

## **INTRODUCTION**

In January and March 2007, the Senate Banking, Finance & Insurance Committee held informational hearings to investigate the origins of, and to identify workable solutions to, the problems California was experiencing in its mortgage markets. Those two hearings were primarily focused on identifying the steps that needed to be taken to halt the issuance of risky loans that were causing the market disruptions. During those hearings, the Committee heard from industry practitioners, consumer advocates, federal and state regulators, and economists about the importance of adequate loan underwriting; the provision of clear, balanced, and timely explanations of loan terms to borrowers; and consistent application of regulatory guidance across industry participants. The Committee also learned that great focus should be placed on housing sustainability, rather than on housing attainability.

In the time since this Committee's two initial hearings, a great deal has changed. In part due to market corrections, and in part due to federal and state regulatory actions, lenders have tightened their underwriting standards significantly, relative to the standards in place during 2005 and 2006. The media has been filled with reports of lenders' decisions to restrict the use of stated income loans and simultaneous second liens, increase the credit scores necessary to obtain products with multiple layers of risk, take greater steps to verify borrowers' ability to afford their loans after interest rate resets, and improve oversight of mortgage brokers. A great deal of emphasis has also been placed upon the need for due diligence by borrowers seeking mortgage loans. While the situation in today's mortgage market is far from stable, it is clear that many of the abuses which prompted this Committee's January and March hearings have abated. While the Committee will continue to keep a watchful eye on developments in the mortgage market, it has chosen to redirect its immediate focus to borrowers whose mortgage interest rates are about to reset.

On August 21, 2007, the Senate Banking, Finance & Insurance Committee will convene its third informational hearing on mortgage lending, and will hear from a variety of experts about several aspects of homeownership preservation within the current mortgage environment. Witnesses will discuss the regional and statewide, social and economic and implications of foreclosures; address barriers that can hamper efforts to develop loan workout plans designed to keep people in their homes; review what is currently being done by industry, non-profit organizations, and government to minimize defaults and foreclosures; and hear from consumer groups about what more needs to be done in that regard.

## **THE SCOPE OF THE PROBLEM**

According to the Mortgage Bankers Association, 46,265 homes in California were in foreclosure in March 2007. Another 76,732 mortgage loans were seriously delinquent. The vast majority of the problematic loans were subprime adjustable rate mortgages (ARMs), which are failing at a rate of about 15 times higher than prime loans. As of March 2007, 4.84% of all subprime ARMs in California were in foreclosure, and another 7.5% of all subprime ARMs were seriously delinquent.

Some California regions are being hit harder than others. Areas with large numbers of subprime

loans are concentrated in the Central Valley and the Inland Empire. According to First American LoanPerformance, the five metropolitan statistical areas (MSAs) with the highest concentrations of subprime loans at the end of 2006 included Merced (21.56% of all mortgages were subprime as of December 2006), Bakersfield (20.23%), Riverside-San Bernardino (19.91%), Stockton-Lodi (19.78%), and Modesto (18.23%).

First American LoanPerformance also tracked the percentage of all subprime loans that were delinquent in each MSA as of December 2006. Sacramento topped the list, with 14.12% of all subprime loans delinquent. Three of the MSAs with the highest concentrations of subprime loans were also in the top five MSAs with the highest percentage of delinquencies (Modesto with 13.18%, Stockton-Lodi with 12.74%, and Merced with 12.24%).

Unfortunately, many experts believe that the delinquency and foreclosure numbers will get worse before they improve. Loans originated during late 2005 and all of 2006, a period of peak origination volumes and decreased underwriting quality, are only now beginning to reset in large numbers. According to Credit Suisse, the peak month for interest rate resets will come this October, when more than \$50 billion in mortgages nationwide will reset from introductory teaser rates to new, higher rates. The level of first-time resets will remain above \$30 billion per month through September 2008. In all, the interest rates on \$1 trillion in mortgages (12% of the nation's total) will reset for the first time in 2007 or 2008.

The significance of rising defaults and foreclosures extends beyond the individuals and families who lose their home equity and their homes. While less than 1% of *all* loans in California (prime and nonprime, fixed and adjustable rate) were in foreclosure as of March 2007, certain neighborhoods saw much higher percentages of foreclosures and short sales. (A short sale is one in which the institution that holds the mortgage agrees to accept less than it is owed upon sale of the house, in lieu of foreclosing on the property). A neighborhood's housing prices tend to become depressed when large numbers of homes go on the market; house prices are depressed even further when many of the homes for sale are being sold at bargain basement prices by banks and other lending institutions through foreclosures or short sales.

