CONGRESSIONAL OVERSIGHT PANEL

APRIL OVERSIGHT REPORT *

EVALUATING PROGRESS ON TARP FORECLOSURE MITIGATION PROGRAMS

APRIL 14, 2010.—Ordered to be printed

* Submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343

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CONGRESSIONAL OVERSIGHT PANEL

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EXECUTIVE SUMMARY*

When the Panel last examined the foreclosure crisis in October of 2009, the picture was grim. About one in eight mortgages was already in foreclosure or default, and an additional 250,000 foreclosures were beginning every month. The Panel's report raised serious concerns about Treasury's efforts to address the problem, noting that six months after the programs had been announced and two years into the foreclosure crisis, the Home Affordable Modification Program (HAMP) had permanently modified the mortgages of only 1,711 homeowners, that it had failed to address foreclosures caused by such factors as unemployment and negative equity, and that it appeared unlikely to help any significant fraction of the homeowners facing foreclosure.

Since then, Treasury has taken steps to address these concerns and to stem the tide of foreclosures. HAMP began requiring loan servicers to explain to homeowners why their applications for loan modifications had been declined, and Treasury launched a drive to convert temporary modifications into long-term, five-year modifications. In keeping with Panel recommendations, Treasury also announced new programs to support unemployed borrowers and to help "underwater" homeowners—those who owe more on their mortgages than their homes are worth—regain equity through principal write-downs.

Despite Treasury's efforts, foreclosures have continued at a rapid pace. In total, 2.8 million homeowners received a foreclosure notice in 2009. Each foreclosure has imposed costs not only on borrowers and lenders but also indirectly on neighboring homeowners, cities and towns, and the broader economy. These foreclosures have driv-

* The Panel adopted this report with a 3–1 vote on April 13, 2010.

en down home prices, trapping even more borrowers in a home that is worth less than what they owe. In fact, nearly one in four homeowners with a mortgage is presently underwater. Although housing prices have begun to stabilize in many regions, home values in several metropolitan areas, such as Las Vegas and Miami, continue to fall sharply.

Treasury's response continues to lag well behind the pace of the crisis. As of February 2010, only 168,708 homeowners have received final, five-year loan modifications—a small fraction of the 6 million borrowers who are presently 60+ days delinquent on their loans. For every borrower who avoided foreclosure through HAMP last year, another 10 families lost their homes. It now seems clear that Treasury's programs, even when they are fully operational, will not reach the overwhelming majority of homeowners in trouble. Treasury's stated goal is for HAMP to offer loan modifications to 3 to 4 million borrowers, but only some of these offers will result in temporary modifications, and only some of those modifications will convert to final, five-year status. Even among borrowers who receive five-year modifications, some will eventually fall behind on their payments and once again face foreclosure. In the final reckoning, the goal itself seems small in comparison to the magnitude of the problem.

After evaluating Treasury's foreclosure programs, the Panel raises specific concerns about the timeliness of Treasury's response to the foreclosure crisis, the sustainability of mortgage modifications, and the accountability of Treasury's foreclosure programs.

Timeliness. Since early 2009, Treasury has initiated half a dozen foreclosure mitigation programs, gradually ramping up the incentives for participation by borrowers, lenders, and servicers. Although Treasury should be commended for trying new approaches, its pattern of providing ever more generous incentives might backfire, as lenders and servicers might opt to delay modifications in hopes of eventually receiving a better deal. In addition, loan servicers have expressed confusion about the constant flux of new programs, new standards, and new requirements that make implementation more complex.

The long delay in dealing effectively with foreclosures underscores the need for Treasury to get its new initiatives up and running quickly, but it also underscores the need for Treasury to get these programs right. Even if Treasury's recently announced programs succeed, their impact will not be felt until early 2011—almost two years after the foreclosure mitigation program was first launched—and more than three years after the first foreclosure mitigation program was undertaken.

Sustainability. Although HAMP modifications reduce a homeowner's mortgage payments, many borrowers continue to experience severe financial strain. The typical post-modification borrower still pays about 59 percent of his total income on debt service, including payments on first and second mortgages, credit cards, car loans, student loans, and other obligations. Furthermore, HAMP typically does not reduce the total principal balance of a mortgage, meaning that a borrower who was underwater before receiving a HAMP modification will likely remain underwater afterward. The typical HAMP-modified mortgage has a balance 25 percent greater than the value of the underlying home.

Most borrowers who proceed through HAMP will face a precarious future, but their resources will be severely constrained. With a majority of their income still tied up in debt payments, a small disruption in income or increase in expenses could make repayment almost impossible. Many will have no equity in their homes and are likely to question whether it makes sense to struggle so hard and for so long to make payments on homes that could remain below water for years. Many borrowers will eventually redefault and face foreclosure. Others may make payments for five years under a so-called "permanent modification," only to see their payments rise again when the modification period ends. The redefaults signal the worst form of failure of the HAMP program: billions of taxpayer dollars will have been spent to delay rather than prevent foreclosures.

Accountability. As always, Treasury must take care to communicate clearly its goals, its strategies, and its specific metrics for success for its programs. The Panel is concerned that the sum total of announced funding for Treasury's individual foreclosure programs exceeds the total amount set aside for foreclosure prevention. It is unclear whether this indicates that Treasury will scale back particular programs or will scale up its financial commitment to the foreclosure prevention effort. Treasury must be clearer about how much taxpayer money it intends to spend. Additionally, Treasury must thoroughly monitor the activities of participating lenders and servicers, audit them, and enforce program rules with strong penalties for failure to follow the requirements.

Treasury has made progress since the Panel's last foreclosure report, and the Panel applauds those efforts. But the Panel also notes that even now Treasury's programs are not keeping pace with the foreclosure crisis. Treasury is still struggling to get its foreclosure programs off the ground as the crisis continues unabated.

SECTION ONE: FORECLOSURE MITIGATION

A. Introduction

The Emergency Economic Stabilization Act (EESA), which established the Panel, charged it with providing periodic reports on foreclosure mitigation efforts. In March 2009, the Panel issued its first report on foreclosure mitigation, in which it offered a checklist of key items that are necessary for a successful foreclosure mitigation effort. Coinciding with the release of the report, Treasury announced a foreclosure mitigation initiative known broadly as Making Home Affordable (MHA). MHA includes various programs and subprograms, including the Administration's signature Home Affordable Modification Program (HAMP).

Seven months later, the Panel revisited the foreclosure mitigation programs in its October 2009 report. The MHA programs were measured against the March checklist, but further assessment was limited because many of the programs were still in their early stages and did not have a demonstrated track record. The Panel noted its intention to monitor carefully all available data going forward and to make further recommendations.

Now, more than one year after the announcement of the foreclosure mitigation programs, the Panel turns once again to the programs. What have the programs accomplished in the last year? Have they demonstrated a track record of success since the October report? Has Treasury implemented the findings and recommendations identified by the Panel in the last six months?

B. State of the Housing Markets and General Economy

In order to evaluate Treasury's efforts at foreclosure mitigation, it is necessary to understand the broader context of the housing market and the economy as a whole.

In Annex I, the Panel reviews recent trends in the major housing market statistical indicators. The current market prices and the level of activity in the housing sector provide context for understanding the nature and scale of the foreclosure issue, and metrics for evaluating the progress of Treasury's foreclosure mitigation initiatives. As the information in the annex shows, on the whole, the U.S. housing market remains extremely weak, although there are some signs of stabilization. While several indicators of housing market health have shown improvement in recent months, others are trending in the opposite direction. Housing price levels are crucial for foreclosure prevention, as default rates have a strong negative correlation with changes in housing prices from the time of financing. Depressed housing prices contribute to negative equity, which impedes refinancings and encourages strategic defaults. A slow recovery of housing prices means that default and foreclosure rates are likely to remain elevated for some time into the future, and also threatens the sustainability of HAMP permanent modifications.

Some observers view recent improvements as grounds for optimism. Jay Brinkmann, the Mortgage Bankers Association's chief economist, recently said that "[w]e are likely seeing the beginning of the end of the unprecedented wave of mortgage delinquencies and foreclosures that started with the subprime defaults in early 2007 . . ." [1] Others, however, are more skeptical. Peter Flint, CEO of the online home listing database Trulia, expects that "government interventions will start to disappear, shadow inventory will hit the market and mortgage rates will start to rise . . . We're in a false state of stability." [2]

The second portion of the annex discusses general economic indicators. The state of the broader economy has a great influence on the housing market, and therefore on foreclosure mitigation efforts. After all, the best foreclosure mitigation initiative is a sound economy with low unemployment. Certain economic indicators, such as unemployment, have a direct effect on the housing market; people without jobs are rarely able to pay their mortgages for long, even if they receive favorable concessions from their lender. The unemployed are also often forced to move to take advantage of better job opportunities. This can undermine many loan modifications designed to prevent foreclosure, since these modifications are generally based on an assumption that the borrower will stay in place for several years.

Opinions are mixed on the outlook for the economy. Some, such as Richard Bernstein, chief investment strategist at Merrill Lynch, are encouraged by recent economic growth, and believe that the economy is charging ahead as if "on steroids . . . because of the huge amount of credit and leverage." [3] Others are less sanguine, and see structural problems with the recovery. Former Federal Reserve Chairman Alan Greenspan calls the current recovery "extremely unbalanced . . . because we're dealing with small businesses who are doing badly, small banks in trouble, and of course there is an extraordinarily large proportion of the unemployed in this country who have been out of work for more than six months and many more than a year." Instead, he believes the recovery is being driven by high-income consumers and corporations benefitting from rising stock prices.[4]

C. Discussion and Evaluation of Program Changes Since October

The Panel, in its October report, described and evaluated the MHA program, with a focus on HAMP, the largest segment that uses Troubled Asset Relief Program (TARP) funds. Treasury, through HAMP, provides servicers, borrowers and investors/lenders with a series of financial incentives and cost-sharing measures to modify loans, bringing the borrowers' first-lien mortgage debt-to-income (DTI) ratio down to 31 percent.

[1] Mortgage Bankers Association, *National Delinquency Survey* (Fourth Quarter 2009) (online at www.mbaa.org/ResearchandForecasts/ProductsandSurveys/NationalDelinquencySurvey.htm) (hereinafter "MBA National Delinquency Survey") (subscription required). *See also* Mortgage Bankers Association, *Delinquencies, Foreclosure Starts Fall in Latest MBA National Delinquency Survey* (Feb. 19, 2010) (online at www.mortgagebankers.org/NewsandMedia/PressCenter/71891.htm) (hereinafter "February MBA Survey Results").

[2] Lynn Adler, *Foreclosure Buyer Demand Dips as Supply Mounts,* Reuters (Dec. 15, 2009) (online at www.reuters.com/article/idUSTRE5B90JZ20091215).

[3] Michelle Lodge, *U.S. Recovery "On Steroids": Bernstein,* CNBC (Mar. 25, 2010) (online at www.cnbc.com/id/36036362).

[4] David Lawder, *Greenspan: U.S. Recovery Extremely Unbalanced,* Reuters (Feb. 23, 2010) (online at www.reuters.com/article/idUSTRE61M4B120100223).

In describing and evaluating MHA, the Panel also made a number of recommendations as to how Treasury could improve the program and how success could be defined. The Panel revisits those recommendations in Section G. This section of the report discusses and evaluates the changes that Treasury and the Administration have made to MHA since the Panel's October report.

