



TESTIMONY OF

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BEFORE THE

**UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY**

HEARING ON

**H.R. 5679, THE FORECLOSURE PREVENTION AND
SOUND MORTGAGE SERVICING ACT OF 2008**

APRIL 16, 2008

Madame Chairwoman, Ranking Member Capito and distinguished Members of the Subcommittee,

My name is Tom Deutsch and I am the Deputy Executive Director of the American Securitization Forum (“ASF”)¹. I very much appreciate the opportunity to testify before this Subcommittee again on behalf of the 370 member institutions of the ASF and the 650 member institutions of the Securities Industry and Financial Markets Association (“SIFMA”)². These members include all of the major lenders, servicers, underwriters and institutional investors in all forms of mortgage and asset-backed securitizations.

Background

No securitization market constituency—including lenders, servicers and investors—benefits from loan defaults and foreclosures. Foreclosure is usually the most costly means of resolving a loan default. As a result, it is typically the least-preferred alternative for addressing a defaulted loan whether or not the loan is held in a securitization trust. We therefore strongly support the policy goal of avoiding foreclosures wherever reasonable alternatives exist.

Overview of Typical Securitization Document Modification Provisions

A basic principle underlying the servicing of non-performing loans in securitization transactions is to maximize recoveries and minimize losses on those loans. This principle is embodied in the contractual servicing standards and other provisions that set forth the specific duties and responsibilities of servicers in securitizations. In turn, these contractual provisions, and the duties they impose on servicers and other securitization transaction participants, are relied upon by investors in mortgage-backed securities who depend primarily upon cash flows from pooled mortgage loans for the return on their investment.

Servicing of residential mortgage loans included in a securitization is generally governed by either a pooling and servicing agreement (PSA) or by a servicing agreement (SA). Typical PSA and SA provisions require servicers bound by those contracts to follow accepted servicing practices and procedures as they would employ “in their good faith

¹ ASF is a broad-based professional forum of over 370 member organizations that are active participants in the U.S. securitization market. Among other roles, ASF members include issuers, investors, financial intermediaries, professional advisers and rating agencies working on securitization transactions backed by all types of assets. ASF’s mission includes building consensus, pursuing advocacy and delivering education on behalf of the securitization markets and its participants. Additional information about the ASF, its members and activities may be found at ASF’s internet website: www.americansecuritization.com.

² SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA’s mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public’s trust and confidence in the markets and the industry. SIFMA works to represent its members’ interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

business judgment” and that are “normal and usual” in their general mortgage servicing activities.

Most subprime securitization transactions authorize the servicer to modify loans that are in default or for which default is imminent or reasonably foreseeable. Generally, permitted modifications include changing the interest rate on a prospective basis, capitalizing arrearages, extending the maturity date, and forgiving principal, among other actions. The “reasonably foreseeable” default standard derives from the restrictions imposed by the Real Estate Mortgage Investment Conduit (REMIC) sections of the Internal Revenue Code of 1986 on modifying loans included in a securitization for which a REMIC election is made. Market participants interpret the two standards of future default—“imminent” and “reasonably foreseeable”—to be substantially the same.

Contractual loan modification provisions in securitizations typically also require that the modifications be in the best interests of the security holders or not materially adverse to the interests of the security holders, and that the modifications not result in a violation of the REMIC status of the securitization trust. Market participants generally interpret the standards “in the best interest of” or “not materially adverse to the interests of” investors or securityholders in a securitization to refer to investors in that securitization in the aggregate, without regard to the specific impact on any class of investors or any class of securities.

Consistent with typical contractual provisions governing servicing activities in securitizations and applicable law and regulation, we believe that a loan modification may be appropriate where the loan is either in default or where default is reasonably foreseeable, and if the latter, where there is a reasonable basis for the servicer to determine that the borrower is unlikely to be able to make scheduled payments on the loan in the foreseeable future. The servicer must also have a reasonable basis for concluding that the borrower will be able to make scheduled payments on the loan as modified, and for modifying the loan in a manner that is likely to be sustainable, but that does not reduce required payments beyond the magnitude required to return the loan to performing status, or beyond the anticipated period of borrower need.

We believe that loan modifications meeting the above criteria are generally preferable to foreclosure where the servicer concludes that 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. Whichever action is determined by the servicer to maximize recovery should be deemed to be in the best interest of investors in the aggregate.

In addition to the authority to modify the loan terms, most PSAs and SAs permit other loss mitigation techniques, including forbearance, repayment plans for arrearages and other deferments which do not reduce the total amount owed but may extend the term of payment. In addition, these arrangements typically permit loss mitigation through non-foreclosure alternatives to terminating a loan, such as short sales or deeds-in-lieu.