The combination of depressed home prices in certain areas, together with California's already slow housing market and a tightening of mortgage lending standards, has caused significant pain among many whose incomes are dependent on California's real estate market. New housing starts are down, along with construction spending; mortgage brokers, loan officers, real estate salespersons, and real estate brokers have significantly less business, and therefore lower income; many real estate and housing construction professionals have lost their jobs; restrictions of credit have led to fewer home equity loans being made, which has depressed consumer spending; businesses who rely on that spending have seen lower sales. All of these outcomes combine to depress state and local tax revenue. The ongoing and future regional and statewide impacts of rising defaults and foreclosures lend support to this Committee's decision to focus on what can and should be done to preserve homeownership among California's at-risk borrowers.

## **OPTIONS FOR AVOIDING DEFAULT AND FORECLOSURE**

Once a borrower finds that he or she will be unable to make his or her minimum required monthly mortgage payment, the borrower has several options. Some options allow the borrower to retain possession of his or her home (retention options), while some involve sale of the home without the expense and stigma of foreclosure (non-retention options).

### **Retention Workout Options:**

The simplest option is refinancing out of the unaffordable mortgage into a more affordable one. However, this option is increasingly unavailable to many subprime borrowers in today's tight credit markets.

Loan modifications involve making the loan more affordable for the borrower by modifying the loan contract in writing and permanently changing one or more of its original terms. Examples of changes that can be made include interest rate reductions, reductions in the outstanding principal balance, extensions of the loan term, establishment of escrows for taxes and insurance, or adding delinquent interest to the unpaid principal balance.

Forbearance involves an agreement by the lender or servicer to allow a reduced or suspended payment for a specific period of time. Under a policy of forbearance, the borrower still owes the unpaid amount, which may be folded into a repayment plan, or may ultimately be deferred or forgiven through a loan modification.

### **Non-Retention Options:**

Borrowers with enough equity can sell their homes and pay off their mortgages in full.

Lenders and servicers can also agree to a short-sale, in which the institution agrees to accept the proceeds of a pre-foreclosure sale in satisfaction of the loan, even though the proceeds may be less than the amount owed on the mortgage.

Another alternative, often used when a property has been listed for a period of time with no interest among potential buyers, is a deed in lieu of foreclosure. A "deed in lieu" is a workout in which a borrower voluntarily conveys clear property title to the lender or servicer in exchange for a discharge of the debt.

Given today's depressed housing market, many borrowers are finding it impossible to refinance their mortgages to obtain more affordable terms. Furthermore, unless they purchased their home several years ago, few borrowers have the equity they would need to be able to sell the house and pay off their mortgage. In fact, many borrowers are upside down in their mortgages, a situation in which they owe more on their mortgages than their homes are worth.

Workout plans have become a subject of increased attention in 2007, as more and more borrowers find themselves unable to sell or refinance, and unable to afford their mortgage

payments. The remainder of this background paper will focus on options available to lenders, servicers, and borrowers who wish to avoid default and foreclosure. The pages that follow will also discuss many of the challenges that face those who wish to accomplish a loan workout in lieu of foreclosure.

## **SECURITIZATION: A SOURCE OF COMPLEXITY**

The retention workout options listed above are predicated on the assumption that the borrower contacts his or her institution before becoming seriously delinquent on his or her loan or that the lender reaches out to contact borrowers who have missed a payment or who the lender believes are likely to run into trouble upon an interest rate reset. The retention workout options listed above also assume that the institution which holds the loan is able to negotiate freely with the borrower to develop a workout option in the best interests of both. This latter assumption is valid when the originating lender retains the loan in its portfolio, but can be less accurate when the loan has been securitized, because the terms of the securitization governing documents may place restrictions on the servicer's flexibility to engage in loan modifications.

Historically, lenders made loans from their own funds and retained the loans in their portfolios. The originating lender would also service the loan (i.e., calculate the monthly payments due, collect them from the borrower, perform other administrative duties relative to the loan, and, if necessary, inform the borrower that he or she was behind on his or her payments).

In today's mortgage market, lenders often do not retain or service the loans they make to borrowers. More commonly, the originating lender funds the loan with a line of credit from a Wall Street investment bank or a commercial bank. Once the loan funds, the originator sells the loan to a bank or securities firm (usually the one from which it obtained its line of credit, but not always). The purchasing bank packages that loan with others into mortgage-backed securities (MBSs) it sells to institutional investors. In today's mortgage market, the servicing rights to a loan may be held by the originating lender or sold to a separate servicer. Today, several scenarios are possible – lenders may retain and service the loans they originate; lenders may sell some of the loans they originate into the securitized market and either retain the servicing rights on the securitized loans or sell the servicing rights to a separate institution; and lenders may purchase the servicing rights to loans made by other lenders. The decisions made by each lender are unique, and the mix of loans that are retained and serviced, only serviced, acquired from others, and sold varies by lender.

