Foreclosure Prevention and Intervention: The Importance of Loss Mitigation Strategies in Keeping Families in Their Homes

Written Testimony
of

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Chairwoman Waters and members of the Subcommittee, thank you for inviting me to testify today regarding loss mitigation strategies and foreclosure prevention. My name is Tara Twomey. I am an attorney, currently of counsel to the National Consumer Law Center[1] (NCLC), and a Lecturer at Stanford Law School. 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 low-income clients of the National Consumer Law Center (NCLC). 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. In addition, NCLC's California Economic Justice Initiative focuses specifically on the needs of California's low-income consumers and provides support to advocates throughout the state who represent low-income California consumers. Currently, our greatest demands for assistance in California are related to the growing foreclosure crisis.

Today, I will talk about loan modification[2] as a strategy to limit the devastating consequences of skyrocketing foreclosure rates. I will highlight some of the challenges to implementing this strategy at a scale commensurate with the foreclosure problem. These challenges are significant, but they are not insurmountable roadblocks. We have not come to a dead end, but Congress needs to act now to make long-term, sustainable loan modifications a viable option for the millions of homeowners that will face foreclosure in the coming years.

Specifically, members of Congress must require servicers to engage in reasonable loss mitigation efforts before initiating a foreclosure. This would have the result of moving loan servicers to scale up their loss mitigation activities, promote home-saving options over home-losing options, and offer affordable, long-term loan modifications. We also support automatic loan modifications to address the large magnitude of the foreclosure crisis. Such automatic loan modifications must be accompanied by case-by-case analysis for borrowers who are not eligible for such automatic treatment or for whom such change is insufficient to provide long-term affordability.

The Foreclosure Crisis

For over a decade, abuses in the subprime market have undermined the efforts of hardworking families to acquire and retain the dream of homeownership. For many, it is their only source of wealth accumulation. Since 1980, foreclosures have increased almost 300 percent, but homeownership has increased only five percent.[3] Last year, homeowners suffered over one million foreclosures, more than a 40 percent increase from the previous year.[4] In 2007, foreclosure filings have continued to soar. As of the end of the third quarter of 2007, residential foreclosure filings are nearly double what they were for the same period in 2006.[5] 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.[6]

For California the picture is even bleaker than that of the United States as a whole. The most recent data available shows 148,147 foreclosure filings on 94,772 properties in California for the third quarter of 2007.[7] These figures represent a 36 percent increase from the previous quarter and a 297 percent increase from the previous year. Fourteen of the fifteen markets with the largest increase in projected subprime foreclosure rates are in California and, it is estimated that more than 21% of all California subprime loans originated in 2006 will fail.[8]

Big Problem, Little Response.

Loan modification has been identified as one of the preferred strategies for addressing the rising tide of foreclosures.[9] Despite the potential benefits of loan modifications,[10] the magnitude of the foreclosure crisis dwarfs the current response from the financial services industry.

A loan modification is a written agreement between the servicer and the homeowner that *permanently* changes one or more of the original terms of the note in order to help the homeowner bring a defaulted loan current and prevent foreclosure. Loan modifications may reduce the interest rate or principal amount of a mortgage loan, may change the mortgage product (for example, from an adjustable rate to a fixed rate), may extend the term of the loan, or may capitalize delinquent payments. While not a panacea for all that is ailing in the subprime mortgage market, long-term, sustainable loan modifications can provide significant relief to the nation's distressed homeowners.

There have been several efforts to seek mass loan modifications through voluntary measures. Senate Banking Committee Chairman Dodd held a meeting last spring resulting in a set of servicing principles aimed at long-term affordability.[11] More recently, Treasury Secretary Paulson has encouraged voluntary commitments from servicers to contact borrowers and explore new loan modification approaches.[12] In September 2007, the federal and state banking regulators issued a joint statement on loss mitigation strategies, referencing earlier guidance and encouraging usage of loss mitigation authority available under pooling and servicing agreements and the Dodd principles.[13] Unfortunately, to date the commitments from the industry have not resulted in large-scale changes on the ground.

