.

60 11 U.S.C. § 1322(b)(2); *Nobleman v. Am. Sav. Bank*, 508 U.S. 324, 332, 113 S. Ct. 2106 (1993).

61 In order to retain a home in bankruptcy, the Code generally requires debtors to make ongoing monthly mortgage payments as well as additional monthly payments to make up any arrearage on the mortgage loan.

Chapter 12 cases. Section 1322 should be amended to include a provision similar to section 1222(b)(9) which permits the borrower's loan to be reamoritized based on the modified terms and paid over a period beyond the plan term, generally up to thirty years.

VI. Conclusion

Thank you for the opportunity to testify before the Committee today. The foreclosure crisis is continuing to swell and the need to act is great. Foreclosure freezes and loan modifications by the GSEs, passage of H.R. 5679 and enactment of bankruptcy legislation all are needed to save homes and stabilize the market. We look forward to working with you to address the economic challenges that face our nation today.