The system of securitization that has developed generally worked well in a rising housing market, by spreading loan risks among various investors and other market participants, and infusing a significant amount of capital into the mortgage markets, thereby expanding credit and homeownership opportunities. However, as the nonprime market has soured in recent months, widespread securitization of nonprime mortgage loans has generated a great deal of confusion among borrowers about who to contact if they find themselves in trouble making their payments and want to restructure their loans to improve their affordability. The existence of multiple parties to securitized loans can also make it difficult to discern the lines of responsibility among lenders, servicers, trustees, investors, and borrowers in some cases.

The lucrative business of packaging loans for sale to investors has evolved into a very large and important part of worldwide debt capital markets. The sheer size of the securitized mortgage market makes an understanding of its workings critical for understanding the challenges the securitized market poses to developing workout plans for borrowers in trouble.

### The Size and Composition Of The Secondary Market For Mortgages

The MBS market is one of the largest financial markets in the world. As of June 30, 2006, MBSs accounted for the largest segment of the US bond market (23% of all outstanding bond market debt, compared to corporate bonds at 20% and Treasury debt at 16%).

According to the Mortgage Bankers Association, \$1.2 trillion of privately-issued, residential mortgage-backed securities were issued in 2006. An additional \$966 million worth of residential mortgage-backed securities were issued by Fannie Mae, Freddie Mac, and Ginnie Mae (collectively called the government-sponsored enterprises, or GSEs). Nonprime loans comprised two-thirds of private MBSs in 2005, up from 46% in 2003.

In the past few years, the growth of nonprime mortgages has changed the market for securities. As the nonprime market has grown, so has the popularity of private-label mortgage backed securities (i.e., those securitized by entities other than the GSEs). Total outstanding private-label MBSs represented 29% of all MBSs in 2005, more than double its share in 2003. At the same time, the share of MBSs held by the GSEs fell by 10 percentage points, from 53% to 43%. The shift is a dramatic reflection of investor choice. Investors left the guaranteed, GSE-backed mortgage market for higher interest rates in the potentially riskier, privately-backed mortgage securities market. As they did so, the amount of capital available to fund subprime loans grew, making more of these mortgages available to more borrowers. The amount of risk taken on by investors also grew, as we are seeing in today's volatile stock market.

### How MBSs Work

MBSs represent an ownership interest in specified cashflows generated by a group of mortgage loans. The most basic mortgage securities, known as pass-throughs or participation certificates, represent a direct ownership interest in a pool of mortgage loans. These mortgage securities may be pooled again to create collateral for a more complex type of mortgage security, known as a collateralized mortgage obligation (CMO) or a real estate mortgage investment conduit (REMIC). CMOs and REMICs allow cash flows to be directed so that different classes of securities with different cashflow characteristics, maturities, and rates of return can be created.

Unlike other fixed-income securities, which return a stated rate of interest (the coupon rate) over the life of the bond and repay the face value of the bond upon its maturity, MBSs pay a coupon rate of interest and generate repayments of their principal over the life of the security. The cash flow generated by mortgage loans (and therefore MBSs) is irregular, because it is impossible to know ahead of time when an individual borrower will repay or refinance his or her loan. If homeowners whose loans are in a pool sell or refinance their homes, prepay their loans, or default, the principal is distributed on a pro-rata basis to investors in pass-through securities. Investors in CMOs and REMICs receive principal repayments according to the payment

priorities of each CMO or REMIC and the class of securities they own. Most MBSs pay interest and principal on a monthly basis, although some pay quarterly or semiannually, depending on the terms of the issue. Because it can be difficult to predict the return on a pool of mortgage loans, their uncertainty has traditionally provided returns that exceed those of most other fixed-income securities of comparable quality.

The issuer and structure of each MBS largely determines its level of risk. Most pass-throughs are issued and/or guaranteed by one of the GSEs and carry an implied AAA credit rating. The remainder are privately issued and generally rated AAA or AA. Payments of principal and interest on pass-throughs are considered secure, but the cash flow on these investments can vary from month to month, depending on the actual prepayment rate of the underlying mortgages.

CMOs and REMICs are multi-class bonds backed by a pool of mortgage loans. In structuring a CMO or REMIC, an issuer distributes the cash flow from the underlying collateral over a series of risk classes called tranches. Each CMO or REMIC is a set of two or more tranches, each having an average life and cash-flow pattern designed to meet a specific investment objective. These bond issues can become quite complicated, and some have as many as 50 tranches.

As payments on the underlying mortgage loans are collected, the CMO or REMIC issuer typically first pays the coupon rate of interest to the bondholders in each tranche. As principal is received, it is distributed first to the investors in the first tranches; investors in later tranches do not start receiving principal payments until the prior tranches are paid off. Any principal remaining after the final tranche has been paid off is known as a residual. The residual can be traded as a stand-alone security. The concept of a residual has also come into play in the discussions (see sections below) over how workout plans on loans that are in a REMIC pool should be accounted for.