Although most PSAs and SAs in securitizations either expressly permit or do not restrict loan modifications, some agreements do impose restrictions. For example, certain transactions limit the total number of permitted occurrences of modifications for any individual loan. Other transactions may limit the amount of modifications to a certain percentage of the initial size of the mortgage loan pool. Some agreements require prior consent (for example, from a rating agency or bond insurer) to allow the amount of modifications to exceed a specified percentage of the initial size of the mortgage pool. In a more limited number of cases, governing agreements may restrict the types of modifications that can be effected, or limit the amount by which the mortgage interest rate may be changed. However, it does not appear that any securitization requires investor consent to a modification that is otherwise authorized under the operative documents.

Based upon the economic and contractual principles outlined above, and consistent with applicable governing documents and regulatory and accounting standards, we have supported the use of loan modifications (along with other loss mitigation tools) by servicers in securitization transactions in appropriate circumstances. In general, “appropriate circumstances” would include situations where a servicer has concluded that a particular loan is in default or that default is reasonably foreseeable, and that the loan modification or other loss mitigation action contemplated by the servicer is likely to maximize recovery and minimize loss on that loan.

As part of its efforts to inform members of the industry and promulgate relevant guidance in light of the widespread challenges currently confronting the securitization market, ASF has published several recommended market standards and practices. One such set of recommendations relevant to the topic of this hearing is ASF’s June 2007 *“Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans.”* This document is designed to provide guidance to servicers modifying subprime residential mortgage loans that are included in securitization transactions, and to provide a common framework for interpreting loan modification standards and contractual provisions, thereby promoting greater uniformity, clarity and certainty of application of these standards and provisions throughout the industry. Our testimony here incorporates by reference the more detailed analysis and discussion set forth in that Statement.

ASF Streamlined Loan Modification Framework

Since I last testified before this Subcommittee on November 30, 2007 in Los Angeles, CA, a significant amount of progress has been made by the industry to help struggling homeowners stay in their homes. One very significant initiative was launched on December 6, 2007, less than a week after your hearing, Madame Chairwoman. On that day, the ASF announced and President Bush and Treasury Secretary Paulson supported and endorsed the ASF streamlined loan modification framework (executive summary attached as Exhibit A) for industry servicers to “fast track” subprime ARM borrowers into interest rate loan modifications in certain circumstances.

The ASF framework uses objective criteria to determine the continued affordability of subprime loans, based on factors such as the borrower's payment history, credit standing, owner occupancy, and amount of home equity. Using these criteria, servicers can segment borrowers into three categories: 1) borrowers who are able to refinance; 2) current borrowers who occupy the home and are eligible for a "fast-track" loan modification; and 3) borrowers who have shown difficulty making their loan payments prior to an upward reset. By streamlining the evaluative procedures of borrowers falling into the first two categories, servicers will be able to devote more resources to borrowers in category three who may require a customized solution based on a comprehensive analysis of that borrowers' debts and income. The net effect of the framework then is to address more efficiently and effectively the needs of all subprime borrowers who may face challenges in making their mortgage payments. The ASF framework was adopted with strong consensus support by our members, including loan servicers, institutional investors and other market participants.

There of course have been differences of opinion regarding the utility and impact of the framework. Much of this debate revolves around individual views regarding how many subprime loans will default without refinancing or modification, how many loans that are modified will nevertheless default in the future, and what form of loan modification would be sufficient to avoid foreclosure. None of these questions can be answered with complete certainty, as they require predictions of future events, such as home price appreciation or depreciation rates. What does seem clear, however, is that absent a balanced, more systematic approach for addressing the wave of subprime ARM resets, a larger number of those loans might default, producing higher foreclosures and losses for borrowers and institutional investors alike.

Unfortunately, many questions and criticisms of this framework appear to be driven by misunderstandings which bear correction and clarification. In particular, the framework is consistent with and builds upon basic loss mitigation principles that mortgage servicers have employed for decades. In simple terms, these principles dictate that if a loan cannot perform according to its contractual terms, a servicer should take steps that are reasonably calculated to minimize loss on that asset. In most cases—and especially in today's environment of higher default rates and home price depreciation—a servicer must carefully consider whether options other than foreclosure are available since foreclosure nearly always produces the lowest returns for investors. Quite simply, the framework identifies loan modifications as one method that servicers can use to minimize losses on impaired mortgage assets.

