EMBARGOED UNTIL DELIVERY

STATEMENT OF

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on

STRENGTHENING THE ECONOMY: FORECLOSURE PREVENTION AND NEIGHBORHOOD PRESERVATION

before the

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Chairman Dodd, Senator Shelby, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding foreclosure prevention and neighborhood preservation. As the Committee members are well aware, problems in the subprime mortgage markets are affecting the broader U.S. housing markets and the economy as a whole, and pose a significant policy challenge for the industry and regulators.

We are now entering a second year of significant distress in U.S. mortgage credit performance. Based on data from the National Delinquency Survey of the Mortgage Bankers Association, we estimate that there were approximately 1.1 million foreclosures in the first three quarters of 2007, an increase of over 60 percent from the same period in 2006. Current market conditions indicate this negative trend will continue, as a significant rebound in housing market activity or home prices is unlikely during the coming year. Problems in mortgage credit performance are expected to continue as the downside of this housing cycle continues to play out. Although much attention has been focused on the impact on borrowers from payment resets on subprime hybrid adjustable rate mortgages (ARMs) which were building throughout 2007 and will peak this year, we also should anticipate additional credit distress from payment resets on other nontraditional mortgages, such as interest-only or payment-option loans, as we move forward in time and as market conditions remain relatively weak.

The combination of declining home prices and scarce refinancing options will stress borrowers with subprime hybrid ARMs and other nontraditional mortgage loans and could result in hundreds of thousands of additional mortgage foreclosures over the next two years. These foreclosures, if they occur, will inflict financial harm on individual borrowers and their communities as they drive down home values. Studies show that property sales associated with foreclosures tend to reduce average home prices in the surrounding neighborhood, placing stress on remaining homeowners and their communities.

My testimony will provide some brief background on the current situation and describe an approach to loan modifications that I believe provides the best means we have at this juncture to avoid unnecessary foreclosures and provide for long-term, sustainable solutions. While recent agreements have incorporated many of the strategies I have been advocating, progress in achieving actual loan modifications has been unacceptably slow and the increasing levels of foreclosure remain too high. In addition to discussing loan modifications for subprime hybrid ARMs, my testimony also includes a discussion of additional developing problems in the mortgage industry, including the upcoming resets of many Alt-A[1] and prime nontraditional mortgages, as well as possible strategies for addressing the issues they will create.

[1] Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.

U.S. Housing Markets and Mortgage Credit Performance Have Deteriorated

The U.S. housing boom of the first half of this decade ended abruptly in 2006. Housing starts, which peaked at over 2 million units in 2005, have plummeted by half, with no recovery yet in sight. Home prices, which were growing at double-digit rates nationally in 2004 and 2005, are now falling in many metropolitan areas and for the nation as a whole. With declining home prices, there are large increases in problem mortgages, particularly in subprime and Alt-A portfolios. The deterioration in credit performance began in the industrial Midwest, where economic conditions have been the weakest, but has now spread to the former boom markets of Florida, California and other coastal states.

Over the past year, investors and ratings agencies have repeatedly downgraded their assumptions about subprime credit performance. A study published over the summer by Merrill Lynch estimated that if U.S. home prices fell by just 5 percent, subprime credit losses to investors would total just under $150 billion and Alt-A credit losses would total $25 billion. The latest data show that the Case-Shiller Composite Home Price Index for ten large U.S. cities had fallen in November to a level that was already 8.4 percent lower than a year before, with futures traded on this index now pointing to the likelihood of further declines over the coming year.

The complexity of many mortgage-backed securitization structures has heightened the overall risk aversion of investors, resulting in what has become a more generalized illiquidity in global credit markets. These disruptions have led to the precipitous decline in subprime lending, a significant reduction in the availability of Alt-A loans, and higher interest rates on jumbo loans. The reduced availability of mortgage credit has placed further downward pressure on home sales and home prices in a self-reinforcing cycle that now threatens to derail the U.S. economic expansion.

Subprime Hybrid Mortgages and Securitization

The current problem in subprime mortgage lending arose with the rapid growth of 2- and 3-year adjustable rate subprime hybrid loans after 2003. Between year-end 2003 and mid-2007, nearly 5 million of these loans were originated. Of these, just over 2.2 million loans with outstanding balances of $441 billion remain outstanding.