Investors in MBSs include institutions of all sizes -- corporations, commercial banks, life insurance companies, pension funds, trust funds, hedge funds, charitable endowments -- as well as individuals. Virtually anyone can and does own a piece of America's mortgage market.

## **BARRIERS TO DEVELOPING WORKOUT PLANS**

As noted earlier, developing a workout plan with a borrower is considerably more straightforward when the originating lender retains and services the loan than when the loan is held by investors and serviced by an institution that was not involved in making the original loan. However, even when a loan is not securitized, there can be barriers that complicate attempts to develop workouts. As many as six barriers to developing loan workouts have been identified.

### **Barriers That Apply Only To Securitized Loans**

#### Limitations Imposed by Securitization Agreements

In June 2007, the American Securitization Forum (ASF) issued a Statement of Principles, Recommendations, and Guidelines for the Modification of Securitized Subprime Residential

Mortgage Loans. ASF, which is the umbrella group for over 350 organizations that are active participants in the US securitization market, issued the guidance in hopes of helping establish a common framework relating to the structure and interpretation of loan modification provisions in securitization transactions. The ultimate goal of ASF's efforts is to promote greater uniformity, clarity, and certainty to industry participants with respect to developing loan workouts with borrowers in trouble.

ASF's Statement is focused on modifications of first lien subprime residential mortgages, although ASF notes that most of the principles contained in its Statement could apply to modifications of other types of residential mortgage loans, as well. Much of the discussion below is based on the contents of ASF's Statement.

Generally speaking, the rules that apply to the servicing of subprime residential mortgage loans included in a securitization are governed by either a pooling and servicing agreement or by a servicing agreement. These agreements typically require the servicer to follow accepted servicing practices that it would employ "in its good faith business judgment" and which are "normal and usual in its general mortgage servicing activities," and/or certain procedures that the servicer would employ for loans held in its own portfolio. Some agreements also require that the servicer adhere to specific loss mitigation plans.

Most subprime securitizations authorize the servicer to modify loans that are either in default or for which default is either imminent or reasonably foreseeable. The "reasonably foreseeable" standard derives from, and is permitted by, the restrictions imposed by the REMIC sections of the Internal Revenue Code. According to ASF, most market participants interpret the two standards of future default (imminent and reasonably foreseeable) as substantially identical.

The modification provisions that govern loans deemed likely to default also require that the loan modifications be in the best interests of the securityholders (aka, the investors) or not materially adverse to the interests of the securityholders and, if the security is structured as a REMIC, that the modifications not result in a violation of the REMIC status of the securitization trust. Loan modifications that are generally acceptable under servicing agreements include changing the interest rate on a prospective basis, forgiving principal, capitalizing arrearages, and extending the maturity date of the loan. In addition to allowing servicers to modify loan terms, most subprime securitization agreements also permit other loss mitigation techniques, such as forbearance, repayment plans for arrearages, and other deferments that do not reduce the total amount owing. Securitization agreements also generally allow short sales.

A key interpretive challenge posed by most servicing and pooling and servicing agreements is a determination of which option (loan modification or foreclosure) is in the best interest of the securityholders. To make this determination, the servicer must evaluate which action is likely to produce the greatest recovery on the loan asset for securityholders – i.e., whether investors will be better served by modifying the terms of the loan or foreclosing on the related property. Clearly, the assumptions made are critical for determining whether a borrower receives a loan modification (and if so, what that modification looks like) or whether the borrower loses his or her home. The decision on whether the best interests of securityholders are being upheld is further complicated by the fact that different classes of securityholders (i.e., the holders of

different tranches) may be affected differently by the same loan modification. ASF's guidance states that the "best interests of investors" standard is appropriately measured with reference to securityholders in the aggregate, rather than with respect to individual classes of securityholders. However, there is currently no guidance as to what assumptions are appropriate for use by servicers in determining whether a loan modification or a foreclosure will better serve the interests of investors. The task of developing reasonable assumptions is further complicated by the extreme volatility in today's mortgage, housing, and investment markets.

Most servicing and pooling and servicing agreements share several similarities relating to the ability of the servicer to work constructively with a borrower to avoid foreclosure. However, some servicing agreements impose specific limitations on workout plans, and these limitations can pose barriers that hamper servicers' ability to work constructively with borrowers. For example, some agreements limit the frequency with which a loan may be modified (e.g., no more than once in any 12-month period and no more than three times over the life of the loan). Other agreements provide a minimum interest rate below which a loan's rate cannot be changed. Other provisions may limit the total number of loans in the pool or in the tranche that may be modified (typically 5% when this provision is used) or may limit the total value of loans that may be modified (typically 5% of the initial size of the loan pool). Some agreements provide that if a loan modification eliminates or reduces a prepayment charge, the servicer must pay the amount of the prepayment charge that would have been due. Some agreements state that loan modifications cannot result in a denial of any primary mortgage insurance policy, or that the maturity date of the loan may not be extended beyond its initial date. Certain restrictions can be waived if approvals are given by mortgage insurers, credit rating agencies, or investors, but the nature of the individual servicing agreement governs the nature and number of approvals that are necessary.

