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Statement of

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Office of Thrift Supervision

concerning

Loan Modifications:  
Are Mortgage Servicers Assisting Borrowers with Unaffordable Mortgages?

before the

Subcommittee on Housing and Community Opportunity  
United States House of Representatives

February 24, 2009

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**I. Introduction**

Good afternoon, Chairwoman Waters, Ranking Member Capito and Members of the Subcommittee. Thank you for the opportunity to offer testimony on behalf of the Office of Thrift Supervision (OTS) on loan modifications and what strategies will work best to keep more Americans in their homes. The importance of the topic of this hearing is hard to overemphasize. Turning back the tide of home foreclosures is an essential element in combating the economic crisis confronting this nation and much of the rest of the world. Foreclosed homes spell tragedy for the uprooted American families, harm neighborhoods by driving down property values and add downward pressure to already depressed home values.

Although about 92 percent of all home mortgages in this country are being repaid on time, the remaining eight percent that are delinquent or in foreclosure represent a historically high number and a contagion in our economic system.

In my testimony today I will discuss interagency guidance by the federal bank regulatory agencies on helping troubled borrowers and encouraging mortgage servicers to take action to preserve homeownership. I will also explain the details of a foreclosure prevention plan that the OTS developed a year ago to provide incentives for avoiding foreclosures among homeowners who are “underwater,” owing more on their mortgages than their homes are worth. Lastly, I will describe in some detail the work by the OTS and the Office of the Comptroller of the Currency (OCC) to produce detailed reports that provide validated, loan-level data on loan modifications and other foreclosure-prevention

measures among about 60 percent of all outstanding mortgages in the nation. These reports provide valuable insight into how well foreclosure prevention efforts are working and what strategies offer the greatest promise for providing sustainable solutions over the long term.

The OTS has had a long standing commitment to affordable and sustainable mortgage modification efforts and has repeatedly encouraged its institutions to work constructively with their troubled borrowers. After proposing its OTS Foreclosure Prevention Proposal a year ago, agency leaders have been testifying on Capitol Hill about foreclosure prevention alternatives, discussing approaches with industry trade groups and working with other bank regulators to help keep American families in their homes.

Just last week, Director Reich urged OTS-regulated institutions to suspend foreclosures on owner-occupied homes until the Administration's Financial Stability Plan "home loan modification program" is finalized. As he stated, "OTS-regulated institutions would be supporting the national imperative to combat the economic crisis by suspending foreclosures until the new Plan takes hold."

The Plan unveiled by President Obama last Wednesday commits \$75 billion to prevent avoidable foreclosures by reducing monthly payments for homeowners. OTS officials participated in the interagency effort led by the Treasury Department to develop the Plan and we look forward to continuing to participate in interagency initiatives to address this national dilemma.

## **II. Background and History**

OTS's efforts to encourage servicers to work with troubled borrowers are not recent. For example, in April 2007, OTS and the other Federal banking regulators issued a statement that encouraged financial institutions to work with homeowners who are unable to make mortgage payments. Because prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower, institutions were assured that they would not face regulatory penalties if they pursued reasonable workout arrangements with borrowers.

The statement advised borrowers who are unable to make their mortgage payments to contact their lender or servicer as soon as possible to discuss available options. The advice remains sound today, although we have refined our notion of what a constructive workout arrangement looks like. Examples of constructive workout arrangements included modifying loan terms, and/or moving borrowers from variable-rate loans to fixed-rate loans.

In the summer of 2007, OTS coordinated with the FDIC to convene several meetings with servicers to better understand the issues they faced. The servicers identified several stumbling blocks they had already encountered, including the direct expense of loan modifications, unresponsive borrowers, the requirement to maximize value to the servicing trust, and legal and accounting impediments in servicing agreements associated with securitized loans.



In September 2007, the OTS joined the other Federal banking regulators and the Conference of State Bank Supervisors in issuing a statement “encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review to determine the full extent of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.”

The statement noted that many subprime and other mortgage loans had been transferred into securitization trusts governed by pooling and servicing agreements. The agreements could allow servicers to contact borrowers at risk of default, assess whether default was reasonably foreseeable and, if so, apply loss mitigation strategies to achieve sustainable mortgage obligations. Servicers could have the flexibility to contact borrowers in advance of loan resets.