The typical structure of these loans has been to provide for a starter rate (usually between 7 and 9 percent), followed in 24 or 36 months by a potentially steep increase in the interest rate (often as much as 3 percent within the first year after the reset depending on the level of market interest rates) and a commensurate change in the monthly payment. Almost three quarters of subprime mortgages securitized in 2004 and 2005 were structured in this manner, as were over half the subprime loans made in 2006. Most of these loans also imposed a prepayment penalty if the loan was repaid while the starter rate was still in effect.

During 2008, subprime hybrid ARMs representing hundreds of billions of dollars in outstanding mortgage debt will undergo payment resets. Based on owner-occupied subprime mortgages included in private mortgage-backed securitizations (MBS), the FDIC estimates that almost 1.3 million hybrid loans are scheduled to undergo their first reset during 2008.[2] An additional 422,000 subprime hybrid loans are scheduled to reset in 2009, which means these problems will not end anytime soon.

Given the steep "payment shock" these loans may impose on subprime borrowers, most were only able to perform through refinancing. For a time, rapid home price appreciation in many areas of the U.S. allowed even highly-leveraged borrowers to refinance or to sell their homes if necessary when the loans reset without a loss to themselves or mortgage investors, thereby masking the underlying weakness of the structure and underwriting of these products. In today's much more challenging environment, payment reset will lead less often to refinancing and more often to default and foreclosure.

The securitization of these 2/28 and 3/27 subprime hybrid ARMs has been very common in recent years and increases the complexity of achieving loan modifications. While initially there was concern that the securitization documents and the pooling and servicing agreements (PSAs) might place limits on the ability of servicers to modify loans in the securitization pool, most documents provide the servicers with sufficient

[2] FDIC estimates are based on the Loan Performance Securities Database. They reflect data collected through August 2007 on first-lien mortgages secured by owner-occupied properties where the mortgage has been securitized in private MBS issues. These figures have been adjusted to include an estimate of subprime securitized loans that are not included in the Loan Performance database.

flexibility to modify loans. In practice, however, third party servicers have been slow to exercise this flexibility on a large scale.

Two key elements of most PSAs determine how servicers can modify loans. While the language varies, the majority of PSAs require that servicers: (1) protect the interests of investors, and (2) conduct a net present value (NPV) analysis when determining the appropriate loss mitigation strategy in a default scenario.

Under the guidance developed by the American Securitization Forum (ASF), servicers should be bound to the interests of bondholders in the aggregate.[3] This guidance provides a common sense approach to a very thorny issue because it simplifies the servicer role in attempting to protect investor interests overall by limiting losses to the pool, instead of trying to consider how each loss mitigation decision will impact each class of bondholder and speculating as to what the various classes might desire.

In evaluating loss mitigation options, servicers determine whether the net present value of the payments on the loan as modified are likely to be greater than the anticipated net recovery that would result from foreclosure. Particularly in today's declining housing market, the NPV of keeping resetting mortgages at the starter rate generally will be

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[3] American Securitization Forum Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, June 2007 (page 4). ("Generally, the ASF believes that loan modifications should only be made: a. consistently with applicable securitization operative documents (including amendments that can be made without investor or other consents); b. in a manner that is in the best interests of the securitization investors in the aggregate; c. in a manner that is in the best interests of the borrower….")

greater than the NPV of foreclosure and will be in the best interest of the securitization of the pool as a whole.

Studies show that foreclosure costs can run to half or more of the loan amount.[4] These loss rates will only rise in today's troubled housing markets -- particularly if more subprime borrowers are needlessly pushed into foreclosure. Studies also show that foreclosures tend to drive down the value of other homes located nearby.[5] As these loans reset from the starter rate to the full contract rate, credit losses will mount as more borrowers default and enter foreclosure. This will be self-defeating for investors, impose hardships on homeowners, and have wider negative effects on local communities and the overall economy.

Achieving Long-term Sustainable Loan Modifications

Last October, I proposed a systematic approach to addressing subprime adjustable rate mortgage loans for owner occupied properties where the borrowers are current on their payments but will not be able to maintain the payments following reset. If servicers do nothing and allow all of these loans to reset to the full contract rate, the result will be the eventual default and foreclosure on hundreds of thousands of additional loans.

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[4] Karen Pence, "Foreclosing on Opportunity: State Laws and Mortgage Credit," Federal Reserve Finance and Economics Discussion Paper 2003-16, May 13, 2003, p. 1.