Positive Interest Rate Developments

The purpose of the ASF Framework was to address the rising tide of subprime ARM borrowers who may not be able to meet their higher payments at their initial reset. Most subprime 2/28 and 3/27 borrowers pay a fixed introductory rate for two to three years, and then adjust to a floating rate based on six month LIBOR thereafter. For most of these ARM borrowers, the formula for arriving at their new rate is simply the addition of approximately 5.5% to 6 month LIBOR. As 6 month LIBOR was approximately 5% in

December, 2007, the average subprime ARM borrower was resetting, on average, from an approximate introductory rate of 7.5% to a new floating rate of 10.5%. For an average principal balance, that borrower's payments would rise by \$450 a month. In many cases, borrowers didn't have the ability to meet those increases, so it was in everyone's best interest—borrowers and investors—to modify that borrower to a reasonable rate that they could afford.

Importantly, since the ASF framework was announced, 6 month LIBOR has dropped precipitously to 2.6% as of today, April 16, 2008. As a result, the average subprime ARM borrower has had little or no rate increase at their reset.

What has really changed then for subprime ARM borrowers since December 6th is that every resetting subprime ARM borrower in America has experienced the equivalent of a 2.5% loan rate modification through the normal contractual functioning of their mortgage note. Falling rates have obviated the need to make contractual rate modifications for these subprime ARM borrowers which largely explains why an even more significant increase in industry contractual rate modification activity hasn't been observed over the last couple of months.

In this period of significant housing market correction, the ASF and SIFMA, including all of our various constituencies of servicers, investors and originators, remains committed to taking vigorous and proactive steps in working with borrowers to address preventable foreclosures.

H.R. 5679, The Foreclosure Prevention and Sound Mortgage Servicing Act of 2008

The Foreclosure Prevention and Sound Mortgage Servicing Act of 2008 would establish a new federal duty for servicers to "engage in reasonable loss mitigation activities that provide for (1) long-term affordability of the loan; and (2) the maximum retention of home equity." Unless or until this new duty is fulfilled, servicers would be unable to exercise their existing legal rights to the collateral and proceed with foreclosure.

The underlying premise of the legislation appears to be that servicers of securitized mortgage loans are not sufficiently engaging in loan modification and workout activity because they do not have sufficient incentives to do so. However, it is worth noting that servicers today face potential legal exposure from overly conservative, as well as overly aggressive, loss mitigation activity, to the extent that a servicer may be accused of not fulfilling its obligations to maximize recoveries on mortgage loans.

It is important to recognize then that servicers are already engaged in expanded loan modification and loss mitigation efforts, consistent with their existing contractual obligations and in response to the challenges presented by current housing market turmoil. Servicers have been increasing their investments in loss mitigation personnel and have developed enhanced processes and procedures to expedite delivery of loan workout, modification and home retention alternatives wherever feasible. Hard data supports these observations, and indicates that an increasing number and accelerating

pace of workouts and modifications are taking place with over 1.2 million homeowners being helped since last summer.

We fully agree that all servicers should engage in “reasonable loss mitigation activities,” which as described above, servicers are already contractually obligated to engage in for the benefit of the security holders. But the new duty the bill proposes compels all servicers nationwide to rewrite every mortgage and PSA contract solely to benefit borrowers in default, rather than to “act in the best interest of security holders” as the mortgage and PSA contracts specify. This bill then disregards the original loan terms to which the borrower agreed as well as the servicers’ obligations under the PSAs to institutional investors.

As a general matter, we have strong concerns with any legislation that would abrogate or interfere with previously established, private contractual obligations. This bill would fundamentally alter the contractual standards of PSAs to require servicers to be the agent of the borrower, rather than the MBS institutional investor. Changing this standard would alter the commercial expectations of investors and would seriously undermine the confidence of investors in the sanctity of contracts which are the bedrock to extension of consumer credit and the process of securitization. Consequently, future investors would be dissuaded from investment in mortgage markets that are in dire need of liquidity.

Since all parties to a contract, including investors, rely on the legal, valid, binding and enforceable provisions of the governing contracts, any legislation that would dilute, amend, or modify such contractual obligations or prejudice how the obligor fulfills its obligations is considered by the ASF to represent dangerous policy. Legislated intervention into otherwise valid legal contracts threatens the stability and predictable operation of the contractual legal framework supporting our capital markets system, and would have a chilling effect on the willingness of investors to participate in our markets.

While we fully support and encourage servicers to meet their contractual obligations by engaging reasonable loss mitigation, we strongly oppose this bill from the very premise that it starts from—mortgage contracts should be modified to serve solely the borrowers interests rather than the original contractual obligations that borrowers have agreed to fulfill.