1. Changes to Previously Announced Programs

a. Denial Letters

In early November Treasury released guidance that took a step toward transparency in the process of determining whether a borrower is eligible for HAMP. The guidance requires servicers to provide borrowers with a reason for any denial from the program. Treasury now requires servicers, within 10 days of their determination of a denial, to send the borrower a Borrower Notice that sets out the reason for the denial and describes other foreclosure alternatives for which the borrower might be eligible.[5] Treasury requires that the servicers write the letters in "clear, non-technical language, with acronyms and industry terms such as 'NPV' explained in a manner that is easily understandable."[6] If the borrower is denied because the transaction has a negative net present value (NPV), meaning that the lender could earn more from a foreclosure than from a HAMP modification, the Borrower Notice must also include a list of certain input fields that went into the NPV calculation. Upon the borrower's request, the servicer must also provide the values for these fields, so that the borrower might correct any inaccuracies. If the borrower requests the input data, and the home is scheduled for foreclosure sale, the servicer may not conduct the sale until 30 days after it provides the borrower with the input data. This provides the borrower with an opportunity to correct the data. If the borrower corrects the data by a material amount, the servicer must re-run the NPV calculation. Announced in early November, this directive was effective January 1, 2010.[7]

Treasury has stated that servicer reporting of the denial codes was only starting to happen in February 2010, but that Treasury expects this reporting to improve in the next several months.[8] When asked why Treasury is not requiring servicers to include the values of certain input fields (rather than just a list of input fields considered) due to an NPV-negative denial, Treasury stated that requiring servicers to set out the data from the input fields in the initial denial letter would have been too burdensome on servicers, as it would have required customized letters for each borrower.[9]

The Panel appreciates that Treasury has tried to reduce the implementation burden on servicers, but it is unclear how burdensome such a requirement would have been. The Panel notes that

[5] U.S. Department of the Treasury, *Home Affordable Modification Program—Borrower Notices,* Supplemental Directive 09–08, at 1–2 (Nov. 3, 2009) (online at www.hmpadmin.com/portal/docs/hamp__servicer/sd0908.pdf) (hereinafter "HAMP Borrower Notices").

[6] Treasury included in the supplemental directive model clauses for the letter. HAMP Borrower Notices, *supra* note 5, at 2.

[7] HAMP Borrower Notices, *supra* note 5, at 3.

[8] Treasury conference call with Panel staff (Mar. 24, 2010). The data supports that servicers have not been reporting denial codes consistently. For additional discussion on the extent of reported data, see Section D(2)c.

[9] Treasury conference call with Panel staff (Mar. 24, 2010).

many of the model clauses for denial letters allow servicers to simply check the box of the reason for denial (e.g., "You did not obtain your loan on or before January 1, 2009" or your property was ineligible because it is "Vacant"). However, many of the model clauses require servicers to fill in the blanks or customize the letter for the borrower (e.g., you are ineligible because your income "which [you told us is $______] OR [we verified as $______]" does not meet debt-to-income ratio (DTI) eligibility requirements, "Your loan was paid in full on ______," or "you notified us on ______ that you did not wish to accept the offer"). Even the list of certain NPV inputs requires some customization because the servicer must provide the data collection date for unpaid loan balance, pre-modification interest rate, and number of months delinquent.[10]

The Panel is concerned that some of the reported denial codes are incorrect or erroneous. For example, the data show that HAMP applications were denied because of a trial plan default. However, a trial plan default can only occur if a borrower is already participating in a trial modification; these borrowers received such denials before they were in a trial modification.[11] Treasury needs an appropriate monitoring mechanism in place to ensure that servicers are accurately reporting the reasons for denial or cancellation and those who are not receive meaningful sanctions for noncompliance.

b. Conversion Campaign

Under HAMP, eligible borrowers are given trial modifications in which first-lien mortgage payments are reduced to 31 percent of income. Generally, after three months of successful payments and provision of certain documentation, the modification is converted to a permanent modification. Although Treasury uses the term "permanent modification," the Panel believes it is important to be clear that these are only five-year modifications; after five years the interest rate and payments on the modified loan can rise,[12] therefore the modification is not truly "permanent." However for clarity and consistency with Treasury's terms, this report will use the term permanent modification.

At the end of 2009, Treasury began a conversion campaign focused on homeowners still in trial status who were eligible for permanent modifications.[13] Treasury took this step in order to move along a backlog of approximately 375,000 eligible borrowers who were still in trial modifications. As part of this campaign, Treasury required the seven largest HAMP servicers to submit plans showing their ability to make and communicate decisions on the eligibility of each borrower before the end of January 2010. Treasury

[10] *See* HAMP Borrower Notices, *supra* note 5, at A–1.
[11] See Section G(1) for additional information on reported denial codes.
[12] If the modified rate is below the market rate as determined from the Freddie Mac Primary Mortgage Market Survey rate on the date the modification agreement is prepared, the modified rate will be fixed for a minimum of five years as specified in the modification agreement. Beginning in year six, the rate may increase no more than one percentage point per year until it reaches the market rate at the time the modification agreement is prepared. The rate can never be higher than the market rate as indicated in the modification agreement. If the modified rate is at or above the market rate at the time the modification agreement is prepared, however, the modified rate is fixed for the life of the loan.
[13] U.S. Department of the Treasury, *Obama Administration Kicks Off Mortgage Modification Conversion Drive* (Nov. 30, 2009) (online at www.financialstability.gov/latest/tg__11302009b.html) (hereinafter "Administration Kicks Off Modification Drive").

also required servicers to provide a strategy for borrowers who were current on their payments but had not submitted certain documentation. Treasury evaluated servicers' plans with on-site servicer reviews by Treasury and Fannie Mae, enhanced borrower communication tools, and the engagement of all levels of government to assist in outreach.[14]

During this review period, servicers were to convert eligible borrowers as quickly as possible. In doing so, servicers had to confirm the status of all borrowers in active trial modifications that were set to expire by January 31, 2010. If appropriate, servicers had to send borrowers written notice that the borrowers had failed to make all scheduled trial plan payments, had failed to submit required paperwork, or both. Borrowers had 30 days (or until January 31, 2010, whichever was later) to submit the required documentation and/or payments.[15] Servicers that did not meet performance expectations detailed in the Servicer Participation Agreements could be subject to withholding or clawbacks of incentives or additional oversight from Treasury.[16]

The conversion campaign appears to have had some success. As of the Panel's October report, modifications were converting at a mere 1.26 percent,[17] but the percentage of trial modifications converted within three months peaked at a rate of 11.84 percent in the most recent data received from Treasury. The percentage converted within six months reached 23.72 percent.[18] These figures are encouraging but still relatively low considering the enormity of the foreclosure problem. Treasury must remain focused on continuing to increase the conversion rate.

Unfortunately, Treasury has been unable to provide data to the Panel regarding the status of the 375,000 borrowers who were the prime focus of the conversion campaign, and indicated that such data would not be available for several months. Treasury should clarify the outcomes for these borrowers and continuously work to improve its systems, as a lack of relevant program data in a timely manner prevents adequate analysis and evaluation.

c. Verified Documentation

In late January 2010, Treasury released a directive that altered borrower documentation requirements "to simplify and speed up the modification process for both borrowers and servicers."[19] This new directive requires servicers to obtain written, or "verified," income before offering trial period plans with effective dates on or

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[14] House Oversight and Government Reform, Subcommittee on Domestic Policy, Written Testimony of Phyllis R. Caldwell, chief, Homeownership Preservation Office, U.S. Department of the Treasury, *Foreclosures Continue: What Needs to Change in the Administration's Response?*, at 11 (Feb. 25, 2010) (online at oversight.house.gov/images/stories/Hearings/Domestic__Policy/2010/022510__Foreclosure/022410__Caldwell__Treasury__OGR__DP__022510.pdf) (hereinafter "Testimony of Phyllis Caldwell").

[15] U.S. Department of the Treasury, *Home Affordable Modification Program—Temporary Review Period for Active Trial Modifications Scheduled to Expire on or before January 31, 2010,* Supplemental Directive 09–10 (Dec. 23, 2009) (online at www.hmpadmin.com/portal/docs/hamp__servicer/sd0910.pdf).

[16] Administration Kicks Off Modification Drive, *supra* note 13.

[17] Congressional Oversight Panel, *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months,* at 74 (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report.pdf) (hereinafter "October Oversight Report").

[18] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

[19] Testimony of Phyllis Caldwell, *supra* note 14.

after June 1, 2010.[20] Currently, servicers can offer trial period plans based on stated or verified income.[21] This new directive was intended to make the HAMP modification process more efficient as well as to streamline documentation requirements. Under the new directive, borrowers must submit an "Initial Package" that includes a Request for Modification and Affidavit (RMA) Form (which includes the reason the borrower needs a modification, such as "curtailment of income" or "loss of job"), an authorization for the servicer to obtain borrower tax records from the IRS, and written evidence of income.[22]

With this directive, Treasury has taken a significant step to improve the documentation process. The directive followed Treasury's initial decision to allow servicers to offer trial period plans based on stated or verified income so that the program could reach a larger number of borrowers in the shortest amount of time in order to stem the flood of foreclosures that many saw coming. This was part of a general decision to roll out HAMP very quickly. Treasury has since modified the program several times to address problems encountered by servicers, borrowers, and housing counselors and in response to recommendations of its TARP oversight bodies-COP, the Special Inspector General for TARP (SIGTARP), and the Government Accountability Office (GAO). For example, Treasury found that allowing servicers to base HAMP eligibility determinations on verbal financial information provided trial modifications to many borrowers who would not ultimately qualify for permanent modifications.[23] (Treasury has always required servicers to review written documentation to evaluate borrowers' conversion to permanent modifications.)[24] Although attempts to streamline and standardize the mortgage modification process can result in uniformity and efficiency, SIGTARP and GAO have found that Treasury's repeated changes to program guidelines (including changing documentation requirements and repeated changes and clarifications in net present value models) were some of the main problems with HAMP or some of the primary reasons that Treasury's progress has been slow and disappointing.[25] Treasury is to be commended for efforts to improve the programs, but when attempting to do so, Treasury should be aware that the slow drip of additional program requirements has been a major challenge in program implementation for servicers that may lack nimbleness to respond to programmatic

[20] U.S. Department of the Treasury, *Home Affordable Modification Program—Program Update and Resolution of Active Trial Modifications,* Supplemental Directive 10–01, at 1 (Jan. 28, 2010) (online at www.hmpadmin.com/portal/docs/hamp__servicer/sd1001.pdf) (hereinafter "HAMP—Update and Resolution of Active Trial Modifications").

[21] *See* U.S. Department of the Treasury, *Introduction of the Home Affordable Modification Program,* Supplemental Directive 09–01, at 5–7 (Apr. 6, 2009) (online at www.hmpadmin.com/portal/docs/hamp__servicer/sd0901.pdf) (hereinafter "Introduction of HAMP").

[22] HAMP—Update and Resolution of Active Trial Modifications, *supra* note 20, at 1–2.

[23] When providing stated incomes, a number of borrowers inadvertently or intentionally under- or over-stated their incomes, or misrepresented that the property was owner occupied. Treasury conversations with Panel staff (Mar. 24, 2010).