Despite the barriers that appear to be posed by pooling and servicing agreements, ASF notes that these types of restrictions appear in only a minority of transactions. It does not appear that any securitization requires investor consent to a loan modification that is otherwise authorized under the operative documents.

### Tax Implications of Restructuring Loans in a REMIC

As noted above, many securitizations are structured as REMICs. REMICs operate as pass-through entities for tax purposes. As such, their gains and losses are passed through to the REMIC's holders; the REMIC is not taxed at the entity level. If a securitized pool of loans were to lose its REMIC status, the tax implications for investors could be significant.

The REMIC portion of the tax code generally provides that in order to be modified, a loan must either be in default or reasonably foreseeable default, or that the modification not be significant, as that term is defined under the REMIC code. As discussed earlier, servicing agreements and pooling and servicing agreements also generally require that the modifications be in the best interests of the security holders or not materially adverse to the interests of the securityholders, and that the modifications not result in a violation of the REMIC status of the securitization trust. To date, the IRS has not issued any guidance on which types of loan modifications are allowable and consistent with the REMIC portions of the IRC and which, if any, would disqualify a pool



from REMIC status. There is also no specific IRS guidance on what steps a servicer must take to determine whether default is reasonably foreseeable.

### Accounting Challenges Posed By Loan Restructuring

Earlier this year, some servicers questioned whether they would be at risk of violating Financial Accounting Standard (FAS) 140 by modifying securitized loans held in trusts, in order to prevent those loans from going into default. FAS 140 governs “qualifying special-purpose entities.” These entities qualify for off-balance-sheet treatment (i.e., the holders of these entities do not have to account for them in the same way they account for other assets and liabilities). Qualifying special purpose entities are supposed to operate passively, under changes adopted after the Enron scandal. The question held by servicers earlier this year was whether loan modifications would disqualify securitized loans from the special accounting treatment for which they are currently eligible. Although servicing and pooling and servicing agreements allow servicers to modify loans in default or for which default is imminent or reasonably foreseeable, many in the industry feared that such modifications would “blow their Q status” under FAS 140 and force them to account for loans they did not own.

In June 2007, House Financial Services Committee Chairman Barney Frank, together with nine Financial Services Committee members, sent a letter to the Securities and Exchange Commission (SEC) asking for clarity in this area. The Congressmen asked, “Does FAS 140 clearly address whether a loan held in a trust can be modified when default is reasonably foreseeable or only once a delinquency or default has already occurred? If not, can it be clarified in a way that will benefit both borrowers and investors?”

In July 2007, SEC Chairman Christopher Cox responded with a letter stating that loan servicers can use their discretion to alter securitized mortgages that may be nearing foreclosure, without affecting the “Q” status of the loans. In his letter, Cox wrote, “The commission’s professional staff believes that, consistent with general agreement in practice, such loan modifications would not result in a requirement for entities to account for those securitized assets on their balance sheet.”

### **Barriers That Apply To All Loans, Whether or Not Securitized**

#### Tax Implications of Forgiven Debt

Under both federal and California tax law, any borrower debt that is forgiven by a lender or a servicer is taxable to the borrower as ordinary income in the year in which the debt is forgiven. For example, if \$50,000 in principal of a \$450,000 mortgage is written off by the lender as part of a workout plan or a short sale, the borrower would have to increase his or her adjusted gross income by \$50,000 that year. These tax law implications reduce the ultimate financial benefit realized by a borrower from a workout arrangement that involves the forgiveness of principal.

The tax law treatment of forgiven interest is less clear. The tax code specifies that discharge of indebtedness is taxable, but does not specify that the discharge of an *obligation* (such as interest) is taxable. According to representatives of the Franchise Tax Board (FTB), the IRS has not

issued any guidance on whether taxpayers who have some portion of their interest payments forgiven by their mortgage holder should treat that forgiven interest as taxable income. Because California conforms to federal law in this area, any decision by the IRS regarding treatment of forgiven interest would be followed by California. On the basis of a preliminary review of the issue, FTB legal staff believes that forgiven interest would not be taxable to the borrower. If this interpretation is correct, it could mean that mortgage workout plans that forgive interest are more beneficial to borrowers in the short-term than those that forgive principal. However, FTB's interpretation is preliminary and non-binding; a final ruling on the matter will have to come from the IRS.