[5] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006), www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf

For this group of borrowers, I have recommended that servicers take a systematic and streamlined approach to restructuring these loans into long-term, sustainable loans at the starter rate -- which is already above market rates for prime loans. Servicers should reach out proactively to borrowers approaching their reset dates to determine the borrowers' ability to make payments following reset of interest rates using common metrics, such as debt-to-income ratios (DTIs). For example, the FDIC, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have jointly advised that DTIs for all recurring debts in excess of 50 percent will increase the likelihood of future difficulties in repayment, as well as delinquencies or defaults.

Where the homeowner has generally remained current at the starter rate, but cannot make the higher reset payments, the loan should be modified to keep it at the starter rate for a long-term, sustainable period of five years or more. In today's market, this modification generally will exceed the net present value of allowing the loan to go into foreclosure. In addition, with the volume of resets that many servicers are facing, loan-by-loan approaches will not maximize the value of the loan pool because servicers lack the resources to address the loans on a timely basis. Failure to act aggressively is likely to increase substantially the NPV of losses to the investors.

Finally, I would note that brief extensions of the starter rate or temporary repayment plans will not provide stability to the borrower, investors, or the market. Brief extensions simply increase the resource stress on servicers and decrease the ability of the market to determine market prices for mortgage assets.

Growing Acceptance of Loan Modifications

As servicers examined the benefits of a systematic approach to loan modifications, many of them came to recognize that there are several advantages to the approach I recommended. A streamlined approach can be undertaken much more rapidly than a loan-by-loan restructuring process. Also, this approach does not involve a bailout involving federal tax dollars. In addition, this policy does not involve government action that would affect the contractual rights of mortgage investors because it is based on voluntary action by servicers and existing legal rights and responsibilities. This approach makes economic sense and is an appropriate, proactive response to rapidly changing market conditions. Modifying loans before reset will avoid negative credit consequences for borrowers, permit borrowers to keep their homes while making payments they can afford, preserve neighborhoods and provide investors with a return that exceeds any return they would receive from foreclosures. Under today's conditions, the net present value analysis itself can be streamlined for many markets. Declining housing prices and experience point to the likelihood of substantial losses through foreclosure in contrast to the income stream that can be achieved by sustainable, long-term loan modifications.

Under the leadership of Secretary Paulson, the Treasury Department brought together market participants to develop a shared framework to address the level of upcoming resets. Last month, the Secretary announced that ASF and the Hope Now Alliance had developed a set of guidelines to be adopted as the standard practices for loan modifications across the servicing industry. This initiative, if fully embraced and implemented by the industry, has the potential to greatly accelerate loan modifications for many borrowers and to achieve real results. Pulling together the competing interests in the industry was no small accomplishment and Secretary Paulson should be commended for his efforts in this area.

In addition, last November, the Governor of California announced that he had reached an agreement with several large loan servicers, including Countrywide, GMAC, Litton and HomEq, to keep current homeowners facing unaffordable resets at the starter rates to help them stay in their homes. This agreement is based on the principles in my proposal. Since then, many of the remaining large subprime mortgage servicers have agreed with Governor Schwarzenegger to apply these principles.

While I am encouraged that servicers have recognized the benefits of addressing problematic loans on a systematic basis by entering into these agreements, now is the time to show progress. Servicers must demonstrate an aggressive effort to dramatically increase the pace of loan modifications. This must be accompanied by prompt and transparent reporting that permits independent analysis of their efforts. The peak of monthly payment resets on subprime hybrid ARMs is still approaching. Current estimates are that initial resets of subprime hybrid ARMs will peak at over 350,000 loans in the third quarter of this year, compared with about 270,000 loans in the first quarter.

Unfortunately, at this point, the available information seems to show that foreclosures continue at an unacceptably high level while true loan modifications are lagging. It is important that servicers demonstrate and document real progress soon or they invite regulatory and legislative action to supplement the industry's actions.

