TESTIMONY OF

TOM MILLER

ATTORNEY GENERAL

STATE OF IOWA

On

PROGRESS IN PREVENTING MORTGAGE FORECLOSURES

Before the

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

November 2, 2007, 10:00 a.m.

Room 2128, Rayburn House Office Building

Good morning, Chairman Frank, ranking member Bachus and members of the Committee. I am Tom Miller, Attorney General of the State of Iowa. I appreciate the opportunity to address you today on the steps that my office and a working group of state attorneys general and banking regulators have been taking since earlier this summer to prevent home foreclosures and reduce the impact of these foreclosures on our homeowners and our communities.

Mortgage lending is an inherently local transaction. While mortgage lending may involve the largest financial institutions on Wall Street, it begins and ends with a home on Main Street. Accordingly, the States have been at the forefront of the fight against predatory lending. The states have led the way with investigations and settlements, including one with Household for $484 million and another with Ameriquest for $325 million. When neighborhoods and cities are damaged by predatory lending practices, it is ultimately city, county, and state governments that bear the most direct costs from foreclosures, not to mention the devastating impact it has on individual families.

Much of this damage can be avoided with common sense loan modifications and other loss mitigation efforts. In many instances, all parties are better off if an unaffordable mortgage loan is modified or permanently restructured to an affordable payment, so long as the net present value of the loan as modified is greater than the net recovery that can be expected after a foreclosure. Whether there was fraud in the origination of the loan, the product was unsuitable for the borrower, or the borrower has experienced an adverse life event, modifying a loan is often the better business decision.

We hope that our existing and ongoing efforts can be coordinated with and complement federal efforts, including the HOPE NOW initiative recently announced by the Treasury Department. We are at the beginning of this foreclosure crisis, not in the middle, and certainly not at the end. Unfortunately, this problem will play out over an extended period of time.

The problem facing this country is big enough that all hands are needed, whether state, federal, public or private. I am here today to tell you that foreclosure relief is an effort that will require participation from every stakeholder in this process, from homeowner to lender to servicer to secondary market investor to regulator.

The Origin and Extent of the Problem

Over the past decade, the mortgage industry has gone through a revolution in the way that home loans are funded and serviced. Home loans have become commodities, to be pooled and sold off in pieces through the process of securitization. Securitization has brought billions of dollars of new capital into the mortgage market, but it has changed the traditional relationship between borrower and lender. Most homeowners are no longer repaying mortgages to George Bailey at the Bedford Falls Savings and Loan; instead, a typical homeowner may borrow money from one financial institution, often through an independent mortgage broker, but make their payments to an intermediary financial institution, known as a servicer, which distributes that payment to secondary market investors who could be anywhere on the globe.

The changes wrought by securitization have created new hazards for consumers, investors, and lenders. Securitization separated the origination of a loan from its consequences by dramatically changing the distribution of risk and incentives for mortgage market participants. This has unfortunately led to weak underwriting and in some instances fraud, and to borrowers being placed in loans they could not afford.

For consumers, what this has done is created incentives for lenders to make loans without appropriate regard to a borrower's ability to repay the loan – and then, when the borrower runs into difficulty, it has made it more difficult for the borrower to seek appropriate relief.

In testimony before the Federal Reserve on proposals to revise the Homeownership and Equity Protection Act (HOEPA), I have described the behavior of some mortgage brokers and lenders, particularly in the subprime market, as irresponsible, reckless and even illegal. These practices need to be addressed, and I have urged the Federal Reserve to issue regulations updating HOEPA.

Our immediate problem, however, is that we are seeing the impact of this behavior now, as adjustable rate mortgages reset. Congress's General Accounting Office reported earlier this month what we in the states already know: foreclosures have risen sharply over the last two years, with subprime and adjustable-rate mortgages accounting for the majority of the increase. Iowa has the unhappy distinction of having the nation's fourth highest subprime foreclosure rate, at over 8.6%.

The GAO also found, as we have seen, that foreclosures are happening across all market segments and loan types. It is not just the first-time, low-income homeowners at risk; it is also the well-established homeowner who succumbed to relentless marketing and refinanced to take advantage of a low "teaser" rate to consolidate debt or pay other expenses. In fact, it is critical to realize that the majority of subprime foreclosures do not involve "purchase money" loans. A myth is emerging that this crisis is due to borrowers who purchased more house than they could afford. However, the Mortgage Bankers Association has found that a mere 12% to 15% of subprime loans in 2006 went to first-time homebuyers. The truth is that the majority of foreclosures involve refinancings by existing homeowners.