### Ability of Lenders and Servicers to Retool Their Operations

Up until very recently, the mortgage industry was based upon a sales model. The objective was to solicit borrowers, sell them loans, package those loans for sale on the secondary market, and service the loans for a fee. In a rising real estate market, everyone in the real estate business made money, and borrowers could easily refinance out of mortgages whose rates reset to levels they could no longer afford. The system was set up to sell mortgages, process payments, and refinance borrowers; few in the mortgage industry were set up to handle borrowers unable to make their payments.

As borrowers began having trouble making their payments, many found their lenders and servicers unprepared to respond. These mortgage professionals had sales forces; they did not generally employ large numbers of people trained to work with borrowers to help identify strategies for helping them remain in their homes. It takes time for a large lender or servicer to retool its operations, train its phone operators to identify borrowers who should be directed to loan workout sections, train other employees to work with borrowers who contact the lender seeking loan modifications, readjust its underwriting guidelines to evaluate which borrowers will receive loan workouts, and create a menu of acceptable loan modifications. Anecdotally, these changes are occurring slowly, and some borrowers who contact their lenders seeking help are not being directed to people able to help them.

Some who are familiar with the inability of lenders and servicers to be responsive to all borrowers' needs have questioned the desire of lenders and servicers to work with borrowers to help avoid foreclosure. Although the motivation of each loan holder to pursue workouts will vary depending on the institution, most institutions have a variety of reasons for wanting to work with borrowers. In June 2007, the OCC issued a briefing paper titled, "Foreclosure Prevention: Improving Contact with Borrowers." In that brief, the OCC cited four reasons why loan servicers would want to help avoid foreclosure. Among these reasons:

Reputation risk: Lenders face negative publicity over rising foreclosure rates in general, as well as over their institution's specific foreclosure rates. When a significant number of loans made by a lender and packaged in an investment pool go into default, the secondary market can develop concerns about all loans originated by that institution. These defaults can negatively affect the institution's ability to sell new loans in the secondary market. An institution's reputation among the rating agencies may also be negatively affected.

Costs to Lenders' Internal Portfolios: If loans are held in a lender's portfolio (i.e., not sold to others), foreclosures can result in direct losses by the institution. A bank that forecloses on a home must absorb the cost to maintain and resell the property, and often loses a significant amount of money in the process. Vacant and abandoned properties are vulnerable to vandalism, deterioration, and criminal activities. Furthermore, housing prices are depressed in areas with large numbers of foreclosures. All of these factors combine to increase the cost of holding onto the home and to decrease the ultimate sales price. According to the OCC, lenders currently receive 40 to 80 cents on the dollar on homes on which they foreclose.

Costs of Servicing: As a delinquency progresses, most servicers make advances for taxes, insurance, property preservation, inspections, and legal costs. Servicers must also make advances on principal and interest to investors, regardless of whether the servicer has received a payment from the borrower. Many, but not all, of those advances are reimbursed once the property is liquidated, but the servicer still faces the cost of advancing these funds. Estimates suggest that servicing a loan in foreclosure is three times more costly than servicing a current loan.

Community Reinvestment Act (CRA) Credit: The OCC notes that two activities useful for preventing foreclosure can qualify a bank for favorable CRA credit. First, banks can provide financial counseling to low- or moderate-income borrowers, either directly or through a nonprofit agency. Second, banks can refinance higher, variable rate mortgages into lower, fixed-rate mortgages for low- or moderate-income borrowers. OCC examiners will consider either of these activities as responsive to helping meet the credit needs of a community.

### Willingness of Borrowers to Step Forward

Although listed last, this barrier is perhaps the most important of all six to overcome. It has been well-documented by consumer groups, counseling organizations, and regulators that early contact with borrowers in trouble is the most effective way to help them avoid default and foreclosure. Yet, it has also been documented that many borrowers are extremely reluctant to come forward and contact their mortgage holder about trouble they are having, or are about to have, making their payments. The Housing Policy Council of the Financial Services Roundtable recently reported that at least half of all borrowers whose homes went into foreclosure never spoke to their servicer.

According to the OCC report referenced above, the following reasons were cited by borrowers for avoiding contact with their loan holders (in decreasing order of frequency): 1) the borrower did not know the lender might be helpful; 2) the borrower assumed that he or she would be able to make the required payment in a few days; 3) the borrower did not think the lender would care; 4) the borrower was afraid the lender would foreclose on the house; 5) the borrower was embarrassed to talk about his or her problems; and 6) the borrower was afraid the lender would charge a penalty or fee.