Housing counselors, attorneys and borrowers still report major problems in seeking loan modifications for unaffordable loans. It is clear that the financial services industry, has failed to implement a loan modification strategy on a scale commensurate with the problem. In September 2007, Moody's Investor Services surveyed 16 mortgage servicers that accounted for 80 percent of the market for subprime loans and found that most of those companies had modified only about 1 percent of loans with interest rates that reset in

January, April and July 2007.[14] In October 2007, the California Reinvestment Coalition surveyed 33 percent of the California's mortgage counseling agencies that offer assistance to financially distressed borrowers and found that servicers were not consistently modifying loans for long-term affordability.[15] Instead most borrowers were being pushed into foreclosure or short sales.[16]

In California, where the anticipated payment shock will effect as many as 300,000 homeowners in the next year.[17] Recently, California Governor Armold Schwarzenegger announced an agreement with four large servicers of subprime mortgage loans under which interest rates will be frozen for homeowners who reside in their property, are not delinquent on their payments,[18] and show that they cannot afford a scheduled rate increase. The length of time for the proposed freeze remains unspecified, though it is clear that the agreement did not contemplate permanent loan modifications. This voluntary effort to "fast-track" these temporary loan modifications is a significant step in the right direction. However, the "kick the can" approach to solving the foreclosure crisis does not achieve the goal of affordable and sustainable homeownership for those affected borrowers. Instead, it merely postpones the day of reckoning.

Sheila Bair, Chairman of the FDIC, has called for automatic loan modifications for borrowers with subprime ARMs.[19] A recent report from the Joint Economic Committee also suggested that automatic loan modifications are needed.[20] We applaud Chairman Bair's leadership on this issue. Without large-scale approaches to loan modifications, many homeowners will be left with no recourse except to surrender their homes as a result of abusive loans that they received.

Getting Over the Hurdles to Loan Modification

It is well-known that there are several structural barriers to "scaling up" loan modification efforts. These include:

- Finding the Decisionmaker – From the homeowner's perspective one of the biggest obstacle 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.[21] Borrowers deserve better and loan servicers need to find a way to provide timely, consistent and competent information to borrowers.

- Pooling and Servicing Agreement Constraints – Once the borrower make contact with someone in the servicer's shop, an appropriate loan modification may remain elusive due to the terms of the pooling and servicing agreement (PSAs), which govern most subprime mortgage securitizations.[22] Some pooling and servicing agreements limit the servicer's ability to modify loans while others may cap loan modifications by number or percentage of outstanding balance in the loan pool. While the majority of PSAs are not likely to have restrictions on loan modifications, a small minority actually prohibit loan modifications altogether.[23]

- Mismatched Interests – Even where PSAs do not restrict loan modifications, the misaligned interests of the borrowers, servicers and investors create impediments to successful loan modification agreements. While borrowers are struggling to save their homes, servicers are tasked with maximizing returns to investors.[24] In addition, servicers have their own incentives to minimize costs and maximize revenues.[25]

- "Tranche" Warfare – The securitization process can also lead to mismatched interests among the investors in any given loan pool. A typical securitization results in different classes of securities, called tranches.[26] 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.[27]

To ensure that loan modifications happen on the scale necessary to address the coming waves of foreclosures, Congress should require servicers to engage in reasonable loss mitigation prior to foreclosure. This requirement will push the market to deal with the above inefficiencies so that loss mitigation opportunities are maximized. Such a measure also would address the limited effect of voluntary efforts undertaken to date.

Beyond Rate Reset Problems

While rate resets pose a substantial hurdle for many borrowers, another group of distressed borrowers have received much less attention. These homeowners have not been subject to payment shocks or adverse life events, but rather have been saddled with unaffordable loans from the moment of origination.