Most ominously, the GAO reported that the number and percentage of home loans in default or foreclosure is likely to grow through the end of this year and 2008, because of the rate adjustments, or "resets," scheduled for many adjustable rate mortgages. Most of the foreclosures to date have not been due to resetting ARMs; thus, an already bad situation is likely to become much worse.

This corresponds to the findings of Assistant Attorney General Patrick Madigan, who prepared a report on the subprime foreclosure crisis for my office earlier this fall.

Although foreclosure rates are now at a historical high, these are – in his words – the tip of the proverbial iceberg.

What my office sees is that today's foreclosures are happening, at least in part, for different reasons than foreclosures in the past. Traditionally, foreclosures occurred because of a weak economy or a major life event, such as job loss, divorce, or illness. While life events are still a factor in many foreclosures, they are a relative constant, and while unemployment and economic weakness might be rising, these factors are still at historically low levels. What's changed from previous experiences with rising foreclosure rates are the types of mortgage products being used, the lower standards for loan underwriting, and unprecedented levels of origination fraud.

Recent practices in mortgage lending seem to have been founded on the belief that appreciation in the housing markets would last forever. But no one has ever repealed the business cycle, and now we are all feeling the impact of the popping of this asset bubble.

The Foreclosure Working Group and HOPE NOW

My office has been aware of current and imminent problems with mortgage defaults and foreclosures for quite some time. In July of this year, I convened a meeting of fellow attorneys general along with select state bank regulators, industry representatives, and the Conference of State Bank Supervisors (CSBS) to explore ways to minimize the impact of rising foreclosure rates. From that initial meeting of approximately 37 states we formed the Foreclosure Prevention Working Group, consisting of 11 state offices of attorneys general, bank regulators and CSBS. As Chairman of this group, I led a two-day meeting in September with the ten largest servicers of subprime mortgages to begin to identify and implement collective, consistent and scaleable solutions to prevent foreclosures with a simple guiding principle: any solutions must be in the interest of both the borrower and the investor. Next week we are meeting with the next 10 largest subprime servicers, in pursuit of the same objectives. Collectively, these top 20 companies service more than 90 percent of the nation's subprime loans.

It is important to understand that the Foreclosure Prevention Working Group is not advocating across-the-board modifications, but only modifications that make sense for both the borrower and the investor. We believe, however, that thousands upon thousands of situations meet this standard -- and, unfortunately, these loans are rarely being modified. We recognize that not every loan is a candidate for foreclosure prevention. Some homeowners will never be able to repay their mortgages, for a variety of reasons, and in those instances loan modifications will merely delay the inevitable. Acknowledging this fact from the beginning will increase our chances for success on a broader scale.

We were pleased to see the Treasury Department's HOPE NOW announcement, which sets goals similar to those of our Foreclosure Prevention Working Group. As I previously mentioned, our working group has been committed from the start to making our efforts complementary to what is occurring at the federal level. We invited the FDIC to speak at our first meeting in July. Before and after our September meetings, CSBS briefed all of the federal banking agencies and OFHEO. We believe that state and federal coordination is essential to success. However, as state officials we are more directly experiencing the impact of foreclosures and witnessing the success or failure of attempts to avoid foreclosures; therefore, the state role in any effort to work with servicers and other financial institutions is critical.

The state Foreclosure Prevention Working Group has also reached out to representatives of the industry. The American Securitization Forum, which represents the various interests that facilitate the secondary market, including investors, was invited to our July meeting and has consulted with our working group on multiple occasions. The Mortgage Bankers Association also attended our July meeting to provide its perspective on foreclosure issues. We must not only work together, but drill down into the details to find the obstacles to foreclosure prevention.

Our effort, like HOPE NOW, is based on our belief that all stakeholders will benefit if we can find ways to help borrowers make their payments and stay in their homes. While every borrower's case is different, we see patterns that identify underlying issues, and we are working with lenders and servicers to address these issues. Preventing or minimizing the impact of foreclosure will require work from all sides, with a combination of everything from modifying the terms of the loans, providing additional credit counseling and financial education to homeowners, facilitating short sales, or providing transition assistance for borrowers to rental properties.

Both servicers and investors have committed to Treasury's HOPE NOW program, and we have found similar willingness to cooperate from the servicers and investors we have met with. While we have commitments from the leadership of these organizations, we hope that the HOPE NOW initiative does not have the unintended consequence of slowing our progress. We can't afford to slow down our progress. While at the senior executive level, servicers may be committed to improving their processes to facilitate loan modifications, it will take time for any changes to be implemented. While servicers and investors now seem to agree that it is in their best financial interests to turn these mortgages into loans that will be repaid over the long term, servicers' staffing and employee incentive systems may not yet reflect this understanding.