Additional Legal Protections for Servicers Engaging in Loan Modifications

One of the reasons stated for the slow pace of loan modifications is that some servicers remain concerned about the potential for legal liability based on those modifications. Given the flexibility provided in most PSAs, it seems unlikely that a servicer engaging in loan modifications to avoid greater losses through foreclosure will be legally liable to investors. In addition, loan modifications that avoid greater foreclosure losses are consistent with industry standards embodied in the principles and guidance provided to servicers by ASF, which should provide an additional degree of protection from legal liability. In fact, servicers who take no action to address upcoming unaffordable resets in their loan portfolios and choose to rely on the traditional loan-by-loan process leading to foreclosure probably run a greater risk of legal liability to investors for their failure to take steps to limit losses to the loan pool as a whole.

Based on existing industry standards and the flexibility provided in servicing agreements, we believe that sufficient legal authority exists to protect servicers from liability for engaging in loan modification activity. However, if Congress determines that statutory affirmation of this authority is desirable, the best approach would seem to be legislation establishing a clear statutory standard regarding servicers' fiduciary obligations. For example, such a standard could state that any duty servicers have to maximize net present value is owed to all parties in a loan pool, not to any particular parties, and that a servicer acts in the best interests of all parties if it agrees to or implements a loan modification or workout plan for which: (1) the loan is in payment default, or payment default is reasonably foreseeable; and (2) anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis. This standard would be consistent with most existing contracts and a confirmation of existing law. Importantly, it would not change the servicers' normal contract obligations. In addition, as long as the statutory provisions do not take away or abrogate existing contractual rights, this approach should avoid the constitutional problems that would be inherent in legislative proposals that altered or overrode existing contractual rights of the parties. The FDIC stands ready to assist Congress if it considers such legislative action necessary.

Additional Developing Problems in the Mortgage Markets

One of the most important arguments for addressing the relatively straightforward problems posed by resets of subprime hybrid ARMs on a systematic basis is that it will free up servicing resources to deal with additional difficult problems that are developing in the mortgage markets. For example, large home price declines in some troubled markets are leaving borrowers owing more than the value of their homes. Past experience is that borrowers may walk away from properties that are significantly "underwater," leaving lenders with a costly foreclosure process.

In addition, the mortgage servicing industry is facing a wave of impending resets on nontraditional mortgage loans that will begin in earnest in 2009. These interest-only or payment-option loans typically require no amortization -- or even permit negative amortization -- during the first five years. Although loans of this type have been available on a limited basis for many years, they became especially popular after 2003 in coastal markets that were seeing large double-digit home price increases. These loans were typically made to borrowers with prime credit scores and they were often securitized in nonconforming Alt-A pools because of the additional risk features in their underwriting and structure. These riskier loans often included more hazardous underwriting approaches such as stated income, low- or no-documentation, and other risk-layered features. More than four in five Alt-A loans securitized in 2006 were low- or no-doc loans.[6] The FDIC's analysis indicates that as of October there were just over 1.7 million nontraditional mortgages with outstanding balances of almost $600 billion securitized in Alt-A pools. Preliminary analysis indicates that large volumes of these loans will undergo payment reset and require amortization beginning in 2009, in market conditions that may not be much better than we see today.

Although nontraditional mortgages made to non-prime and prime borrowers do not typically involve the large interest rate resets typical of subprime hybrid ARMs, they

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[6] See March 12, 2007 Credit Suisse Equity Research, "Mortgage Liquidity du Jour: Underestimated no More" at 4.

may expose borrowers to an even greater degree of payment shock if the borrower has been making the minimum payment and must now make the fully amortizing payment -- often on a larger principal amount after negative amortization. Borrowers who were making the minimum payment during the initial period may find themselves either owing more than the value of their home, facing a significant increase in their monthly payment, or both. Studies indicate that 75 percent or more of borrowers with payment-option loans have been making the minimum payments during the starter period, resulting in negative amortization. As in the case of the subprime payment resets, this is a problem that can be foreseen based on available data. However, Alt-A loans present potentially more difficult loss mitigation issues than subprime hybrid ARMs because of their additional risk features. As a result, it is essential for servicers to start now to develop strategies that will minimize losses to investors and the broader housing market by avoiding unnecessary foreclosures. Waiting to confront the next reset problem will once again create the risk of falling behind a fast-moving trend.