As the August 2007 statement said, appropriate loss mitigation strategies could include loan modifications, conversion of an adjustable rate mortgage into a fixed rate, deferral of payments, or extending amortization. In addition, institutions were asked to consider referring appropriate borrowers to qualified homeownership counseling services to work with all parties to avoid unnecessary foreclosures.

Finally, bank and thrift programs that transition low- or moderate-income homeowners from higher-cost loans to lower-cost loans have long been able to receive favorable consideration under the Community Reinvestment Act (CRA), provided the loans are made in a safe and sound manner. Building on this principle, the OTS joined with other regulators to issue expanded CRA guidance in January 2009. These “questions and answers” encourage financial institutions to participate in foreclosure prevention programs that have the objective of providing affordable, sustainable, long-term loan restructurings or modifications for homeowners who are facing foreclosure on their primary residences.

### **III. Developing Standardized Reporting Templates**

In March of 2008, OTS issued a statement that encouraged its regulated mortgage servicers to use a standard template developed by HOPE NOW to report information on modifications of subprime adjustable rate mortgage loans.

In a memorandum to Chief Executive Officers of OTS-regulated thrift institutions, the agency pointed out that the use of a standard template would support monitoring of foreclosure prevention efforts and provide transparency for investors in loan securitization trusts.

### **IV. OTS Mortgage Metrics Report**

In support of this effort, the OTS worked closely with the OCC to design a standardized reporting template that included more than 60 data fields for each loan. The result of this initiative was the publication of the first OTS Mortgage Metrics Report in July 2008.

The report was based on a data collection process that covered 64 data elements for each of the 11.4 million first-lien residential mortgages held or serviced for the period January 2008 through March 2008 by the five largest OTS servicers. This was the first report to gather and analyze standardized information of this scale and detail on mortgage delinquencies, loss mitigation actions, and foreclosures. OTS used a data vendor to aggregate, validate, store and generate reports, but retained ownership and control of the data. OTS used the same standard data elements and definitions as the OCC and the Hope Now Alliance to promote standard data collection and analytic consistency across the mortgage industry.

## **V. Joint Report with OCC**

The second Mortgage Metrics Report was a joint report by the OCC and the OTS. By joining together, the agencies presented a more comprehensive picture of mortgage performance, loss mitigation and foreclosures among federally regulated banks and thrifts.

The combined report reflects the activities of many of the industry's largest mortgage servicers, and incorporates information on all types of mortgages serviced, not just subprime. The report presents loan-level data on each of the 34.7 million loans in this portfolio. Because we have access to the individual loans, the results we report are not based on estimates or on inferences from surveys, but rather reflect the servicers' actual experience.

The decision to issue a joint report also extends the effort of creating a common reporting framework by using standardized reporting terms and data elements. In particular, the report uses standard definitions for prime, Alt-A, and subprime mortgages, relying on credit score ranges that are common across the industry. A common reporting framework allows for better comparison across the industry and over time.

The agencies collected data from the nine national banks and the five savings associations with the largest mortgage servicing portfolios. At the end of June 2008, the first-lien mortgage loans serviced by these institutions totaled more than \$6.1 trillion in principal balances. The combined servicing portfolio constituted more than 90 percent of all mortgages serviced by national banks and thrifts, and approximately 60 percent of all mortgages outstanding in the United States. Approximately 88 percent of the mortgages in the total servicing portfolio were held by third parties via securitization by government-sponsored enterprises and other financial institutions.

Key findings of the second quarter joint report include:

- New loan modifications increased by more than 80 percent from January 2008 to June 2008 and increased by 56 percent from the first quarter to the second quarter. By comparison, new payment plans grew only 8 percent from January to June 2008 and increased more than 2.7 percent from the first quarter to the second quarter. (A payment plan is a short- to medium-term change in scheduled terms and payments, while a loan modification is a permanent change in the contractual elements of the mortgage, such as the interest rate or other loan terms.)