[24] Introduction of HAMP, *supra* note 21, at 6–7.

[25] Government Accountability Office, *Home Affordable Modification Program Continues to Face Implementation Challenges,* GAO–10–556T (Mar. 25, 2010) (online at www.gao.gov/new.items/d10556t.pdf); *Office of the Special Inspector General for the Troubled Asset Relief Program, Factors Affecting Implementation of the Home Affordable Modification Program* (Mar. 25, 2010) (online at sigtarp.gov/reports/audit/2010/Factors__Affecting__Implementation—of__the__Home__Affordable__Modification__Program.pdf) (hereinafter "Factors Affecting Implementation of HAMP").

changes.[26] There have been 13 new supplemental directives and two revisions of existing supplemental directives in the last 12 months.

It is yet to be seen how the transition to verified income will impact program results. However, a few conclusions can be drawn. The change to verified income is unlikely to result in a net increase in the number of permanent modifications. It should increase the conversion rate from trial to permanent modification, as servicers will have already evaluated the borrower's documentation for modification at the time of trial offer, thus the only reason for failure to convert would be the borrower's failure to make the required payments. But, it also should result in fewer HAMP trial modifications being offered, as the documentation requirements are more stringent and similar to the previous requirements for conversion.[27] It is important to note that this documentation change will give borrowers a stronger, more realistic expectation that they will be able to convert to a permanent modification.

d. Second-Lien Program

Second liens often present legal and financial obstacles to the successful, sustainable modification of first mortgages. Whether they are originated at the same time as the first mortgage, or, in the case of home equity loans, at a later date, second liens often contribute to affordability problems for borrowers. Even with a modified first-lien mortgage, the borrower's total mortgage payments may remain unaffordable after accounting for the borrower's second-lien payment obligations. Second liens also contribute to negative equity, which increases the likelihood that the borrower will default.

In addition, second liens complicate the process of getting an agreement among the various interested parties on a mortgage modification. As part of a modification, holders of first-lien mortgages give up their position as having the first claim on the property, unless the second-lien holder agrees otherwise, and securing this agreement can be difficult.[28] The second-lien holder may be reluctant to remain in the second position because of a concern that its claim on payments from the borrowers will be wiped out by the first-lien modification.[29] So, in exchange for agreeing to keep the junior claim on the property, the second-lien holder may demand money from the first-lien holder.[30] Furthermore, the holder of the first-lien mortgage will be reluctant to make concessions to the borrower unless the second-lien holder does so too. Otherwise, the second-lien holder would effectively free-ride off the first-lien holder's

[26] Factors Affecting Implementation of HAMP, *supra* note 25.

[27] Treasury conversation with Panel. As discussed in Section D(2)e, the data supports this conclusion. The data shows that stated-income servicers have enrolled more borrowers in trial modifications but have converted a smaller number into permanent modifications. The data also shows that verified-income servicers have been offering fewer trial period plans but have converted a larger percentage of those trial modifications to permanent modifications.

[28] October Oversight Report, *supra* note 17, at 24–25.

[29] House Oversight and Government Reform, Subcommittee on Domestic Policy, Written Testimony of David Berenbaum, chief program officer, National Community Reinvestment Coalition, *Foreclosures Continue: What Needs to Change in the Administration's Response?,* at 23 (Feb. 25, 2010) (online at oversight.house.gov/images/stories/Hearings/Domestic__Policy/2010/022510__Foreclosure/022310__DP__David__Berenbaum__022510.pdf) (hereinafter "Testimony of David Berenbaum").

[30] October Oversight Report, *supra* note 17, at 25 fn 70.

concessions; to the extent that the borrower's cash flow is freed up by the first-lien holder's concessions, it would accrue to the benefit of the second-lien holder.

To address these issues, last year Treasury announced the Second Lien Program (2MP) as part of HAMP. Under this program, Treasury uses incentive payments to encourage second-lien servicers to voluntarily reduce the cost of these loans to borrowers who participate in first-lien modifications under HAMP.[31] As announced, the program gave participating servicers two options: reduce borrower payments or extinguish the lien.[32] Under the first option, Treasury would pay servicers incentive payments of up to $1,250 to modify second-lien loans to a lower interest rate—one percent on amortizing loans and two percent on interest-only loans. Borrowers also would receive up to $1,250 in incentive payments to stay current on the second lien. Investors also would receive an incentive payment from Treasury equal to half of the difference between (i) the interest rate on the first lien as modified and (ii) either one or two percent, depending on the loan type.[33] The maturity date of the second lien was to be extended to match the modified first lien.[34] Under the second option, investors would receive a lump sum incentive payment to extinguish the loan.

The Second Lien Program was announced more than a year ago, but in its initial form it did not attract much participation from second-lien holders, and consequently failed to get off the ground. More recently, Treasury announced a number of changes to the program, and the four largest second-lien servicers (Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo) have now enrolled.[35] Together, Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo hold approximately 58 percent of the $1.03 trillion in outstanding second liens.[36]

Previously, for interest-only loans, servicers were to reduce the interest rate to two percent, and retain the interest-only feature.[37] Under the revisions, servicers have the option of reducing the rate to two percent and converting the loan to a fully amortizing loan. Servicers are also now permitted to extend the amortization term to 40 years. In addition, second liens for borrowers in bankruptcy

[31] U.S. Department of the Treasury, *Update to the Second Lien Modification Program,* Supplemental Directive 09–05 Revised (Mar. 26, 2010) (online at www.hmpadmin.com/portal/docs/second_lien/sd0905r.pdf) (hereinafter "Update to the Second Lien Modification Program").

[32] For a complete discussion of the Second Lien Program, see the Panel's October report. October Oversight Report, *supra* note 17, at 74.

[33] U.S. Department of the Treasury, *Making Home Affordable Program Update* (Apr. 28, 2009) (online at www.financialstability.gov/docs/042809SecondLienFactSheet.pdf) (hereinafter "Apr. 2009 MHA Update").

[34] Update to the Second Lien Modification Program, *supra* note 31.

[35] Bank of America had enrolled before the new changes were announced, but had not yet implemented the program. After the changes were announced, Wells Fargo, J.P. Morgan Chase, and Citigroup signed up. Bank of America, *Bank of America Becomes First Mortgage Servicer to Sign Contract for Home Affordable Second-Lien Modification Program* (Jan. 26, 2010) (online at newsroom.bankofamerica.com/index.php?s=43&item=8624); Wells Fargo, *Wells Fargo Signs Home Affordable Second-Lien Modification Program Agreement With U.S. Treasury* (Mar. 17, 2010) (online at www.wellsfargo.com/press/2010/20100317_2MP); Chase, *Chase Joins Second-Lien Program to Keep More Families in Homes* (Mar. 22, 2010) (online at investor.shareholder.com/jpmorganchase/releasedetail.cfm?ReleaseID=453682); Citigroup, *Citi Expands Efforts to Keep Families in Their Homes With Commitment to Second-Lien Program* (Mar. 25, 2010) (online at www.citigroup.com/citi/press/2010/100325a.htm).

[36] Amherst Securities Group LP, Amherst Mortgage Insight, *Second Liens—How Important?,* at 10 (Jan. 29, 2010) (hereinafter "Second Liens—How Important?"). For further discussion of the banks' second-lien holds see Annex I, Section 1.g, *infra.*

[37] Update to the Second Lien Modification Program, *supra* note 31, at 5.

must be modified.[38] Treasury increased the lump sum incentive payments to between 10 percent and 21 percent of the unpaid principal balance of the second lien to investors that agree to extinguish loans.[39] None of these revisions alter the basic structure of the Second Lien Program; the program still uses TARP funds as an incentive for second-lien modifications or extinguishments.

The Panel has been highlighting the need for the modification and removal of second liens since March 2009, and Treasury has acknowledged the issue's importance for just as long, so it is a positive sign that the Second Lien Program now appears to be gaining traction. The Panel will monitor the program closely to evaluate its progress.

Specifically, the Panel plans to monitor the effect of second-lien write-downs on the capital levels of the banks holding second liens. As discussed previously, Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo have large second-lien portfolios. The stress tests conducted last year by federal banking regulators found that under adverse economic conditions, those four banks could lose a total of $68.4 billion in 2009 and 2010 on their second-lien portfolios;[40] those losses were based on estimated loss rates of 13.2 percent to 19.5 percent, rates that could go higher because so many first liens are underwater.[41] There is a tension between Treasury's goal of removing second liens as an obstacle to mortgage restructurings and Treasury's stated interest in maintaining bank capital levels.[42]

The Panel also believes that Treasury should consider incorporating borrowers' second-lien payments into the formula used to calculate mortgage affordability under HAMP. Currently, only the first-lien payment is used in the calculation,[43] which may provide a skewed picture of whether the borrower can afford to pay the modified mortgage. Second liens have a high correlation with poorer loan performance; delinquencies are higher on properties with multiple liens.[44] Treasury must account for this reality if HAMP is going to produce modifications that are sustainable over the long run.

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[38] This is only a sampling of the revisions to the Second Lien Program.

[39] Update to the Second Lien Modification Program, *supra* note 31.

[40] Under the stress tests' more adverse scenario, estimated losses on second liens were $21.4 billion for Bank of America, $20.1 billion for JPMorgan Chase, $14.7 billion for Wells Fargo, and $12.2 billion for Citigroup. Board of Governors of the Federal Reserve System, *The Supervisory Capital Assessment Program: Overview of Results,* at 9 (May 7, 2009) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf).

[41] *See* Letter from Rep. Barney Frank, chairman, Committee on Financial Services, U.S. House of Representatives, to Brian Moynihan, Vikram Pandit, James Dimon, and John Stumpf, Mar. 4, 2010 (online at online.wsj.com/public/resources/documents/BFranksLttr100307.pdf) (hereinafter "Letter from Rep. Barney Frank") ("Large numbers of these second liens have no real economic value—the first liens are well underwater, and the prospect for any real return on the seconds is negligible").

[42] *See e.g.,* U.S. Department of the Treasury, *Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and Comptroller of the Currency John C. Dugan: The Treasury Capital Assistance Program and the Supervisory Capital Assessment Program* (May 6, 2009) (online at financialstability.gov/latest/tg91.html).

[43] The debt-to-income ratio (DTI) used in HAMP establishes that the borrower's first-lien mortgage payments each month must not exceed 31 percent of the household income.