Much of the loan modification strategy has focused on dealing with upcoming rate resets on the ubiquitous 2/28 and 3/27 ARMs.[28] This mortgage product, which dominated the subprime market from 2004 to 2006, is characterized by a fixed rate for the first two years, followed by an adjustment every 6 months thereafter. Often these loans are structure with an initial "teaser" or discounted rate. After the two-year fixed period for these loans expires, the interest rate, and accordingly the borrower's payments, can increase significantly. The "payment shock" resulting from this adjustment is often cited as a major cause of rising defaults in the subprime market.[29]

However, many other borrowers were unwittingly pushed into unaffordable loans by unscrupulous mortgage brokers or lenders. Such unsustainable loan can quickly drag families into financial trouble, and in some cases into bankruptcy in an effort to save their homes. Ms. Halliburton, a 77-year old, Philadelphia homeowner, is one such borrower.[30]

She was given a 2/28 ARM from Countrywide Home Mortgage in April 2006.[31] As is common with a 2/28 ARM, her initial payment was based on a discounted rate of interest.[32] In Ms. Halliburton's case that "discounted rate" was 9.625%.[33] In March 2007, Ms. Halliburton testified at a Senate congressional hearing about the circumstances surrounding the origination of her mortgage loan and her difficulties in making her mortgage payments.[34] Much of the discussion at that hearing focused on teaser rates, payment shocks and the underwriting standards for 2/28 ARMs. In many respects Ms. Halliburton fit the all-too common portrait of a borrower suffering payment shock, save one important fact. Her loan was not scheduled to adjust until May 2008.[35]

Ms. Halliburton's initial monthly loan payment was $922.24 for principal and interest. This amount did not include approximately $180 a month for taxes and insurance. All totaled Ms. Halliburton's monthly payment for principal, interest, taxes and insurance consumed 62% of her Social Security income, leaving her with only $664 a month for other expenses such as food, medicine, and utilities.

A loan modification strategy that will work for Ms. Halliburton, and those like her, will take more than temporary or even permanent freezes on adjustable rates. Borrowers like her need interest rate reductions and principal reductions in order to restore long-term stability.

A sensible approach would involve a two-step process in which automatic loan modifications are made to certain classes of loans where borrowers are eligible, followed by a variety of case-by-case measures. Automatic loan modifications would include conversion of adjustable rate mortgages to fixed rate loans at the teaser rate, or the fully indexed rate, which is lower; write downs of fixed rate loans to the par rate; and/or principal reductions to present market value. After exhaustion of this tier, case by case assistance would include a stay on foreclosure while the servicer does a good faith review of the borrower's long-term financial situation and offers a repayment plan, forbearance, loan modification or other option to bring the arrears current. Failure to engage in this process, as noted above, should be a defense to foreclosure.

It remains to be seen whether servicers and lenders are willing to take the necessary steps in modifying loans. Given hurdles in even achieving minimal concessions on loan modifications, it is unlikely that servicers and holders will fix the wrongs perpetrated on vulnerable homeowners across the nation without a requirement to do so.

Loan Modification Should Not Be A New Opportunity for Abuse

Recent headlines and court decisions around the country have called into question servicer and holder conduct with respect to borrowers in default.[36] For some time now homeowners and consumer advocates have struggled with 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.[37] 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.[38] These abuses exist because there are market incentives rather than deterrents for this type of behavior.[39]

For the same reasons, large-scale loan modifications present new opportunities for servicer abuse. The information asymmetry often critiqued in the loan origination context is even worse in the loss mitigation process.[40] The disclosure of information is entirely one-sided. The borrower is required to provide much of the same documentation related to their financial status as is required (or should have been required) at the origination stage. The servicer produces nothing except a "take-it-or-leave-it" agreement. Two problems that have already taken root are the charging of unreasonable fees and a requirement that the borrower waive any past or future claims. These practices need to be nipped in the bud and not allowed to flourish.

- Unreasonable or Unearned Fees – Compensating loan servicers for loan modifications may be critical to the success of the loan modification strategy.[41] However, the amounts charged by the servicer, usually to the homeowner, should reflect a reasonable fee and actual costs, must be allowed under the terms of the note and security instrument, and should not violate state law.[42] Additionally, fees assessed to the borrower should be reduced when another party is compensating the servicer for their work.[43] Reduced fees or waiver of the fee should also be available.