The incentives for the companies involved are powerful. Subprime servicers are reporting that on average, subprime loans lose 50 cents on the dollar with every foreclosure. This translates into an average dollar loss of around $50,000 on every foreclosure. Of course, as the number of foreclosures increases these losses will only grow larger, creating a downward spiral.

Challenges in Foreclosure Prevention

Given the incredibly high losses suffered by lenders and investors with every foreclosure, it is clear that modifications should be the order of the day. And yet, our analysis, as well as the analysis of Moody's, is that loan modifications are not happening with the frequency necessary to address the scale of this problem.. Modifications are increasing, but are still not at the level needed to prevent unnecessary foreclosures.

While modifications certainly are not free, lenders and investors must compare the severe loss they take on a foreclosure with a much more modest loss from a modification. As long as the value of the payments on a modified loan is greater than the net recovery from a foreclosure sale, it is the better business decision to make a modification. While this common-sense economic principle is easy to understand, we have found that it is quite difficult to implement loan modifications because of the complicated and fractured nature of today's mortgage market.

Based on our examination of servicing practices, one fundamental challenge is that the servicing system was built to manage routine collections of debts, not to engage in systemic rewriting of loans to make them affordable. In the last decade of strong housing prices, loan modifications have been at the bottom of the servicer "waterfall" of options, as most borrowers could escape distress by refinancing their home or selling it on the market for a gain. Servicers are now struggling to make the old model work in this new environment, and we intend to keep working with them until a homeowner anywhere in the country can get the loan resolution they need and can afford in a streamlined, efficient manner. We are not there yet.

This challenge is evident in the disconnect between executive management at servicers and the experiences of homeowners seeking to save their homes from foreclosure. It has been widely acknowledged that up to 50% of borrowers who are foreclosed upon never talked to their servicers. However, significant problems exist for the 50% of borrowers who DO contact their servicer. While servicers have said to us, and to the Treasury Department, that they are willing to talk to the borrower to work something out, this is not happening consistently on the front lines. All too often, the people answering the telephone at servicing companies may be short-term employees who are not trained or empowered to serve "problem" customers.

If, for example, a homeowner could afford the initial payment on a 2/28 adustable rate mortgage, but will not be able to afford the loan after the payment jumps by 30%, he or she may have to become significantly delinquent on the loan before being referred to a loss mitigation person who has the authority to modify the loan. Until then, the homeowner will get increasing numbers of phone calls asking for immediate payment.

Anecdotal reports from HUD-approved counseling agencies underscore that servicers have a long way to go in effectively handling loss mitigation for those borrowers who do contact their servicer. The servicers we have met with have said they are working aggressively to staff up and facilitate a shift for some borrowers from collections to loss mitigation and loan modifications. We look forward to seeing those improvements.

We do believe that many of the top servicers are making significant changes in their operating systems to make loan modifications easier. Some servicers tell us they are able to proactively predict a borrower's likelihood of default, and can offer those borrowers a proposed loan modification before payment shock forces the borrower to become significantly delinquent. We would like to see more servicers proactively analyzing the likelihood of default, rather than waiting for a homeowner to enter delinquency.

In addition, we have some concerns that servicers still have incentives to offer temporary solutions to permanent problems. Homeowners who experience the payment shock of a 2/28 loan are not suffering due to a life event, they are suffering due to a product they cannot afford at their income level. A two-year "modification" is a temporary action that may simply perpetuate the foreclosure crisis. A couple of servicers have told us that when they modify a loan, they do so for the life of the loan. We encourage servicers to take this approach, as we believe it not only addresses the root of the problem, but it also enables servicers to represent investor interests by efficiently processing the massive numbers of loan expected to reset in the next year. Reliance on an outdated system of allowing loans to edge to foreclosure before engaging in serious efforts to modify a loan is only likely to exacerbate economic losses.

We believe that often-cited challenges to preventing foreclosures – pooling and servicing agreements, REMIC rules, and FAS 140 interpretations – are no longer significant barriers to loan modifications. The servicers we have met with have told us they feel they have the discretion and authority needed to make loan modifications where those modifications benefit the investor and the homeowner. Upwards of 95% of pooling and servicing agreements do not pose significant constraints, according to the servicers we have met with.