[44] *See, e.g.,* Second Liens—How Important?, *supra* note 36, at 1.

e. Extension of HARP

Part of MHA, but not funded by TARP dollars, the Home Affordable Refinance Program (HARP) allows borrowers who hold mortgages guaranteed by government-sponsored entities (GSEs) Fannie Mae and Freddie Mac to refinance into new GSE-eligible mortgages. This program allows borrowers whose loan-to-value (LTV) ratios have risen above 80 percent, and therefore would generally have insufficient equity for a traditional refinancing, to take advantage of the current lower mortgage interest rates.[45] The program extends to borrowers with LTV ratios of up to 125 percent. HARP is administered by the Federal Housing Finance Agency (FHFA), the government agency that regulates Fannie Mae and Freddie Mac, which recently announced plans to extend it by one year, to June 30, 2011. FHFA acting director Ed DeMarco explained that it had "determined that the market conditions that necessitated the actions taken last year have not materially changed."[46]

When announced, Treasury expected HARP to reach four to five million homeowners eligible to refinance.[47] More than a year later, only 221,792 borrowers have refinanced their mortgages under the program. Despite the lower than projected participation, HARP remains a good refinancing opportunity for borrowers of underwater GSE-guaranteed mortgages who are current in their payments. The program can help borrowers refinance into a more stable 30-year fixed rate product. The 30-year fixed rate mortgage, created during the Great Depression as the standard to protect the housing market and economy, provides households with a predictable housing cost. In addition, HARP refinancings do not involve any direct taxpayer expenditures.

f. Borrower Outreach and Communication

On March 24, 2010, Treasury announced additional guidance for HAMP servicers related to borrower outreach and communication. Most significantly, servicers must now proactively solicit borrowers who have missed two mortgage payments and meet the basic HAMP eligibility conditions.[48] If a borrower meets these criteria, the servicer must reach out to the borrower to determine whether he or she is eligible for HAMP. The new guidance sets out a series of steps and timeframes that the servicer must follow before initiating foreclosure proceedings.[49] The servicer may not refer the borrower to foreclosure until the borrower has been evaluated and determined not to be eligible for HAMP, unless the borrower did not respond to the servicer's solicitations.

This guidance also sets out a defined regime that establishes timely performance for each party to a modification, which is in-

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[45] U.S. Department of the Treasury, *Making Home Affordable: Summary of Guidelines,* at 1 (Mar. 4, 2009) (online at www.treas.gov/press/releases/reports/guidelines__summary.pdf).

[46] Federal Housing Finance Agency, *FHFA Extends Refinance Program By One Year* (Mar. 1, 2010) (online at www.fhfa.gov/webfiles/15466/HARPEXTENDED3110[1].pdf).

[47] U.S. Department of the Treasury, *Making Home Affordable Updated Detailed Program Description* (Mar. 4, 2009) (online at www.ustreas.gov/press/releases/reports/housing__fact__sheet.pdf) (hereinafter "MHA Detailed Program Description").

[48] U.S. Department of the Treasury, *Supplemental Directive 10–02: Home Affordable Modification Program—Borrower Outreach and Communication* at 2 (Mar. 24, 2010) (online at www.hmpadmin.com/portal/docs/hamp__servicer/sd1002.pdf) (hereinafter "Supplemental Directive 10–02"). See Section E.2 for a description of HAMP eligibility criteria.

[49] Supplemental Directive 10–02, *supra* note 48, at 2–4.

tended to establish clear steps that the servicer and borrower must take to proceed with the modification or move into foreclosure. In addition, the guidance requires servicers to consider the HAMP eligibility of borrowers who have filed for bankruptcy. Prior to this guidance, consideration of those who had filed for bankruptcy was optional.[50] All of these changes will be effective June 1, 2010.

The Panel applauds Treasury's new guidance promoting borrower outreach, with three aspects standing out as a positive evolution of Treasury assistance to distressed homeowners: (1) the enunciation of clear expectations and timelines for both borrower and servicer obligations; (2) the clarification with regard to the eligibility of homeowners who are facing bankruptcy; and (3) the required evaluation of borrowers for HAMP before foreclosure can commence. In particular, the Panel is pleased that Treasury is prioritizing early intervention in the new guidance. As discussed in Section D.2.d, statistics show that early intervention modifications are more successful than modifications on loans in default.

The clarification of good faith efforts to contact a borrower is an important point. The Panel is aware that many servicers currently conduct efforts beyond the newly articulated standard and hopes that they will continue with such efforts. The standard should be viewed as a floor rather than a measure of maximum servicer effort.

g. Help for Unemployed Homeowners

When HAMP was announced in March 2009,[51] the U.S. unemployment rate was 8.6 percent; it is currently 9.7 percent. Just as important, the median length of a period of unemployment has risen in that same time from under 12 weeks to nearly 20 weeks.[52] So, unemployment today generally means a sharp curtailment of income for 4–5 months, with a mortgage becoming delinquent after just 60 days without full payment. A recent Freddie Mac survey notes that 58 percent of conforming borrowers who have made contact with their servicers cite "unemployment or curtailment of income" as the principal cause of hardship.[53] In a survey of distressed homeowners by the National Community Reinvestment Coalition, 39 percent of respondents cited the loss of a job as the reason for their inability to make their mortgage payments. Another 44 percent of respondents cited a reduction in work hours.[54] The curtailment of income caused by unemployment may lead to a rise in household debt and, consequently, an increase in redefaults on modified mortgages.[55]

It has generally been quite difficult for unemployed borrowers to qualify for HAMP because affordable monthly mortgage payments for people without a paycheck are usually too low to make economic sense for the investor. Originally under HAMP, unemployment in-

[50] *Id.,* at 7–8.

[51] U.S. Department of the Treasury, *Relief for Responsible Homeowners One Step Closer Under New Treasury Guidelines* (Mar. 4, 2009) (online at financialstability.gov/latest/tg48.html).

[52] *See* Figure 50, *infra.*

[53] Freddie Mac, *Featured Perspectives with Chief Economist Frank Nothaft: What's Driving Mortgage Delinquencies?* (Mar. 22, 2010) (online at www.freddiemac.com/news/featured_perspectives/20100322_nothaft.html?intcmp=1004FPFN).

[54] National Community Reinvestment Coalition, *HAMP Mortgage Modification Survey 2010,* at 7 (online at www.ncrc.org/images/stories/mediaCenter_reports/hamp_report_2010.pdf).

[55] Factors Affecting Implementation of HAMP, *supra* note 25, at 15–16.

surance payments were counted in the calculation of the borrower's income,[56] but only if the servicer determined that the assistance would last for nine months.[57] Nonetheless, unemployment benefits were often insufficient to make a modified mortgage affordable.

In response to the problem of foreclosures caused by unemployment, Treasury in March 2010 announced changes to HAMP that will provide temporary assistance to unemployed homeowners. This feature aims to assist unemployed homeowners as they search for new employment. It is available to any eligible borrower whose servicer participates in HAMP; borrowers do not need to be evaluated for a trial modification to participate. To be eligible, the borrower must (1) have a mortgage that meets HAMP's eligibility requirements;[58] (2) submit evidence that he or she is receiving unemployment benefits; and (3) request the temporary assistance within the first 90 days of delinquency. Servicers that participate in HAMP are required to provide these temporary modifications to eligible borrowers.

The new unemployment assistance sets the borrower's monthly payment at up to 31 percent of monthly income (which in most cases will be unemployment insurance). The 31 percent payment is reached via forbearance; no taxpayer dollars will be spent on the forbearance plans. The borrower's payment will stay at the unemployment forbearance amount for at least three months and can be extended up to six months, subject to investor and regulatory guidelines. If the borrower becomes re-employed during this period, his or her temporary assistance will stop. If, when the borrower finds a new job, the mortgage payment is more than 31 percent of gross monthly income, the servicer must evaluate the borrower for HAMP. If at the end of the six-month period the borrower has not yet found a new job, the servicer must evaluate the borrower for a HAMP short sale or deed-in-lieu.[59]

Considering the high and persistent level of unemployment, the Panel believes that Treasury is right to focus on assisting unemployed borrowers. Treasury must create a plan that can meet the needs as presented, such as giving people enough time. As with all foreclosure mitigation programs, it is important to create sustainable situations rather than simply delaying a foreclosure. The implementation of the program raises a number of issues. Because it only applies to unemployed new entrants into HAMP, borrowers already in HAMP modifications at the time they lose their jobs are omitted from participation. Treasury's rationale for this is not clear. Averting a HAMP redefault prevents not only a foreclosure but also the waste of taxpayer dollars that accompanies a HAMP redefault. Also not clear is how Treasury will reliably determine when participants have found new work and are no longer eligible. Self-reporting, which seems to be the current mechanism, carries the potential for abuse.

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[56] U.S. Department of Treasury, *Home Affordable Modification Program Guidelines* (Mar. 4, 2009) (online at www.ustreas.gov/press/releases/reports/modification__program__guidelines.pdf).

[57] Introduction of HAMP, *supra* note 21, at 7–8.

[58] Introduction of HAMP, *supra* note 21. See Section E.2 for a further description of HAMP eligibility criteria.

[59] U.S. Department of the Treasury, *Making Home Affordable Program Enhancements to Offer More Help for Homeowners,* at 2 (Mar. 26, 2010) (online at makinghomeaffordable.gov/docs/HAMP%20Improvements__Fact__%20Sheet__032510%20FINAL2.pdf) (hereinafter "MHA Enhancements to Offer More").

As with all forms of foreclosure mitigation, federal efforts to assist unemployed borrowers can be supplemented by innovative state and local government initiatives as well as private sector initiatives. There are a number of proposals that hold promise in combating the problem of foreclosures caused by unemployment. One idea that the Panel discussed in October involves establishing a fund to provide emergency loans to unemployed homeowners. Since 1983, the state of Pennsylvania has operated such a fund, known as the Homeowners' Emergency Mortgage Assistance Program (HEMAP). It offers loans for as long as two years or for as much as $60,000. Unemployed borrowers do not have to pay interest on the loans until they start working again.[60] This program actually earned money for the state of Pennsylvania between 1983 and 2009.[61] A second idea, proposed by University of Wisconsin School of Business Professor Morris Davis, is to provide housing vouchers to unemployed homeowners. These vouchers would supplement traditional unemployment benefits. Under Davis' proposal, the size of the housing voucher would vary depending on the mortgage payment owed each month and the amount of traditional unemployment benefits being collected by the homeowner. The housing voucher and 30 percent of the homeowner's traditional unemployment benefits together would be large enough to cover the monthly mortgage payment.[62] A third idea comes from the Federal Reserve Bank of Boston. Under this proposal, unemployed borrowers would receive a limited-duration monthly grant or loan based on their loss of household income and the size of their monthly mortgage payments.[63] While the Panel does not endorse any particular proposal, it does believe there is a clear need for assistance targeted at unemployed borrowers, and innovative proposals can play a role in supplementing federal efforts; the Panel urges Treasury in its new Hardest Hit Fund programs (discussed below in Section C.2) to help develop promising ideas in this area.

h. FHA Refinancings

On March 26, 2010, the Administration announced a number of changes to its foreclosure mitigation efforts. One of these changes was the announcement of a Federal Housing Administration (FHA) refinance option, which offers HAMP incentive payments to encourage the extinguishment of existing second-lien loans in order to encourage the voluntary refinancing of underwater mortgages into FHA mortgages.[64] This refinancing option is available for all mort-

[60] Pennsylvania Housing Finance Agency, *Pennsylvania Foreclosure Prevention Act 91 of 1983* (online at www.phfa.org/consumers/homeowners/hemap.aspx) (accessed Apr. 12, 2010).

[61] *See* Congressional Oversight Panel, Written Testimony of the Honorable Annette M. Rizzo, Court of Common Pleas, First Judicial District, Philadelphia County, *Philadelphia Field Hearing on Mortgage Foreclosures,* at 10 (Sept. 24, 2009) (online at cop.senate.gov/documents/testimony-092409-rizzo.pdf).