- Waiver of Rights – Often loan modification agreements 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. For example, in a recently reviewed forbearance agreement the borrower upon execution of the agreement released the "lender" from any claims or damages, including those that were unknown, including "tort claims, demands, actions and causes of action of any nature whatsoever arising under or relating to the Loan Documents or any of the transactions related thereto, prior to the date hereof, and borrowers waive application of California Civil Code Section 1542."[44] This broad release language potentially cuts off all claims the borrower may have related to the origination or servicing of the loan and is simply inappropriate in the context of a loan modification agreement.

Conclusion

The foreclosure crisis is real, it is big, and it is growing. To date, the financial industry has failed to voluntarily scale up their loss mitigation activities to address the magnitude of the problem. A right to reasonable loss mitigation prior to foreclosure is needed to promote home-saving options over home-losing options and encourage affordable, long-term loan modifications. Measures also need to be taken to address general servicing abuses, which otherwise could derail the loan modification process. We look forward to working with Representative Waters and the Committee to address these issues.

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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. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws and bankruptcy, including Foreclosures (2d ed. 2007), Consumer Bankruptcy Law and Practice (8th ed. 2006), Truth In Lending, (5th ed. 2003) and Cost of Credit: Regulation, Preemption, and Industry Abuses (3d ed. 2005) as well as bimonthly newsletters on a range of topics related to consumer credit and bankruptcy issues. 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. NCLC's attorneys have been closely involved with the enactment of all the federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

[2] Loan modification is one of several loss mitigation alternatives. For those experiencing temporary hardships options such as a repayment plan or forbearance agreement may be the most appropriate option. These generally require homeowners to make up missed payments within a specified period of time. By contrast loan modification is appropriate when short-term relief measures are insufficient. Other loss mitigation alternatives do not result in the borrower remaining the home. A short sale is a sale of property in which the servicer/lender agrees to accept the proceeds of the sale to satisfy the defaulted mortgage, even though this may be less than the amount owed on the mortgage. A deed in lieu of foreclosure is a workout option in which a homeowner voluntarily conveys clear property title to the servicer/lender in exchange for a discharge of the debt.

[3] NCLC analysis based on data through 2005 from Mortgage Bankers Association, National Delinquency Survey; U.S. Census Bureau, Statistical Abstract of the Unites States, U.S. Census Bureau, American Housing Survey and American Community Survey.

[4] RealtyTrac, *More Than 1.2 Million Foreclosure Filings Reported in 2006* (Jan 25, 2007), *available at* http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=1855&accnt=64847.

[5] ReatlyTrac, *Foreclosure Activity Up 30 Percent in Third Quarter* (Nov.1, 2007), *available at* http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3567&accnt=64847.

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

[7] RealtyTrac, *Foreclosure Activity Up*, *supra* note 5.

[8] Schlomer , *supra* note 6 at 20, 47.

[9] *See, e.g.,* Cheyenne Hopkins, *Modification: Tentative Steps Toward a Regulatory Consensus*, American Banker (Nov. 27, 2007); *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 (October 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); Remarks of FDIC Chairman Sheila C. Bair, American Securitization Form (ASF) Annual Meeting (June 6, 2007)("The immediate task is to sustain homeownership by ensuring the servicers have the flexibility they need to make prudent loan modifications").

[10] *See* Remarks of FDIC Chairman Sheila C. Bair, *supra* note 9 (stating that loan modification that provide sustainable mortgage for borrowers are generally the best option for investors and borrowers).

[11] 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

[12] 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/.

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

[14] Michael P. Drucker, et al., *Moody's Subprime Mortgage Servicer Survey on Loan Modifications*, Moody's Investor Services (Sept. 21, 2007), *available at* http://americansecuritization.com/uploadedFiles/Moodys_subprime_loanmod.pdf.