Conclusion

The shared goal of participants in the mortgage financing markets is to keep people in their homes. Loan modification is one effective method which mortgage loan servicers are using to avoid foreclosures, but it is not the only solution. Refinancing, forbearance, borrower counseling and other loss mitigation tools are also effective options available to troubled borrowers, and servicers are employing all viable alternatives to preserve home ownership wherever possible. There is no silver bullet that will fix the current problems in the mortgage market and there is no single plan that will address all the problems related to the housing market. Market participants have and continue to collaborate and work towards developing coordinated solutions to the current issues in the mortgage

financing market, recognizing that it is essential to balance the interests of borrowers and investors, while preserving the significant benefits of the securitization market.

I thank you for the opportunity to testify on this important and timely issue today. While the ASF and SIFMA are not able to support H.R. 5679 in its current form, we look forward to working with you, Madame Chairwoman, Congress and the Administration in the pursuit of reducing preventable foreclosures.

APPENDIX A

American Securitization Forum

Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans

Executive Summary

December 6, 2007

Scope:

This streamlined framework applies to all first lien subprime residential adjustable rate mortgage (ARM) loans that have an initial fixed rate period of 36 months or less (including “2/28s” and “3/27s”), referred to below as “subprime ARM loans” that:

- were originated between January 1, 2005 and July 31, 2007;
- are included in securitized pools; and
- have an initial interest rate reset between January 1, 2008 and July 31, 2010.

This streamlined framework would be applied to subprime ARM loans in advance of an initial reset date. Typically, servicer/borrower communication should begin 120 days prior to the initial reset date.

Overarching Principles:

- The servicer will not take any action that is prohibited by the pooling and servicing agreement (“PSA”) or other applicable securitization governing document, or that would violate applicable laws, regulations, or accounting standards. ASF’s Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans, published concurrently with this document, analyzes how the framework described in the Executive Summary is consistent with typical PSA provisions. The ASF urges readers of this Executive Summary to review the full Statement.
- The ASF believes that this framework is consistent with the authority granted to a servicer to modify subprime mortgage loans in typical PSAs. The ASF expects that the procedures in this framework will constitute standard and customary servicing procedures for subprime loans.

- The servicer will expeditiously implement the ASF Investor Reporting Guidelines for the Modification of Subprime ARM Loans recommended by the ASF, which is simultaneously released with this framework.
- LTV and CLTV will be determined based on information at origination. If an origination LTV is below 97%, a servicer may obtain an updated home value by obtaining an AVM, BPO or other means.
- All servicers of second liens to subprime borrowers should cooperate fully with this framework by providing information needed by first lien servicers and by agreeing to subordinate the second lien to any new first lien resulting from a refinance (with no cash out) under this framework.
- All existing contractual obligations and remedies related to fraudulent mortgage origination activity should be strictly enforced.
- The streamlined framework outlined in this framework represents the consensus view of the membership of the ASF, acting through its Board of Directors, as to the parameters used to determine the segmentation of subprime ARM loans, including the numeric values included in those parameters. It is understood by the ASF's members that the numeric values included in the parameters are not based on historic data, but rather simply represent a consensus view as to appropriate numeric values for use within this framework for the purpose of supporting a streamlined approach to loan modifications that complies with typical securitization governing documents. The ASF, acting through its Board of Directors, may in the future change these numeric values or further refine these parameters as experience is gained and market conditions evolve.

Borrower Segmentation:

Under this framework, subprime ARM loans are divided into 3 segments.

Segment 1 includes current (as defined below) loans where the borrower is likely to be able to refinance into any available mortgage product, including FHA, FHA Secure or readily available mortgage industry products.

- Generally, the servicer will determine whether loans may be eligible for refinancing into readily available mortgage industry products based on ascertainable data not requiring direct communication with the borrower, such as LTV, loan amount, FICO and payment history. Servicers will generally not determine current income or DTI to determine initial eligibility for refinancing.

- If the borrower also has a second lien on the property, this framework contemplates that the borrower is able to refinance the first lien only, on a no cash out basis. In order for the loan to fall into this segment, the second lien does not have to be refinanced; however, any second lien holder will need to agree to subordinate their interest to the refinanced first lien.

Segment 2 includes current loans where the borrower is unlikely to be able to refinance into any readily available mortgage industry product.