[62] Morris A. Davis, *The Foreclosure Problem and the WI–FUR Plan Solution,* Wisconsin School of Business, James A. Graaskamp Center for Real Estate (Nov. 19, 2009) (online at morris.marginalq.com/WIFUR/2009_11_17 WI–FUR Overview.ppt).

[63] Morris A. Davis, Jeff Fuhrer, Chris Foote & Eileen Mauskopf, *Staff Briefing on Reducing Foreclosures* (Dec. 4, 2009) (online at morris.marginalq.com/WIFUR/2009_12_04%20House%20Briefing.ppt); Federal Reserve Bank of Boston, *A Proposal to Help Distressed Homeowners* (Winter 2010) (online at www.bos.frb.org/commdev/c&b/2010/winter/Foote_Fuhrer_Mauskopf_Willen_foreclosure.pdf).

[64] MHA Enhancements to Offer More, *supra* note 59, at 1.

gages meeting FHA underwriting standards and is not restricted to refinancing existing FHA loans.

The new initiative, which should be available by the fall, alters the required loan-to-value ratios of the refinanced mortgage, provides incentives for principal write-downs on second liens, and provides TARP-funded protection for the new FHA loan. Under the changes, participating original first-lien holders must write down the principal of the existing first-lien loan by at least 10 percent; but the existing first-lien loan holder may subordinate a portion of the remaining original first-lien loan up to a combined LTV ratio of 115 percent combined LTV (in other words, the new second-lien loan may be between 97.75 percent and 115 percent combined LTV). The first lien LTV ratio of the new loan must be no higher than 97.75 percent after modification. If there was an original second lien, it must be written down to ensure a maximum of 115 percent combined LTV in new mortgage debt. Treasury will pay from TARP funds the original second-lien servicer between 10 and 21 percent of the extinguished amount, the same level of payments mentioned above under the Second Lien Program. For the newly refinanced first-lien loans, FHA insurance will only cover approximately 90.00 percent of the value of the home, and TARP funds will cover an approximate additional 7.75 percent of the value of the home (resulting in a combined insurance of 97.75 percent of the value of the home, equivalent to standard FHA-insured loans). To be eligible, borrowers must (1) be current on their mortgage, (2) occupy the home as a primary residence, (3) qualify under FHA underwriting guidelines, (4) have a FICO credit score of at least 500, and (5) document their income.[65]

Up to $14 billion in TARP funds will support these changes through incentives to second-lien holders, incentive to servicers and the provision of a letter of credit to cover a share of any losses FHA might experience.[66] It is unclear how the $14 billion will be divided between incentives and the letter of credit. This is especially important, as second liens are concentrated in four banks, and thus the majority of incentive payments will go to those same four banks. Treasury and FHA need to be transparent regarding how the funds will ultimately flow.

While the Panel has expressed concern over the growing scope and scale of negative equity for the past year, it is unclear whether this program will be able to make significant headway against the problem. First, like HARP and Hope For Homeowners, the FHA refinance option targets underwater borrowers who are current on their mortgages. It is unclear how this program would entice sizable additional participation from the same general group of borrowers. Unlike HAMP, though, lenders and servicers would not sign broad commitments to participate in the program, but rather would be able to decide on a case-by-case basis whether to participate. Because refinancings move loans out of servicers' portfolios, and thus eliminate a source of servicing income, servicers would

[65] U.S. Department of the Treasury, *FHA Program Adjustments to Support Refinancings for Underwater Homeowners* (Mar. 26, 2010) (online at makinghomeaffordable.gov/docs/FHA__Refinance__Fact__Sheet__032510%20FINAL2.pdf) (hereinafter "FHA Program Adjustments").

[66] The use of TARP funds for the program is authorized by the Helping Families Save their Homes Act. Pub. L. No. 111–22 § 202(b).

not have strong incentive to participate. Further, first-lien holders, unlike second-lien holders, do not receive incentive payments; therefore, their motivation to participate is questionable. The similar Hope For Homeowners program did not attract widespread participation, despite the added lender incentive of equity sharing. Thus, especially in light of uncertainty about key parties' desire to participate, the coordination between borrower, servicer, first-lien holder, and second-lien holder poses a significant challenge to the program's effectiveness and is a potential program weakness that Treasury and FHA need to address.[67]

Unlike modification programs, the FHA refinance option will refinance the mortgage into an FHA mortgage, providing explicit taxpayer backing for the loan. Treasury and FHA have yet to specify fully the loss sharing arrangements between the two entities. It will be extremely important to have transparent accounting for the joint program; FHA has faced serious mounting losses recently and is currently below its statutorily mandated reserve levels.

Treasury has indicated that some portion of the $14 billion will be used to purchase a letter of credit to cover losses. Where does Treasury plan to obtain such a letter of credit, and how will the pricing be effective? If Treasury has to obtain the letter of credit from the very banks it so recently bailed out, it is unclear how the risk has been shifted, since Treasury has been acting as a backstop for the financial sector.

As noted above, the FHA refinance option provides a foreclosure alternative for underwater borrowers current on their loans, yet many key elements remain unclear, including the allocation of the $14 billion, the loss-sharing arrangement between the TARP and FHA, the degree of risk the taxpayers may bear, and the coordination challenge. Treasury and FHA need to continue to provide clearer details and a more developed program.

i. Principal Write-Down Incentives

Negative equity, which occurs when the current market value of a home is less than the amount owed on the mortgage, continues to be an important factor driving foreclosure rates. In fact, it is more highly correlated with foreclosure than any other factor besides a lack of affordability. The primary way to eliminate negative equity is a principal write-down. The importance of negative equity will persist, especially given the large number of option ARMs and interest-only loans scheduled to reset to higher interest rates in the next few years.[68] While negative equity alone will not create an imminent default, when combined with other financial factors and life events of the borrower, the possibility of default and foreclosure increases.

When homeowners owe more than their homes are worth, they are ill-equipped to respond to major life events, such as the loss of a job or divorce. In addition, they may struggle to deal with an unaffordable mortgage payment or other constraint on their incomes. Under normal circumstances, a homeowner would be able to sell his or her home and buy another near the location of his or

[67] FHA acknowledged the current lack of a clear plan to address the coordination challenge in conversation with Panel staff (Apr. 1, 2010).
[68] *See* Annex I(1)a, *infra*.

her next job; but moving because of a job opportunity becomes more difficult when the homeowner is underwater. Homeowners with negative equity have the choice of either walking away from their loans, thereby depressing nearby property values, or honoring the loans' terms and turning down the job, thus disrupting the labor market. In either case, the economic impact is negative. In addition, underwater homeowners are more inclined to postpone decisions that might improve the labor force, such as enrolling in continuous learning programs, job training programs, or graduate school.

Principal reductions are the primary method of addressing the problem of negative equity, because they incentivize a borrower to stay in his or her home. Up until the most recent HAMP program changes, servicers lacked any incentive to make modifications through principal reductions, as servicers' primary compensation is a percentage of the outstanding principal balance on a mortgage.[69] Thus, principal reductions reduce servicers' income, whereas interest reductions do not, and forbearance and term extensions actually increase servicers' income because there is greater principal balance outstanding for a longer period of time. Servicers that participate in HAMP have been allowed but not required to reduce principal as part of the effort to reduce the borrower's monthly mortgage payment to 31 percent of their monthly income. Because servicers so far have lacked incentives to write down principal, principal reductions under HAMP to date have been rare.[70]

In late March 2010, Treasury announced new conditions and incentive payments for HAMP servicers to write down principal. This change requires servicers to consider a modification that utilizes a principal write-down if the borrower has an LTV ratio that exceeds 115 percent. The servicer must run the standard NPV test and an alternative NPV test that includes the incentive payments for principal write-down. If the alternative NPV is higher, the servicer then has the option to use it, but is not required to do so.[71] If a principal write-down proves to be the optimal modification option based on the two NPV analyses, and the servicer chooses to use the principal write-down option, the servicer forbears principal that exceeds 115 percent of the home's value to bring the borrower's monthly payment to 31 percent of his or her monthly income. The entire amount is initially treated as forbearance, and it is forgiven in three equal installments over three years as long as the borrower remains current on mortgage payments.

Servicers must retroactively consider for the program borrowers who are already in trial or permanent modifications and are current on payments at the time of the change's implementation. Treasury has stated that additional guidance for second liens is forthcoming but that second-lien holders must agree to extinguish principal if principal is written down on the first lien. Treasury will

[69] *See* Section C(2)b, *infra.*
[70] *See* Section D(2)a, *infra.*
[71] MHA Enhancements to Offer More, *supra* note 59, at 2 ("Under alternative approach, servicers assess the NPV of a modification that starts by forbearing principal balance as needed over 115 percent loan-to-value (LTV) to bring borrower payments to 31 percent of income; if a 31 percent monthly payment is not reached by forbearing principal to 115 percent LTV, the servicer will then use standard steps of lowering rate, extending term, and forbearing additional principal").

provide second-lien holders with incentives equal to between 10 percent and 21 percent of the principal written down.[72] Treasury will also provide these same incentives for the write down of principal on the first lien.

The Panel is encouraged by Treasury's increased incentives for servicers to employ principal write-downs in mortgage modifications. It provides a potential for underwater borrowers to avoid foreclosure and also, in its retroactive application, has the potential to lower redefault rates in underwater loans currently in HAMP trials. As with other aspects of HAMP, however, uncertainty remains as to whether the incentives will be enticing enough to encourage servicers to forgo income and actually write down principal.

Finally, Treasury must continue to be mindful of the matter of moral hazard. When Treasury Secretary Timothy Geithner was asked at a Panel hearing in December 2009 about the problem of underwater borrowers, he cited moral hazard for borrowers as one reason why Treasury had not prioritized principal reduction. "And the problem in doing that, apart from its expense," Secretary Geithner said, "is the basic sense of fairness and what it does to incentives in the future." [73]

Treasury's recently announced principal reduction program has two important features that may help minimize the moral hazard problem. First, because lenders are not required to write down principal, even if a borrower could qualify for the modification program, he or she would have absolutely no assurance that the lender would be willing to employ principal reduction. Second, the program does not provide the principal reduction upfront; rather, it must be earned over three years with timely payments. Treasury must monitor data carefully going forward to watch for early signs of abuse and take necessary steps to prevent it from recurring. The Panel will also monitor the program's performance in this area.

j. Increased Incentive Payments

Treasury in late March 2010 increased incentive payments to lenders, servicers, and borrowers in a variety of situations. HAMP and its various subprograms are structured to provide incentive payments to borrowers, lenders, and servicers in order to encourage modifications or other foreclosure prevention activities.

For example, under the Home Affordable Foreclosure Alternative Program (HAFA), subordinate lien holders that agree to release borrowers from debt will receive up to six percent or $6,000 of the outstanding loan balance, with the amount reimbursed by TARP increased to a maximum of 2 percent or $2,000. Servicer incentive payments under the program will increase from $1,000 to $1,500 to encourage additional outreach to homeowners who are unable to complete a modification and to increase the use of short sales and deeds-in-lieu. Borrowers who successfully complete a deed-in-lieu or

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[72] The level of incentive varies depending on the LTV of the initial loan, from 10 percent incentive for a 140 or greater LTV, 15 percent for between 115 and 140, and 21 percent for less than 115.