[15] California Reinvestment Coalition, *Survey Results Show Lenders not Helping Borrowers Keep their Homes* (October 10, 2007), *available at* http://www.calreinvest.org/news-room/2007-10-10

[16] *Id.*

[17] *Gov. Schwarzenegger Works with Lenders to Help Homeowners Avoid Foreclosure*, Press Release, Office of the Governor (Nov. 20, 2007), *available at* http://gov.ca.gov/press-release/8147/.

[18] Oddly, the agreement does not appear to provide any relief to borrowers who may be in default as a result of rate resets that have already occurred. Presumably, these borrowers may continue to request loan modifications through the "slow-track" channels.

[19] Remarks of FDIC Chairman Sheila C. Bair, *supra* note 9.

[20] *See, e.g.*, *Subprime Lending Crisis*, *supra* note 9.

[21] *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. 2000)(describing the process of trying to get through to an 800 number as a "vexing and protracted undertaking").

[22] *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).

Pooling and servicing agreements broadly govern the formation of the trust in the securitization process, the servicing of the loans in the trust, and the duties of the various parties to the trust agreement.

[23] This later group of PSAs are particularly troublesome given that, according to the Consumer Mortgage Coalition, in most private label securitizations there is a "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 waivers." Sam Garcia, *Group Warns on Large Scale Modifications: Consumer Mortgage Coalition sends letters to the FDIC*, Mortgage Daily News (Oct. 9, 2007).

[24] Pooling and servicing agreements universally require servicers to act in the best interest of the certificate holders. Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications* (April 5, 2007). To determine whether a purposed loan modification maximizes the recovery to the investors, servicers compare the anticipated recovery under the loan modification to the anticipated recovery through foreclosure on a net present value basis. American Securitization Forum, Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans (June 2007), *available at* http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf.

[25] *See* Eggert, *supra* note 16; Joseph R. Mason, *Mortgage Loan Modification: Promises and Pitfalls* (Oct. 3, 2007), *available from SSRN at* papers.ssrn.com/sol3/papers.cfm?abstract_id=1027470

[26] Eggert, *supra* note 16.

[27] *Id.*

[28] *See, e.g.*, *Subprime Lending Crisis*, *supra* note 9 (identifying the root of the subprime mortgage crisis as the prevalence of 2/28 and 3/27 hybrid loans).

[29] *Id.*

[30] Written Statement of Alan M. White on behalf of Jennie Haliburton, Mortgage Market Turmoil, Causes and Consequences, U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 22, 2007).

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] Mortgage Market Turmoil, Causes and Consequences, U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 22, 2007).

[35] Written Statement of Alan M. White on behalf of Jennie Haliburton, Mortgage Market Turmoil, Causes and Consequences, U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 22, 2007).

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

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

[38] *Id.*

[39] *See* Eggert, *supra* note 9

[40] *See* Mason, *supra* note 19, at 9-10 (noting that the modification proposal and acceptance by the consumer are not required to generate any of the records, disclosure, and restrictions placed on loan originations).

[41] *See* Mason, *supra* note 19 at 6-7 (describing the high costs that result from the labor-intensive process of evaluating each borrower's capacity to pay).

[42] The Fannie Mae Single Family 2006 Servicing Guide allows servicers to charge the borrower $500 to cover its administrative processing costs, plus the actual out-of-pocket expenses for a credit report and other documented expenses. *See* Fannie Mae Single Family 2006 Servicing Guide, Part VII, 502.02 (Modifying Conventional Mortgages)(9/30.05), available at http://www.allregs.com/efnma/. There is no limit on modification or workout fees charged by servicers on loans not covered by the Fannie Mae or Freddie Mac Servicing Guides.

[43] For example, the Office of Thrift Supervision is reported to be working on its own loan modification strategy, which will compensate servicers with $500 per modified loan. *See* Alan Zibel, "Proposal would pay to convert loans," *The Sun Herald* (Nov. 21, 2007), available at http://www.sunherald.com/business/story/194064.html.

[44] Section 1542 of California's Civil Code provides that: "A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."