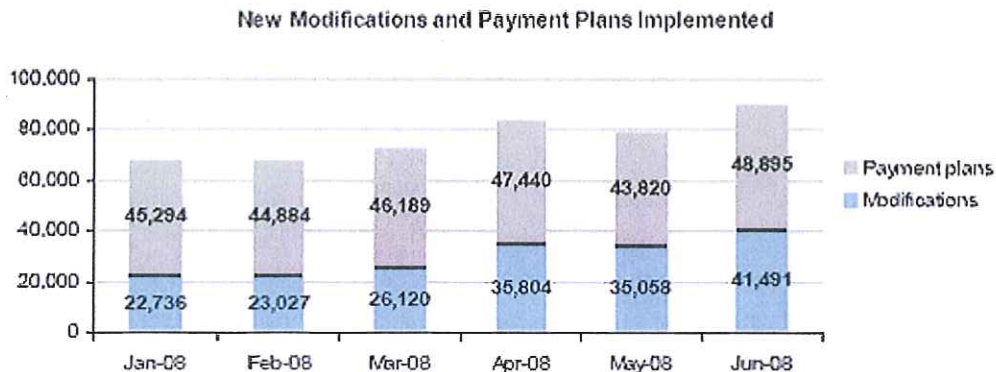


- As a result, the mix of loss mitigation shifted toward loan modifications from the first quarter to the second quarter with the share of loan modifications increasing from 34.5 percent to 44.5 percent.

	First Quarter Total	Second Quarter Total
Loan modifications	71,883	112,353
Payment plans	136,367	140,155
Loss mitigation actions	208,250	252,508

- There were increases in early stage delinquencies (30-59 days past due) and seriously delinquent mortgages, defined as mortgages that are 60 or more days past due plus loans to bankrupt borrowers who are 30 or more days past due.
- Foreclosures in process also increased in the second quarter from 1.40 percent (or about 483,000) in the first quarter to 1.60 percent (or about 556,000).
- New loss mitigation actions increased more quickly than new foreclosures during the second quarter.
- Overall, new loss mitigation actions relative to new foreclosures averaged more than 87 percent during the second quarter, about 12 percentage points higher than the first quarter (from 75.68 percent to 87.45 percent).
- Total new loss mitigation actions (loan modifications and payment plans) totaled 252,508 during the second quarter, an increase of more than 21 percent over the first quarter. Total monthly loss mitigation actions reached more than 90,000 in June.

New Modifications and Payment Plans Implemented	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Loan modifications	22,736	23,027	26,120	35,804	35,058	41,491
Payment plans	45,294	44,884	46,189	47,440	43,820	48,895
Total loss mitigation actions	68,030	67,911	72,309	83,244	78,878	90,386



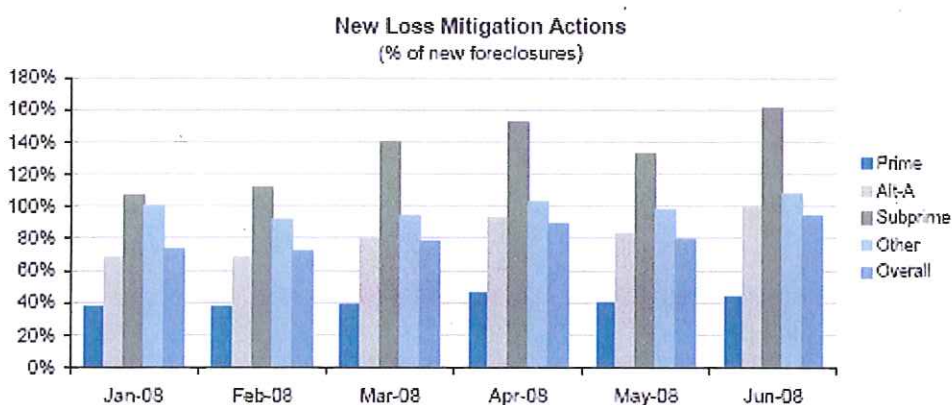
## New Loss Mitigation Actions Relative to New Foreclosures

The following data show new loss mitigation actions as a percentage of foreclosures initiated during the month. For any given risk category, a percentage exceeding 100 percent means there were more new loss mitigation actions than new foreclosures during the month. New loss mitigation actions increased faster than new foreclosures during the second quarter. Overall, new loss mitigation actions relative to new foreclosures averaged more than 87 percent during the second quarter, about 12 percentage points higher than the first quarter. Subprime mortgages consistently had the highest percentage of new loss mitigation actions to new foreclosures, well above 100 percent throughout the period.