[73] Congressional Oversight Panel, *Transcript: Testimony of Secretary Timothy F. Geithner* (Dec. 10, 2009) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing-121009-geithner.cfm).

short sale will receive $3,000, up from $1,500, for relocation assistance.[74]

It is unclear whether these and other increased incentive payments—discussed in Sections C(1)d and C(1)i, *supra*—will be enough to offset the additional costs that servicers incur under HAMP. Servicers have a variety of additional costs, including hiring and training new employees and overhauling their processing systems. Prior to the recent sharp decline in housing prices, servicers were primarily in the business of processing transactions. They have had to shift resources from that business, which relies heavily on automation, to the loss-mitigation business, which depends much more on employees with underwriting expertise.[75] More than a year has passed since HAMP's inception, so participating servicers that have failed to retool their businesses lack a good excuse, but the costs to servicers of implementing these changes may nonetheless be impeding HAMP modifications.[76]

Further complicating the calculus on modifications are a variety of payments that servicers receive and outlays they must make while a loan is delinquent. When a loan defaults, the servicer is able to collect significant ancillary fees from the borrower, such as late fees and fees for various in-sourced activities like collateral inspection; a monthly late fee is typically five percent of the payment due. In addition, the servicer continues to accrue its monthly servicing fee—25–50 basis points annually of the outstanding principal balance of the loans serviced. These fees are recovered off the top from foreclosure or real estate owned (REO) sale proceeds, before any payments are made to investors. Offsetting this income, however, is the requirement that the servicer advance all delinquent payments to investors from its own funds. While the servicer is able to recover the advances from foreclosure or REO sale proceeds, it does not receive any interest on the advances. Thus, to a servicer without a low-cost funding channel like deposits, advances can be quite costly.[77] After several months, the cost of advances will outweigh the servicer's income from the defaulted loan.[78] Thus, while servicers can often initially profit from a defaulted loan, if the loan is delinquent for too long, the servicer will start to lose money on it. Accordingly, servicers are under particular financial pressure as foreclosure timetables have lengthened due to court backlogs caused by the rise in foreclosures.

Servicer compensation structures may also make servicers reluctant to attempt loan modifications.[79] Servicers incur significant costs when undertaking a loan modification—estimated at between $1,000 and $1,500 per modification. These are sunk costs for the servicer. If the modified loan continues to perform, the servicer will recoup the costs of the modification and earn more than if it had

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[74] MHA Enhancements to Offer More, *supra* note 59, at 3.

[75] *See, e.g.,* Paul A. Koches, Ocwen Financial Corporation, *Mods Make Sense,* DSNews (Feb. 25, 2010) (online at www.dsnews.com/articles/mods-make-sense-2010–02–25) (hereinafter "Mods Make Sense").

[76] *See* October Oversight Report, *supra* note 17, at 66–67.

[77] Servicers that are also banks (e.g., Bank of America or Wells Fargo) have access to low-cost funding channels while other servicers that are just servicers (e.g., Ocwen Financial Corporation) do not have access to this low-cost funding source.

[78] Adam J. Levitin & Tara Twomey, *Mortgage Servicing,* 28 Yale J. on Reg. (forthcoming 2011) (hereinafter "Levitin & Twomey").

[79] *Id.*

proceeded directly to foreclosure. But if the modified loan redefaults before the servicer recoups the costs of the modification, then the servicer will incur a larger loss than if it had proceeded directly to foreclosure.

Thus, as a recent article by Paul A. Koches, general counsel for Ocwen Financial, a leading subprime servicer, notes, "servicers make money when delinquent loans become reperforming. Servicers collect the most servicing fees and incur the lowest costs when this is the case."[80] Koches also notes, however, that sustainability is key and that "picking the right people pays off." While a reperforming loan is the optimal outcome for a servicer, a servicer must weigh the chance that a loan will reperform against the chance that it will redefault. The critical question for the servicer is not *whether* the loan will redefault, but *when*. If the servicer anticipates early redefaults, the servicer will be disinclined to attempt modifications, lest it incur greater losses.

For most mortgage modifications, not just those within HAMP, it takes a servicer between 12 and 24 months to recoup the cost of a modification.[81] Given that redefault rates on all loans modified by OCC/OTS institutions have been in the 60-percent range for a single year, and at 30 percent just in the first three months post-modification,[82] servicers have a strong incentive not to attempt modifications, especially of loans they think are likely to redefault quickly. Most servicers, however, lack predictive capabilities regarding redefault, and therefore, if they are risk-averse, are likely to assume that all loans are likely to be early redefaulters.

In light of the redefault timing problem, HAMP incentive payments so far may have been too low to have a significant effect.[83] HAMP servicer incentive payments of $1,000 barely cover the cost of a modification. HAMP incentive payments are only made when a loan modification converts to a permanent modification. If a trial modification's costs are similar to a permanent modification's costs, then a payment of $1,000 per permanent modification will fail to come anywhere close to offsetting servicers' costs when only one in four trial modifications becomes a permanent modification. With trial to permanent roll rates at around 23 percent, servicers are on average receiving incentive payments of $1,000 for every $4,000–$5,000 of modification costs they incur. If so, then HAMP incentive payments may have simply been too small to correct misaligned servicer incentives. It remains to be seen whether the recently announced payment increases will change servicers' decision-making.

To the extent that the new payment schedules increase modifications, Treasury should be careful that monetary incentives encourage but do not overpay for increased servicer participation.

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[80] Mods Make Sense, *supra* note 75, at 104.

[81] Levitin & Twomey, *supra* note 78.

[82] Office of the Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report (Fourth Quarter 2009),* at 7 (Mar. 2010) (online at www.occ.treas.gov/ftp/release/2009–163a.pdf) (hereinafter "OCC and OTS Mortgage Metrics Report—Q4 2009").

[83] Levitin & Twomey, *supra* note 78; House Judiciary, Subcommittee on Commercial and Administrative Law, Written Testimony of Adam J. Levitin, associate professor of law, Georgetown University Law Center, *Home Foreclosures: Will Voluntary Mortgage Modifications Help Families Save Their Homes? Part II* (Dec. 11, 2009) (online at judiciary.house.gov/hearings/pdf/Levitin091211.pdf) (hereinafter "Testimony of Adam Levitin").

2. New Program Announcements

On February 19, 2010, the White House announced a new initiative, the Help for the Hardest Hit Housing Markets (Hardest Hit Fund) program.[84] To date, Treasury has committed to the Hardest Hit Fund $2.1 billion of the $50 billion in TARP funds allocated for foreclosure mitigation.

Originally five states—Arizona, California, Florida, Michigan, and Nevada—qualified for Hardest Hit Fund assistance.[85] State and local housing finance agencies (HFAs) in these states have been allocated caps totaling $1.5 billion. The states must submit proposals using these allocations, which will be evaluated by Treasury, before funds are disbursed. States were eligible if home prices had fallen by at least 20 percent from their peaks; in each of the five recipient states, borrowers who made traditional downpayments of 20 percent during the boom years are now at or near negative equity. The $1.5 billion is to be allocated among the five states based on a two-part formula that takes into account both home price declines and unemployment.[86] For each state, two ratios are summed: (1) the ratio of the state's unemployment rate to the highest unemployment rate in any state and (2) the ratio of the state's price decline to the largest price decline in any state. The sum of these two ratios is then multiplied by the number of delinquent loans in the state, and the funds are then distributed based on each state's resulting weighted share of delinquent borrowers.[87]

On March 29, 2010, Treasury announced a second allocation to provide assistance to HFAs in Rhode Island, South Carolina, Oregon, North Carolina, and Ohio. This second set of states was chosen because they had large percentages of their populations living in high-unemployment counties, which were defined as those counties having an unemployment rate over 12 percent. For example, 60 percent of Rhode Island residents live in such distressed counties, as opposed to 15 percent of the population nationwide. This second allocation will make available $600 million, which on a percapita basis is the same amount provided under the first allocation.[88] The $600 million will be split among Rhode Island, North Carolina, South Carolina, Ohio, and Oregon based on a formula that uses the product of the state's total population and the per-

[84] White House, *Help for the Hardest Hit Housing Markets* (Feb. 19, 2010) (online at www.whitehouse.gov/the-press-office/help-hardest-hit-housing-markets).

[85] U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, *Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets ("HFA Hardest-Hit Fund"): Frequently Asked Questions,* at 3 (online at www.makinghomeaffordable.gov/docs/HFA%20FAQ%20—%20030510%20FINAL%20(Clean).pdf) (hereinafter "Hardest-Hit Fund: FAQs").

[86] Hardest-Hit Fund: FAQs, *supra* note 85, at 1, 3.

[87] The allocation is: Nevada $102.8 million, California $699.6 million, Florida $418 million, Arizona $125.1 million, and Michigan $154.5 million. Hardest-Hit Fund: FAQs, *supra* note 85, at 3. Data for these calculations is derived from the Bureau of Labor Statistics unemployment data, the FHFA Purchase Only Seasonally Adjusted Index, and the MBA National Delinquency Survey; Treasury conversation with Panel staff (Mar. 5, 2010).

[88] U.S. Department of the Treasury, *Update to the HFA Hardest Hit Fund Frequently Asked Questions* (Mar. 29, 2010) (online at financialstability.gov/docs/Hardest%20Hit%20public%20QA%200%2029%2010.pdf) (hereinafter "Hardest Hit Fund: Updated FAQs").

centage of that population that is located in high-unemployment counties.[89]

According to Treasury, the Hardest Hit Fund's purpose is "to support new and innovative foreclosure prevention efforts in the areas hardest hit by housing price declines and high unemployment rates." [90] The Hardest Hit Fund is expected to be used to modify mortgages that HFAs hold, to provide incentives for financial institutions, servicers, or investors to modify mortgages, to refinance mortgages in whole or part, to facilitate short-sales and deeds-in-lieu of foreclosure, to pay down principal for borrowers with severe negative equity, to provide assistance to unemployed borrowers, and to provide incentives for the reduction or modification of second-lien loans.[91]

Because of EESA's requirement that TARP funds be used to purchase troubled assets from financial institutions,[92] Hardest Hit Fund money will be available to qualifying entities (the entities must be financial institutions) that will implement state HFA programs. HFAs in the eligible states are expected to submit proposals for how they will use their Hardest Hit Fund allocations. To be eligible, the funding recipient "must be a regulated entity that is incorporated separately from the state government itself, which has the corporate power to receive [Hardest Hit Fund money] from Treasury and to work with the related state HFA in implementing that state's HFA Proposal(s). Agencies of state governments are not considered Eligible Entities for purposes of the HFA Hardest-Hit Fund." [93] Proposals for the first round of Hardest Hit Fund grants are due April 16, 2010; [94] proposals for the second round are due June 1, 2010.

Treasury has developed guidelines for approval of Hardest Hit Fund grants and is requiring all funded program designs and program effectiveness metrics to be posted online. All programs funded by the Hardest Hit Fund are subject to Treasury's direct oversight as well as the full range of EESA oversight. Because the Hardest Hit Fund is a grant program, Treasury does not expect HFAs or their program partners to repay to Treasury any of the $2.1 billion that is to be distributed.[95]

The Hardest Hit Fund is not, in and of itself, a solution to the foreclosure crisis, a point acknowledged by Treasury. Instead, Treasury bills it as a targeted use of TARP funds for particularly hard-hit markets that is meant to encourage local experimentation and innovation. While the Panel applauds Treasury for seeking to encourage local initiatives, it is unsure how much local expertise can bring to bear on a foreclosure problem that is national in scope and nature.