- *Current*: For purposes of this framework “current” means the loan must be not more than 30 days delinquent, and must not have been more than 1 x 60 days delinquent in the last 12 months, both under the OTS method. Corresponding tests would apply under the MBA method if the servicer uses that standard.
- *LTV test*: All current loans with an LTV (based on the first lien only) greater than 97% are deemed not to be eligible for refinance into any available product, and thus are within Segment 2. (97% is the maximum LTV allowed under FHA Secure.)
- *Not FHA Secure eligible*: All current loans that otherwise do not satisfy FHA Secure requirements, including delinquency history, DTI at origination and loan amount standards for this program, are within Segment 2 unless the servicer can determine whether they may meet eligibility criteria for another product, by reviewing eligibility criteria without performing an underwriting analysis.

Segment 3 includes loans where the borrower is not current as defined above, demonstrating difficulty meeting the introductory rate.

Segment 1 – Refinance:

- It is expected that borrowers in this category should refinance their loans, if they are unable or unwilling to meet their reset payment. However, a servicer may evaluate each borrower in this category on a case by case basis or apply any framework consistent with the applicable servicing standard in the transaction documents for a loan modification or other loss mitigation outcome.
- The servicer will facilitate a refinance in a manner that avoids the imposition of prepayment penalties wherever feasible. This may be accomplished by timing the refinance to occur after the upcoming reset date.
- Servicers should take all reasonable steps permitted under the PSA and other governing documents to encourage or facilitate refinancing for borrowers in Segment 1, or to borrowers in Segment 2 who become eligible for a refinance, including, where permitted, providing borrowers with information about FHA,

FHA Secure and other readily available mortgage industry products, even if that servicer is not able to provide those products through any affiliated originator.

Segment 2 – Loan Modification:

- The servicer will determine the following for each Segment 2 borrower: current owner occupancy status (based on information known to the servicer, including billing and property address), current FICO score and the FICO score at origination of the loan.
- FICO test:
 - If the current FICO score is less than 660 and is less than a score 10% higher than the FICO score at origination, the borrower is considered to have met the “FICO test.” If the borrower meets the FICO test, the servicer will generally not determine the borrower’s current income.
 - If either a) the current FICO score is 660 or higher, or b) the current FICO is at least 10% higher than the FICO score at origination, the borrower is considered to not meet the “FICO test.” If the borrower does not meet the FICO test, the servicer will use an alternate analysis to determine if the borrower is eligible for a loan modification.
- Segment 2 loans will only be eligible for a fast track loan modification if:
 - The borrower currently occupies the property as his or her primary residence;
 - The borrower meets the FICO test; and
 - The servicer determines that, at the upcoming reset, the payment amount would go up by more than 10%.
- Borrowers in this segment and eligible for a fast track loan modification as described above may be offered a loan modification under which the interest rate will be kept at the existing rate, generally for 5 years following the upcoming reset.
- As to Segment 2 loans eligible for a fast track loan modification, the servicer may make the following presumptions:
 - The borrower is able to pay under the loan modification based on his or her current payment history prior to the reset date.

- The borrower is willing to pay under the loan modification, as evidenced by a) an agreement to the modification after being contacted or b) in the event that the affirmative agreement of the borrower cannot be obtained, the borrower's payment of two payments under the loan as modified after receiving notice of the modified terms.
 - The borrower is unable to pay (and default is reasonably foreseeable) after the upcoming reset under the original loan terms, based on the size of the payment increase that would otherwise apply.
 - The modification maximizes the net present value of recoveries to the securitization trust and is in the best interests of investors in the aggregate, because refinancing opportunities are likely not available and the borrower is able and willing to pay under the modified terms.
- For borrowers that do not meet the FICO test, the servicer will use an alternate analysis to determine if the borrower is eligible for a loan modification, as well as the terms of the modification (which may vary). This may include a) conducting an individual review of current income and debt obligations, debt-to-income analysis, and considering a tailored modification for a borrower, or b) applying any other framework consistent with the applicable servicing standard in the transaction documents to determine if a borrower is eligible for a loan modification.
 - For borrowers that are eligible for a fast track modification, the fast track option is non-exclusive and does not preclude a servicer from using an alternate analysis to determine if a borrower is eligible for a loan modification, as well as the terms of the modification.

Segment 3 – Loss Mitigation:

- For loans in this category, the servicer will determine the appropriate loss mitigation approach in a manner consistent with the applicable servicing standard in the transaction documents, but without employing the fast tracking procedures described under Segment 2. The approach chosen should maximize the net present value of the recoveries to the securitization trust. The available approaches may include loan modification (including rate reduction and/or principal forgiveness), forbearance, short sale, short payoff, or foreclosure.
- These borrowers will require a more intensive analysis, including where appropriate current debt and income analysis, to determine the appropriate loss mitigation approach.