Prime mortgages consistently had the lowest percentage, averaging 43 percent over the last three months of the reporting period. (These findings are illustrated in the following charts.)

New foreclosures consist of all mortgages on which servicers commenced formal foreclosure proceedings during the month (e.g., public notice, judicial filing). New foreclosures do not always result in a foreclosure sale or loss of the borrowers' homes because banks simultaneously pursue other mitigation strategies, or borrowers take action to return their mortgages to a current and performing status.

New Loss Mitigation Actions (% of new foreclosures)	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Prime	36.85%	37.20%	38.79%	48.29%	40.03%	44.08%
Alt-A	68.01%	68.01%	78.89%	92.73%	82.77%	93.12%
Subprime	106.07%	112.18%	139.66%	152.96%	132.10%	160.53%
Other	100.81%	92.21%	94.20%	102.96%	98.11%	108.20%
Overall	73.01%	72.40%	78.70%	89.24%	79.39%	94.04%



The second quarter data showed that servicers were increasingly using loan modifications relative to payment plans as well as engaging in more loss mitigation activity, especially as measured relative to new foreclosures initiated.



## **VI. Third Quarter Mortgage Metrics Report**

The joint third quarter report on mortgage performance showed continued increases in delinquencies and foreclosures in process. The key results include:

- Delinquencies, foreclosures in process, and other actions leading to home forfeiture continued to rise.
- Loan modifications continued to grow more quickly than other loss mitigation strategies, as banks and thrifts worked with borrowers to keep them in their homes while minimizing losses. The number of new loan modifications increased 16 percent in the third quarter to more than 133,000.
- For the first time, this report included re-default rates on modified loans. The number of loans modified in the first quarter that were 30 or more days delinquent was more than 37 percent after three months and more than 55 percent after six months. The number of loans modified in the first quarter that were 60 or more days delinquent was more than 19 percent at three months and nearly 37 percent after six months.
- The number of delinquent loans increased during the third quarter across all loan categories—prime, Alt-A, and subprime. More than nine out of 10 mortgages remained current, but the percentage of current and performing mortgages fell from 93.33 percent at the end of the first quarter to 91.47 percent at the end of the third quarter.
- Banks and thrifts continued to work with borrowers to mitigate losses and help borrowers retain their homes. The number of newly initiated home retention actions—loan modifications and payment plans—increased by 13 percent from the second quarter to the third quarter.
- Loans held on the books of servicing banks and thrifts had the lowest re-default rates at 35.06 percent after three months, and 50.86 percent after six months, compared with loans serviced on behalf of third parties. The lower re-default rate for loans held by servicers may suggest that there is greater flexibility to modify loans in more sustainable ways when loans are held on a servicer's own books than when loans have been sold to third parties.

## **VII. Fourth Quarter Mortgage Metrics Report**

For the fourth quarter report, scheduled for release in March, the OCC and the OTS have expanded the scope of the mortgage performance data gathered from national banks and thrifts to include additional information on the affordability and sustainability of loan modifications.

The additional data will show how loan modifications changed the total amount of borrowers' monthly principal and interest payments in 2008. The fourth quarter report will review categories of loan modifications that:

- Increased borrowers' monthly principal and interest payments.



- Brought no change to payments.
- Reduced payments by 10 percent or less.
- Reduced payments by more than 10 percent.

Importantly, for loans modified in the first and second quarters of 2008, the report will show the percentage of modifications in each of the four categories that are 60 or more days past due at six months after modification. This will help gauge the effectiveness of the four categories of changes in monthly payments in making mortgages more sustainable and in keeping borrowers in their homes.

Future reports covering all of 2008 and subsequent periods will also show trends in the types of modifications undertaken by loan servicers.

### **VIII. Summary of Results**

Our experiences with servicers, our data collection efforts, industry analyses, academic research, and internal analyses suggest the following:

- Incenting the servicer and borrower to make affordable, sustainable modifications, as measured by prompt payments over time, serves a useful purpose to properly align behavior.
- The significant difference in performance between bank-owned modified loans and those serviced for others suggests certain impediments exist (legal, accounting) in securitization structures that inhibit successful loan modifications.
- Loan modifications are costly for the servicer. We believe that providing additional incentives to servicers for loan modifications will likely result in more modifications.
- Analyses by Merrill Lynch, Amherst Holdings, Fitch, and others suggest that three major factors affect the performance of loan modifications:
  - A decrease in the monthly payment. Larger decreases are associated with lower post-modification delinquencies.
  - The extent to which the borrower is underwater (owes more than the home is worth) after the loan modification. Borrowers who are still underwater after a loan modification are more prone to delinquencies.
  - The length of time the borrower has been in the home. In general, the longer the borrower has been in the home, the more likely the modified mortgage will perform.