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[89] Ohio's allocation cap is $172 million, followed by $159 million for North Carolina, $138 million for South Carolina, $88 million for Oregon, and $43 million for Rhode Island. Hardest Hit Fund: Updated FAQs, *supra* note 88.

[90] Hardest-Hit Fund: FAQs, *supra* note 85, at 3.

[91] Hardest-Hit Fund: FAQs, *supra* note 85, at 4–5.

[92] 12 U.S.C. § 5211(a)(1).

[93] U.S. Department of the Treasury, *Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets ("HFA Hardest-Hit Fund"): Guidelines for HFA Proposal Submission,* at 6 (online at www.makinghomeaffordable.gov/docs/HFA%20Proposal%20Guidelines%20-%20030510%20FINAL%20(Clean).pdf) (hereinafter "Hardest-Hit Fund: Proposal Guidelines").

[94] Hardest-Hit Fund: Proposal Guidelines, *supra* note 93, at 3.

[95] *Id.,* at 5.

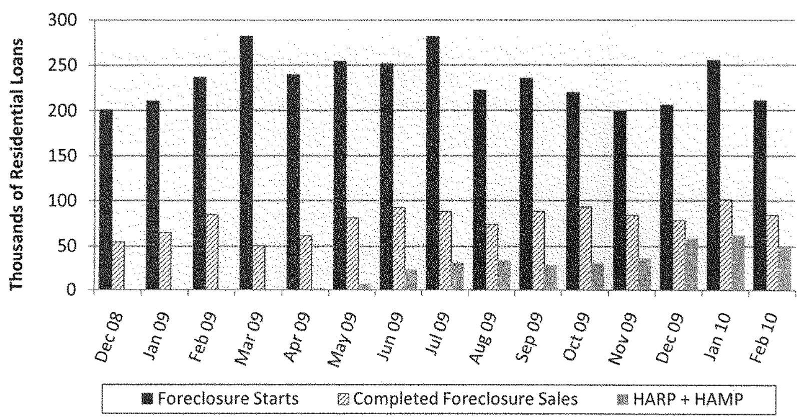
D. Data Updates Since October Report

1. General Program Statistics

MHA is the umbrella program under which HARP, HAMP, and a number of other foreclosure mitigation efforts are housed. HAMP is a $75 billion program that provides lenders, servicers, and investors with incentive payments in order to entice them to modify mortgages, thereby creating affordable monthly payments for the borrower. In tandem with other initiatives such as the HPDP, the HAFA, Hope for Homeowners (H4H), and the newly announced Hardest Hit Fund, the Administration has announced that MHA will provide assistance to as many as 7 to 9 million borrowers.

Figure 1, below, compares the number of loans in the foreclosure process, by month, with the number of permanent HAMP modifications and HARP refinances. For several reasons, these statistics are not directly comparable and do not provide an accurate measure of Treasury's progress in preventing foreclosures. They do, however, offer a sense of the scale of the foreclosure problem and the scale of Treasury's efforts.

FIGURE 1: MHA FORECLOSURE PREVENTION ACTIONS VS. FORECLOSURES [96]



Of the $75 billion allocated to HAMP, $50 billion comes from the TARP and the remaining $25 billion comes from the Housing and Economic Recovery Act of 2008 (HERA).[97] Of the $50 billion of TARP funds allocated to HAMP, the Office of Management and Budget (OMB) has approved $45.5 billion in apportionments. The following table provides a breakdown of these apportionments by program.

[96] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010); HOPE NOW Alliance; RealtyTrac, *Foreclosure Activity Press Releases* (online at www.realtytrac.com//ContentManagement/PressRelease.aspx) (hereinafter "RealtyTrac Foreclosure Press Releases") (accessed Apr. 12, 2010). "HARP + HAMP" is comprised of permanent HAMP modifications began as well as all HARP refinancings.

[97] Congressional Oversight Panel, *Questions for the Record from the Congressional Oversight Panel Philadelphia Field Hearing on September 24, 2009: Questions for Seth Wheeler, Senior Advisor U.S. Department of the Treasury* (Sept. 24, 2009) (online at cop.senate.gov/documents/testimony-092409-wheeler-qfr.pdf) (hereinafter "Seth Wheeler QFRs").

FIGURE 2: MHA PROGRAM APPORTIONMENTS BY OMB AS OF MARCH 29, 2010 [98]

[Dollars in billions]

Program	Amount
HAMP First-Lien Modifications	$31.7
Second Lien Modification Program (2MP)	5.7
Home Affordable Foreclosure Alternatives Program (HAFA)	4.6
Home Price Depreciation Program (HPDP)	3.4
Total	**$45.5**

[98] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

Adding the combined stated value of newly announced programs—$1.5 billion and $0.6 billion for the first and second Hardest Hit Fund installments [99] and $14 billion for the FHA principal reduction program[100]—to the total apportionments above, the budgeted amount would exceed the $50 billion in TARP funds allocated to foreclosure mitigation efforts by around $11.6 billion. However, Treasury has explained that the numbers announced for future programs are in the process of being developed into finalized program models that will be sent to the OMB for the apportionment process and that Treasury will ensure that total apportionments will not exceed $50 billion.[101] This raises the question of whether Treasury intends to scale back the spending announced for individual programs or scale up the total spending announced for foreclosure mitigation.

Of the total amount apportioned to HAMP, $36.9 billion had been obligated to servicers by Servicer Participation Agreements through February.[102] This represents the maximum amount each servicer could receive, not the amount that has actually been paid. The following table shows the HAMP cap for the top 16 servicers, a total for remaining servicers, and the overall total.

FIGURE 3: HAMP CAP BY SERVICER AS OF FEBRUARY 2010 [103]

Servicer	Current Cap Amount
Countrywide Home Loans Servicing LP	$7,206,300,000.00
Wells Fargo Bank, N.A.	5,738,626,343.90
JPMorgan Chase Bank, N.A.	3,863,050,000.00
Bank of America, N.A.	2,433,020,000.00
OneWest Bank	2,170,170,000.00
CitiMortgage, Inc.	1,984,190,000.00
GMAC Mortgage, Inc.	1,875,370,000.00
American Home Mortgage Servicing, Inc.	1,469,270,000.00
Litton Loan Servicing	1,363,320,000.00
Saxon Mortgage Services, Inc.	1,242,130,000.00
EMC Mortgage Corporation	1,209,800,000.00
Ocwen Financial Corporation, Inc.	933,600,000.00
Select Portfolio Servicing	913,840,000.00
National City Bank	700,430,000.00

[99] Hardest Hit Fund: Updated FAQs, *supra* note 88, at 1.
[100] FHA Program Adjustments, *supra* note 65, at 1.
[101] Treasury conversation with Panel staff (Mar. 31, 2010).
[102] Treasury provided that $39.89 billion had been obligated to servicers by Servicer Participation Agreements as of March 29, 2010. This adjusted HAMP cap amount was included in Treasury's April 6, 2010 TARP Transactions Report. U.S. Department of the Treasury, *Troubled Asset Relief Program: Transactions Report For Period Ending April 2, 2010,* at 20–28 (Apr. 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-6-10%20Transactions%20Report%20as%20of%204-2-10.pdf) (hereinafter "Treasury Transactions Report").

FIGURE 3: HAMP CAP BY SERVICER AS OF FEBRUARY 2010 [103]—Continued

Servicer	Current Cap Amount
Home Loan Services, Inc.	639,850,000.00
HomEq Servicing	516,520,000.00
Other Servicers	2,612,893,656.10
Total	**$36,872,380,000.00**

[103] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010). Some of the listed servicers have been acquired by, or are related to, other institutions on the list. For example, Bank of America includes Countrywide and Home Loan Services and JPMorgan Chase includes EMC Mortgage in Treasury's Monthly Servicer Performance Reports. *See* Levitin & Twomey, *supra* note 78, at 4. In addition, Litton Loan Servicing is a subsidiary of Goldman Sachs; Saxon Mortgage Services is a subsidiary of Morgan Stanley; Select Portfolio Servicing is a subsidiary of Credit Suisse; and HomeEq Servicing is a subsidiary of Barclays. Bloomberg Data.

Of the amount obligated to servicers, very little was actually spent through February 2010. Payments occur only once a trial has converted to permanent modification status, and further, the payments occur over a five-year schedule rather than all at once. Treasury explained that all payments made through February relate to the first-lien modification program only; no money had been paid out for the other programs (2MP, HAFA, HPDP). The following table shows the breakdown of the money spent for the top 16 servicers, the total for remaining servicers, and the overall total.

FIGURE 4: HAMP INCENTIVES BY SERVICER AS OF FEBRUARY 2010 [104]

Servicer	Servicer Total
Ocwen	$10,070,232.00
Select Portfolio Servicing, Inc.	8,232,946.57
Saxon Mortgage Services, Inc.	6,243,121.40
GMAC Mortgage, LLC	5,665,573.60
JPMorgan Chase Bank, N.A.	4,845,384.27
CitiMortgage Inc.	4,525,867.83
Bank of America Home Loans	3,292,936.74
Litton Loan Servicing, LP	3,284,724.01
EMC Mortgage Corporation	1,728,646.74
Nationstar Mortgage, LLC	1,678,104.03
Wells Fargo Bank, N.A.	1,614,533.04
Carrington Mortgage Services, LLC	1,378,869.20
Aurora Loan Services, LLC	1,270,372.18
Wilshire Credit Corporation	885,064.02
HomEq Servicing	693,276.95
OneWest Bank	665,207.25
Other Servicers	1,676,249.93
Total	**$57,751,109.76**

[104] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010). Some of the listed servicers have been acquired by, or are related to, other institutions on the list. In addition to the relationships noted in footnote 103 above, Bank of America includes Wilshire Credit Corporation. *See* Levitin & Twomey, *supra* note 78, at 4.

a. Home Affordable Refinance Program

HARP was established to provide borrowers current on their mortgage payments, with loans owned or guaranteed by Fannie Mae and Freddie Mac, an outlet to reduce their monthly payments through refinancing, as well as an opportunity to refinance into a more stable fixed-rate mortgage product. Borrowers receive assistance through refinancing—not modifications. The program does not employ incentive payments, and there are no TARP expenditures for HARP. Unlike other components of MHA, HARP is not intended for borrowers who are behind in their mortgage payments. Instead, HARP is aimed at eligible borrowers suffering from little equity or negative equity due to the decline in home price values.