Some lenders and servicers are employing the assistance of nonprofit credit counseling agencies to perform the initial contact with the borrower, in hopes that counseling agencies are more trusted by borrowers and that borrowers may be more likely to respond to a call or a letter from a counseling agency. Several reputable nonprofit organizations have also partnered with mortgage servicers to provide no-cost telephone counseling to delinquent borrowers.

## **SOME EXAMPLES OF WHAT IS BEING DONE**

The examples below are intended to be illustrative, rather than all-inclusive. Several of the witnesses that will appear before the Committee on August 21<sup>st</sup> will expand upon the discussions below to provide more information about ongoing outreach efforts.

### **Actions By Counseling Organizations**

NeighborWorks America is a national nonprofit organization created and funded by Congress to provide financial support, technical assistance, and training for community-based revitalization efforts. In response to rising foreclosures, NeighborWorks created a Center for Foreclosure Solutions. Working with national nonprofit, mortgage, and insurance partners, the Center builds capacity among foreclosure counselors around the nation, conducts public outreach campaigns to reach struggling homeowners, and researches local and national trends to develop strategic solutions. In cities and states with high rates of foreclosure, the Center works with local leaders to create sustainable foreclosure intervention programs.

In 2006, NeighborWorks America partnered with the Homeownership Preservation Foundation to create a hotline open 24 hours a day, 7 days a week. The toll-free hotline, which is manned by over 100 English- and Spanish-speaking counselors, is called the HOPE hotline and can be reached at 1-888-995-HOPE. Depending on the nature of a caller's problem, counseling can be provided as part of the initial call, or through a series of follow-up calls, or in-person visits to a local counseling agency close to where the borrower is located. HOPE hotline operators also have the phone numbers for loan modification departments at each of the country's major lenders and servicers; in this way, they can help put borrowers in need directly in touch with the people at those institutions who are best suited to help them. The HOPE hotline received over 25,000 calls from troubled homeowners during 2006 and was able to develop an actionable workout plan to help 42% of those callers avoid foreclosure.

In recognition of the fact that few borrowers realize there is help available, the Center for Foreclosure Solutions recently launched a Foreclosure Prevention Advertising Campaign in partnership with the Ad Council. The campaign seeks to decrease foreclosures by directing struggling borrowers to call the HOPE hotline, where they will receive counseling and be connected, as appropriate, with their lender or local NeighborWorks organization. According to NeighborWorks, the tone and manner of the advertisements will be hopeful, straight forward, empathetic, realistic, and affirming, and will include TV, radio, newspaper, magazine, web and outdoor advertising. The campaign launched nationally in June 2007, with a special focus on areas with high rates of foreclosure.

## **No Homeowner Left Behind**

In Fresno, California, an area that has been hard hit by foreclosures, real estate professionals, counseling organizations, regulators, and financial institutions have partnered to form an organization titled No Homeowner Left Behind (NHLB). The mission of the organization, which runs a local foreclosure prevention hotline, is to ensure that homeowners have access to timely, accurate, unbiased information and reputable professionals to help them preserve home ownership when feasible, and to minimize loss of equity and other adverse impacts when home retention is not possible. More information about the group can be found at [www.nohomeownerleftbehind.org](http://www.nohomeownerleftbehind.org). NHLB believes that its partnership model can be used by other jurisdictions in California that want to reach out to borrowers facing foreclosure.

## **Actions By Federal Regulators**

### Statement on Working with Borrowers

In April 2007, OCC, the Federal Reserve Board (FRB), Office of Thrift Supervision (OTS), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Administration released a “Statement on Working with Mortgage Borrowers.” In that statement, the five federal regulatory agencies encouraged financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment options on their home loans. According to the Statement, “Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.”

The Statement encourages financial institutions to consider prudent workout arrangements that increase the potential for financially stressed residential borrowers to keep their homes, but acknowledges that there may be instances when workout arrangements are not economically feasible or appropriate. Financial institutions should follow prudent underwriting practices in determining whether to consider a workout arrangement. The Statement notes that the regulatory agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems.

The Statement also notes that financial institutions can receive favorable CRA consideration for programs that transition low- and moderate-income borrowers from higher-cost to lower-cost loans, provided the loans are made in a safe and sound manner. The Statement references the Center for Foreclosure Solutions sponsored by NeighborWorks as one example of a reputable organization with which financial institutions can work to help avoid foreclosures through credit counseling.

The Statement concludes by reminding financial institutions that the Homeownership Counseling Act requires them to inform certain borrowers who are delinquent on their mortgage loans about the availability of homeownership counseling and notes that the Department of Housing and Urban Development maintains a list of approved counselors.

## FDIC's Partnership with NeighborWorks

In July 2007, the FDIC announced a partnership with NeighborWorks America to expand foreclosure prevention efforts in nine markets nationwide. Los Angeles was included as one of the nine initial focus areas. The program matches NeighborWorks borrower counseling efforts with the FDIC's Alliance for Economic Inclusion, which includes bankers, community organizations, and other local advocates involved in developing projects to help the underbanked.