In addressing the growing numbers of nontraditional mortgages facing reset and borrowers who did not qualify for the initial loan modification agreements, servicers should consider applying systematic approaches to restructuring these loans that are similar to the strategies for addressing the subprime hybrid ARMs. By applying reasonable measures of the likelihood of default, such as a 50 percent debt-to-income ratio, servicers can quickly identify loans facing likely default, develop broad templates for restructuring these loans into fixed rate loans and proactively initiate that process. Temporary repayment plans will only provide a short-term fix for these nontraditional mortgages, whereas the goal should be to create long-term, sustainable mortgage obligations that homeowners can afford to repay while providing a continuing income stream to investors.

Unfortunately, some borrowers pose even more difficult issues because their debt far exceeds the value of their homes. Servicers have always had to evaluate whether the best option in these cases is foreclosure or some other process, such as a short sale, that results in the loss of the home. There may be no alternative except foreclosure for loans that were made to speculators, under fraudulent circumstances, or to borrowers who have no reasonable ability to repay (even with restructuring). However, in today's market, servicers should carefully consider whether some writedowns of part of the principal balance to the value of the home or forgiveness of arrearages of principal and interest are better options than foreclosure or even short sales in appropriate circumstances. Permitting borrowers with an ability to make reasonable payments to stay in their home would provide greater value to lenders and investors than forcing foreclosures that undercut the value of the property and harm the value of other properties in the neighborhood.

Until recently, strategies involving writing down the value of the loan did not provide a feasible alternative for most borrowers. When lenders restructured loans in this manner, borrowers faced a potential tax liability on the amount of the forgiven debt.

Last month, however, Congress addressed the issue of tax liability for mortgage debt forgiveness in a way that makes long-term workouts involving principal writedowns a reasonable alternative to foreclosure. Such an option might be considered for borrowers having financial difficulty making their payments after their loans reset and where foreclosure is a looming possibility. Congress is to be commended for enhancing the workout options available to borrowers and lenders for negotiating long-term, sustainable restructurings.

Enactment of the Mortgage Forgiveness Debt Relief Act of 2007 provides an additional option for keeping borrowers in their home. This Act recognizes that cash strapped borrowers who are already facing financial difficulty cannot afford a potential tax liability that could hinder their ability to make their modified loan payments. It also provides greater assurance to lenders and servicers that borrowers will be able to perform after their loans are modified and decreasing the principal value will decrease the loan to value ratio, thereby potentially expanding the number of homeowners who could qualify for GSE refinancing. This will allow lenders and servicers to consider forgiving a portion of the principal balance owed to a level a borrower can realistically afford to repay, as long as it produces a net present value that is greater than the anticipated net recovery that would result from a foreclosure. This would require lenders and servicers to ascertain the existence and amount of any second mortgages, and obtain releases from these obligations to the extent appropriate. While this type of modification results in the recognition of a loss by the lender or servicer, it is virtually certain that the amount of the principal write-down will be less than the amount of loss sustained from foreclosure in today's market.

Permanently forgiving part of the principal amount can provide a better financial result for investors than foreclosure by creating long-term, sustainable solutions that will allow borrowers to stay in their homes. This approach also has the added benefit of limiting the overall adverse affect of declining property values on communities.

Conclusion

Poor underwriting and abuses in the subprime mortgage market are having a significant negative impact on the housing markets and the U.S. economy. In the coming months, large numbers of subprime adjustable rate mortgages will reset to higher interest rates and borrowers will generally be facing default and possible foreclosure. In addition, a wave of nontraditional mortgage resets is looming in the next year.

The FDIC is advocating a systematic approach to loan restructuring for borrowers who cannot afford their payments after their loans reset that will create long-term, sustainable solutions that enable borrowers to stay in their homes and provide a better financial result for investors than foreclosure. A systematic approach to restructuring for these borrowers also will free up servicer resources to work with troubled borrowers who will require more individualized solutions. In addition, recent congressional action has removed a potential tax impediment for restructurings that include the forgiveness of debt. The problems in the subprime mortgage markets are only going to increase in coming months and servicers need to be much more aggressive in utilizing the tools available to them to address these issues. Servicers should take proactive measures to deal effectively with upcoming resets to minimize unnecessary foreclosures and losses to both lenders and borrowers. It is especially critical that this process is done in a systemic manner for subprime borrowers.

Congress, the SEC, the Treasury Department, as well as federal bank regulators have expended considerable time and effort to assure that the industry has authority under tax and accounting rules to modify loans proactively. The industry needs to demonstrate greater commitment to using those authorities.

Thank you for the opportunity to testify. I would be happy to answer any questions the Committee might have.