### **IX. Evaluation Framework**

Successful modification plans avoid unnecessary foreclosures by making changes that address affordability issues within the framework of aligning appropriate short and long-term incentives.

With these objectives in mind, almost a year ago, Senior Deputy Director Scott Polakoff testified before the Senate Banking Committee concerning a proposed expedited loan modification effort that addressed the three most important aspects of successful loan modification program: an expedited process, an affordable monthly payment and an approach to dealing with “underwater” mortgages, in which the borrower owes more than the current market value of the home.

The proposal based its analysis of “affordable” monthly payment on sound underwriting criteria that assessed the borrower’s capacity to meet mortgage obligations based on a principal deferral of the present mortgage, if warranted by a current appraisal, and monthly payments lowered by a below-market interest rate (such as 4.5 percent) on a 30-year, fixed-rate mortgage. Borrowers that qualified under the new principal, term and rate would be offered such a loan. Thus, the extent of the loan modification would be based both on market factors and the borrower’s income.

To address underwater mortgages, the loan would be refinanced at the current market value of the property into a new Federal Housing Administration (FHA) insured loan. A key aspect of the OTS proposal was that the original loan holder would receive a negative equity interest (as a non-interest bearing second position claim) equal to the amount of the discount between a new FHA loan and the unpaid balance on the original mortgage. However, this amount could be reduced by a designated percentage, e.g., 15 percent, paid to the borrower upon sale to maintain borrower incentives to preserve the property and maximize its value at sale. The negative equity interest also could be adjusted to provide for a designated percentage to be paid out to an existing second mortgage loan holder to recognize the write-off necessary to permit the FHA refinancing to proceed.

Upon a later sale of the property by the borrower, any appreciation in the value of the property (reflected in the sale price) above the discounted payout (i.e., the amount paid to the original loan holder with the proceeds of the FHA loan) would be payable to the holder of the negative equity interest up to the full amount of that interest (less any prior second mortgage holder allocation and/or borrower offset to preserve the value of the property), with any sale proceeds beyond the amount of the negative equity interest accruing to the borrower.

The OTS Plan provided a market-driven solution that would not “bail out” investors or borrowers. It would allow qualifying borrowers to avoid foreclosure and stay in their homes; it would allow lenders to underwrite mortgages based on acceptable “loan to value” ratios while utilizing current appraised values; and it would allow servicers to maximize proceeds for the securitization.

The plan would provide an incentive for the original loan holders (including the opportunity for participation by existing second lien holders) and the borrowers to participate in the program. The plan would also avoid a windfall to borrowers by requiring any appreciation in a subsequent sale to be paid to holders of the negative equity interest up to the amount of the discount that the original loan holders took when the original loan was modified (again, less any allowance to a prior second lien holder



and any borrower incentive to maintain and maximize the value of the property). And the plan would rely on an existing framework – including FHA-insurance – for addressing problem loans in securitizations. Finally, the OTS Plan would create a potentially marketable financial instrument in the negative equity interest.

## **X. Conclusion**

As mentioned earlier, the OTS has been participating in the interagency effort led by the Treasury Department to develop the Financial Stability Plan's "home loan modification program." We are continuing these efforts as the interagency group works out the details of the modification plan scheduled to be announced in early March.

Some of the issues and solutions we have identified are being addressed, such as providing incentives to servicers and borrowers to make modifications and keep payments current. Others, such as how to standardize the terms of loan modification, remain unsettled. Still others, such as the legal and other impediments to modifying loans in a securitization structure, have yet to be addressed.

We continue to encourage our financial institutions to work with homeowners who are unable to make mortgage payments in a prudent way. We believe that 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. We remain committed to continuing to focus on these problems in the weeks and months ahead and we look forward to continued cooperation with our fellow regulators, Members of Congress and others in this important endeavor.