In the old days – the George Bailey days of home lending – a borrower who got in trouble could go to his or her loan officer to discuss modifying the terms of the mortgage and the lender was highly motivated because it would take the loss if the loan failed. Securitization has dramatically changed this reality. Once a home loan is made, it may be sliced and diced into any number of investment instruments, according to the amount of the loan, the borrower's credit rating, the repayment schedule, the interest rate structure or other factors, and any number of investors may buy different pieces of this loan, packaged into specialized instruments. Because these instruments pay varying returns based on their risk profile, different investors may have different opinions on what modifications are acceptable to the underlying loan. The end result is that investors have threatened lawsuits against servicers who have sought to change the terms of the securities they sold.

One troubling example of this involves the challenges in preventing a foreclosure for a borrower with first and second mortgages. Often called "80/20" loans, these loans were originated in a manner that allowed a borrower to finance 100% of the value of the property and avoid paying mortgage insurance. Regardless of the wisdom of this loan structure, the division of the transaction into two loans has a significant impact on servicing. The 80% loan-to-value first lien mortgage is sold into one security, and the 20% loan-to-value second mortgage is sold into another. Not only are there two securities that are owned by different investors, but these instruments are often serviced by two different servicers.

For the borrower struggling to make payments, this often leads to disaster, as the homeowner receives two sets of phone calls demanding payment, each one telling him to pay immediately. If the servicer for the first mortgage is willing to engage in a loan modification, its fiduciary duty to its investors may make it difficult to modify the first loan to take a loss if the second lien-holder has not also taken some loss – after all, the second lien-holder is supposed to be in a less secure, riskier position. Thus, the two servicers must negotiate together to achieve a resolution, and each one has different interests. In the meantime, the homeowner has to choose which loan to pay first and in what amount, where the wrong answer will drive them to foreclosure.

Identifying Solutions

Our Foreclosure Working Group is working with servicers and industry representatives to develop solutions to these challenges. Without an ongoing and focused dialogue, we will miss the opportunity to prevent unnecessary foreclosures.

Solutions will need to be measureable and quantifiable. We all know that good intentions are essential, but not sufficient, to succeed. As such, our Foreclosure Prevention Working Group has focused first on understanding the dynamics and incentives in the servicing system and real-time reporting of results of the fruits of this system. We are developing a "call report" on servicing activity that we believe will enable us to track the progress of servicers and will provide reliable information to policymakers.

Beyond that, we are trying to identify the things that the top servicers are doing right and having conversations with other servicers to determine whether they can adopt those practices as well. We now have a meaningful discussion with servicers, and believe this discussion will lead to better outcomes for homeowners.

Servicers may need additional incentives to work with borrowers and facilitate modifications. It is in investors' interest to pay servicers or housing counselors an additional fee for modifications that result in performing loans. This additional fee should make it easier for servicers to hire more staff, retain them, train them and give them incentives to work with borrowers. Servicers may find it most effective to create dedicated teams to handle modifications, and to make early contact with borrowers who seem to be having trouble making their payments. Since 50% of borrowers in foreclosure make no effort to contact their servicers, servicers should also look at the possibility – as some have -- of contracting with trusted third parties, such as attorneys, community advocates or faith-based organizations, to broker these contacts. NeighborWorks has provided a commendable service in this area. We are encouraged by industry efforts to work with counselors, and believe that these efforts have only scratched the surface of the potential in these partnerships. We will most likely need more resources dedicated to these efforts as demand grows in the coming months.

My own office has set up a foreclosure hotline. Borrowers in trouble can call a toll-free number to reach the Iowa Mediation Service, which will take information from borrowers and then explore whether a loan modification might work for both the borrower and the lender. The response to the hotline has been overwhelming. Recognizing that Iowa is a relatively small state, since the hotline was launched in early September, it has received around 2,700 phone calls.

Conclusion

Chairman Frank and Representative Bachus, I salute you for calling attention to this crucial issue with today's hearing. While my office continues its efforts to remedy the abusive behavior that contributed to this crisis, our priority for now must be helping the homeowners who are trying to meet their obligations to stay in their homes. While each individual loan default may make no more than a ripple in the global market, every foreclosure is a tsunami for our communities. The impacts of foreclosures are felt far beyond the immediate homeowner and lender. Empirical research has shown that each foreclosure within a city block lowers the value of neighboring properties by around 1%. And, of course, as the number of vacant properties increase, it will create a downward pressure on the real estate market in general. Thus, we all have a stake in this.

We intend to continue our work with you, the industry and with our counterparts nationwide to minimize the impact of this surging disaster in communities across the nation. Thank you for your time and attention, and I would be happy to answer any questions you may have.