## Federal Reserve Bank of San Francisco's Regional Forums

In May and June 2007, the Federal Reserve Bank of San Francisco, together the FDIC, OCC, and OTS, held a series of regional forums in parts of California, Arizona, and Nevada that have been hard-hit by defaults and foreclosures. Although none of the information related to these forums had been made public at the time this background paper was prepared, Federal Reserve Bank staff plan to make the details of the forums public in the near future. Federal Reserve Bank staff indicate that the forums were very similar in focus to this Committee's upcoming informational hearing. The Federal Reserve Bank of San Francisco plans to use the results of their forums to structure outreach efforts aimed at helping reduce defaults and foreclosures among at-risk borrowers.

## **Actions By State Regulators**

In May 2007, the Business, Transportation, & Housing Agency (BT&H) launched the [yourhome.ca.gov](http://yourhome.ca.gov) and [sucasa.ca.gov](http://sucasa.ca.gov) web sites, intended to serve as clearinghouses of information for California consumers looking for information about how to obtain a mortgage or where to get help with an existing mortgage. The web sites provide links to a variety of public and private resources, such as web pages for Cal HFA, the California Departments of Financial Institutions, Corporations, and Real Estate (DFI, DOC, and DRE), Fannie Mae, Freddie Mac, the U.S. Department of Housing and Urban Development, FDIC, and the U.S. Department of Veterans Affairs.

The Department of Consumer Affairs (DCA), in cooperation with BT&H, has also hosted several regional town hall forums intended to reach out to troubled borrowers and offer to link them with housing counselors, real estate professionals, and regulators who can help them. Many of the forums have been attended by representatives from DFI, DOC, and DRE, as well as representatives of major financial institutions. DCA has also developed a mortgage town hall template for use by Assemblymembers and Senators who wish to hold their own mortgage town hall forums.

## **WHAT MORE COULD BE DONE**

Some states, such as New York and Ohio, have plans to sell taxable bonds to raise money for funds to help low- and moderate-income borrowers refinance into more affordable loan products. Some consumer advocacy organizations are urging six-month to one-year moratoriums on residential mortgage foreclosures. Others are encouraging lenders and investment banks to fund

anti-foreclosure efforts. Fannie Mae is seeking a 10% increase in its \$727 billion portfolio cap to buy additional mortgages, hoping to alleviate the ongoing credit crunch in the markets and bring an additional measure of stability. The consumer advocates invited to testify on August 21<sup>st</sup> will expand upon these ideas, and offer more.

## CONCLUSION

One of the primary goals of this Committee's informational hearing is gaining an understanding of which strategies have been found most effective for helping identify borrowers in trouble, and working with these borrowers to develop strategies that – optimally – result in positive outcomes for the borrowers, the investors or lenders who hold their loans, and the servicers who administer their loans.

The literature reviewed by Committee staff suggests that early contact with borrowers who are in trouble or who are likely to encounter difficulties in making their mortgage payments is critical. Identifying who is likely to run into payment trouble in time to offer them an affordable workout plan can help prevent loans from going into default. Reaching out to borrowers and convincing them to come forward at the first signs of trouble can also help avoid default. Providing counseling to borrowers who find themselves unable to make their payments can help identify ways they can either keep their homes, or, if home retention is impossible, can identify ways in which they can avoid trouble with other creditors and, ultimately, can help prevent personal bankruptcy.

Once troubled borrowers have been identified and are in contact with their lenders or servicers, these institutions must be prepared to evaluate which borrowers can be helped, and how. The pages above summarize several barriers to developing workout plans for borrowers. All of the barriers appear to be surmountable, provided that the lender/servicer, the investor(s), and the borrower are motivated to work things out. If lenders or investors decide that foreclosure is preferable to restructuring a loan, they are legally able to force people out of their homes. California's economy could take a significant hit if large numbers of institutions and investors make that decision.

Even if investors and institutions recognize the value of homeownership preservation and opt to restructure large number of home loans, they could run into challenges. One of the problems likely to exacerbate attempts to refinance troubled borrowers into new loans is the credit crunch now gripping Wall Street. News stories abound of lenders restricting credit for consumers and corporations, investors expressing concern over the levels of risk in their portfolios, lenders halting mortgage lending operations and raising interest rates on certain types of loans, and bearish speculators sending the stock market lower and lower. Amid the turmoil, it is likely to be extremely difficult for borrowers whose credit is already shaky to obtain new loans.

The ultimate answers will likely be played out over the next eighteen months, as large numbers of mortgage interest rates reset at a time in which many predict the stock market to remain extremely volatile.