All mortgages that are either owned or guaranteed by Fannie Mae or Freddie Mac are eligible for this program. Initially, borrowers were eligible to refinance if they owed up to 105 percent of the present value of their single-family residence. In response to declining home values, on July 1, 2009, Treasury announced an expansion of the program that included borrowers who owe up to 125 percent of the value of their homes. Treasury estimated that 4 to 5 million borrowers would be eligible for the program. Since the program began on April 1, 2009, there have been 221,792 HARP refinancings. This total is comprised of over 218,000 homeowners with LTVs between 80 percent and 105 percent that received refinancing through HARP and more than 3,000 borrowers with LTVs between 105 percent and 125 percent.[105]

b. Home Affordable Modification Program

HAMP utilizes TARP funds as a match to lender funds to reduce borrowers' monthly payments and as servicer and borrower incentives. Once a lender reduces a HAMP-eligible borrower's front-end DTI ratio to 38 percent, Treasury will match further reductions in monthly payments dollar-for-dollar with the lender/investor to achieve a 31 percent DTI ratio.[106] Treasury also utilizes HAMP funds to provide incentives for servicer participation and borrower performance. Servicers receive a one-time payment of $1,000 for each eligible modification meeting program guidelines, as well as $1,000 per year (for up to three years) as long as the borrower stays in the program. Borrowers receive up to $1,000 per year (for up to five years) as long as he or she remains current on monthly payments within the program; the borrower funds go directly to the servicer/lender as principal balance reduction. A one-time bonus of $1,500 to lenders/investors and $500 to servicers is paid for modifications made while a borrower is still current on monthly payments, again, with the borrower bonus going towards principal balance reduction.[107]

A total of $50 billion in funding has been allocated from TARP funds to finance the non-GSE segment of HAMP. As of February 2010, there were 835,194 active trial modifications under HAMP.[108] During the same period, there were 168,708 active permanent modifications, or modifications that have passed beyond the trial modification phase into the permanent modification phase under HAMP.[109] In total, over 1.35 million trial period plan offers have been extended to borrowers. The non-GSE segment of HAMP is based upon voluntary servicer participation. Currently, there are

[105] Federal Housing Finance Agency, *HAMP Modifications Up in January; HARP Growing,* at 4 (Mar. 24, 2010) (online at fhfa.gov/webfiles/15570/FPR32410F.pdf).

[106] U.S. Department of the Treasury, *Home Affordable Modification Program Guidelines* (Mar. 4, 2009) (online at www.treas.gov/press/releases/reports/modification__program__guidelines.pdf) (hereinafter "HAMP Guidelines").

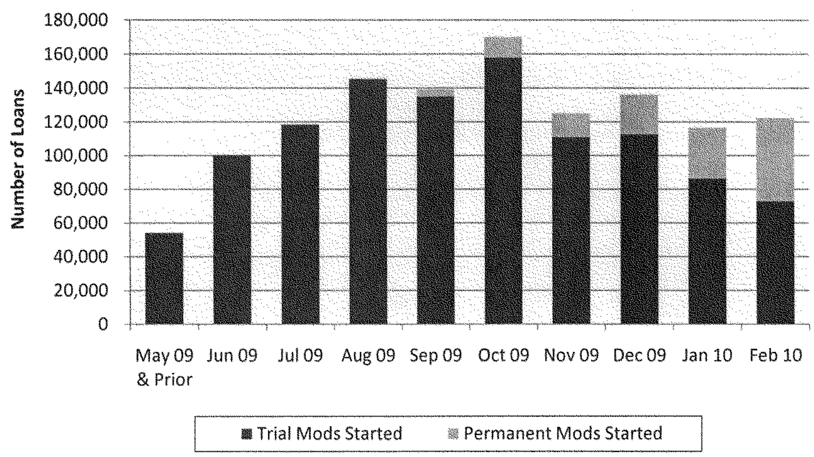
[107] HAMP Guidelines, *supra* note 106.

[108] Active trial modifications include all modifications currently in place but exclude modifications that were cancelled or converted to permanent status. Active permanent modifications include all permanent modifications currently in place but exclude redefaults and loans that have been paid off.

[109] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

106 servicer participants in HAMP.[110] A detailed analysis of HAMP program data follows in Section D.2, after the general program overviews.

FIGURE 5: HAMP ACTIVE TRIAL MODIFICATIONS STARTED VS. ACTIVE PERMANENT MODIFICATIONS STARTED BY MONTH[111]

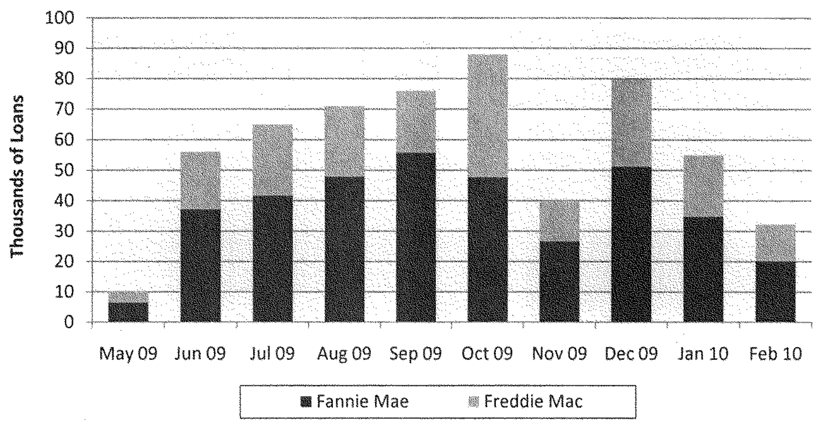


c. GSE–HAMP

In total, $25 billion in funding was apportioned under HERA to fund the GSE portion of HAMP.[112] The $25 billion portion of funds derived from HERA is dedicated to Fannie Mae and Freddie Mac for providing incentive payments in HAMP loan modifications. As of December 2009, Fannie Mae and Freddie Mac completed 23,500 and 19,500 permanent modifications, respectively.[113] These agencies account for approximately 38 percent of the active permanent modifications under HAMP.

[110] U.S. Department of the Treasury, *Making Home Affordable Program: Servicer Performance Report Through February 2010* (Mar. 12, 2010) (online at www.makinghomeaffordable.gov/docs/Feb%20Report%20031210.pdf) (hereinafter "MHA Servicer Performance Through February 2010").
[111] These figures include trials converted to permanent and pending permanent modifications. Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).
[112] Seth Wheeler QFRs, *supra* note 97, at 1.
[113] Federal Housing Finance Agency, *Foreclosure Prevention & Refinance Report,* at 2 (Jan. 29, 2010) (online at fhfa.gov/webfiles/15389/Foreclosure_Prev_release_1_29_10.pdf) (hereinafter "FHFA Foreclosure Report").

FIGURE 6: FANNIE MAE AND FREDDIE MAC HAMP TRIAL AND PERMANENT MODIFICATIONS STARTED BY MONTH THAT WERE ACTIVE AS OF FEBRUARY 2010 [114]



d. Home Price Decline Protection Program

HPDP was established in order to facilitate additional mortgage modifications in those areas hardest hit by home price declines. HPDP provides the mortgage investor with further incentives to modify mortgages on properties in areas that have suffered from price declines. The HPDP incentive payment is a cash payment on all eligible loans and is linked to the rate of recent home price declines in the particular area, the unpaid principal balance, and the mark-to-market LTV of the mortgage.[115] Following a successful HAMP trial modification, the lender/investor accrues 1/24th of the HPDP incentive per month for 24 months. Treasury has allocated $10 billion of the $50 billion in TARP funds dedicated to HAMP for this subprogram; however, the actual amount expended will depend upon participation and housing price trends.[116] Although some servicers may be offering this program to borrowers, Treasury does not yet have a system of record to which the servicers can submit records. Therefore, no borrowers are yet officially considered to have been assisted by HPDP, and no money has been paid out under the program.

e. Home Affordable Foreclosure Alternatives Program

In some circumstances a modification that keeps the borrower in the home is not possible or preferable. HAFA is intended to widen the scope of mitigation options by providing incentives to servicers that pursue short sales or deeds-in-lieu of foreclosure. While this may not keep the borrower in the home, it avoids foreclosure and

[114] FHFA Foreclosure Report, *supra* note 113, at 2.
[115] U.S. Department of the Treasury, *Home Affordable Modification Program—Home Price Decline Protection Incentives,* Supplemental Directive 09–04, at 1 (July 31, 2009) (online at www.financialstability.gov/docs/press/SupplementalDirective7-31-09.pdf).
[116] *See* U.S. Department of the Treasury, *Making Home Affordable: Update: Foreclosure Alternatives and Home Price Decline Protection Incentives,* at 4 (May 14, 2009) (online at www.treas.gov/press/releases/docs/05142009FactSheet-MakingHomesAffordable.pdf) (hereinafter "Foreclosure Alternatives and Home Price Decline Protection Incentives").

provides a more orderly transition for both the borrower and lender. A short sale takes place when a borrower is unable to make the mortgage payment, and the servicer allows the borrower to sell the property at the current value, regardless of whether the proceeds from the sale would cover the remaining balance of the mortgage. It is necessary for the borrower to list and market the property; however, if the borrower is unable to sell the property, the servicer may choose to pursue a deed-in-lieu transaction, where the borrower willingly transfers ownership of the property to the servicer.[117]

HAFA facilitates short sales as well as deed-in-lieu transactions by offering incentive payments to borrowers, junior lien holders, and servicers that are similar to the structure and amounts of MHA incentive payments.[118] While servicers are required to evaluate borrowers for the program, they are not required to offer foreclosure alternatives. Although some servicers may be offering this program to borrowers, Treasury does not yet have a system of record to which the servicers can submit records. Therefore, no borrowers are yet officially considered to have been assisted by HAFA, and no money has been paid out under the program.

f. Hope for Homeowners

H4H was created by HERA and is voluntary for lenders.[119] Although the program is not a TARP program and is run by the Department of Housing and Urban Development (HUD), it is still considered part of the Administration's umbrella MHA foreclosure mitigation initiative. The program is now more closely linked to the TARP because subsequent legislation apportioned TARP funds to the H4H program. Due to low servicer participation, the Helping Families Save Their Homes Act of 2009 added TARP-funded servicer incentive payments similar to those under HAMP to the structure of the H4H program.[120] H4H is intended to provide borrowers who are having trouble making their monthly payments the opportunity to refinance into an FHA-insured loan. H4H requires the participant's lender to decrease the principal of the loan to 90 percent of the newly appraised value, thereby addressing the issue of underwater mortgages.[121] As of February 2010, 35 loans had closed.[122] No TARP dollars have been used for the recently added servicer incentive payments under H4H.[123]

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[117] *See* Foreclosure Alternatives and Home Price Decline Protection Incentives, *supra* note 116.

[118] U.S. Department of the Treasury, *Introduction of Home Affordable Foreclosure Alternatives—Short Sale and Deed-in-Lieu of Foreclosure,* Supplemental Directive 09–09 (Nov. 30, 2009) (online at www.hmpadmin.com/portal/docs/hamp__servicer/sd0909.pdf) (hereinafter "Introduction of Home Affordable Foreclosure Alternatives").

[119] Housing and Economic Recovery Act, Pub. L. No. 110–289 §§ 1401–04 (2008).

[120] Preventing Mortgage Foreclosure and Enhancing Mortgage Credit, Pub. L. No. 111–22 § 202(b) (2009).

[121] U.S. Department of Housing and Urban Development, *Fact Sheet: HOPE for Homeowners to Provide Additional Mortgage Assistance to Struggling Homeowners* (online at www.hud.gov/hopeforhomeowners/pressfactsheet.cfm) (accessed Apr. 13, 2010).

[122] U.S. Department of Housing and Urban Development, *Letter from Assistant Secretary for Housing David H. Stevens to The Honorable Richard C. Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, United States Senate enclosing the February HOPE for Homeowners Program monthly report* (Mar. 29, 2010).

[123] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

2. HAMP Data Analysis

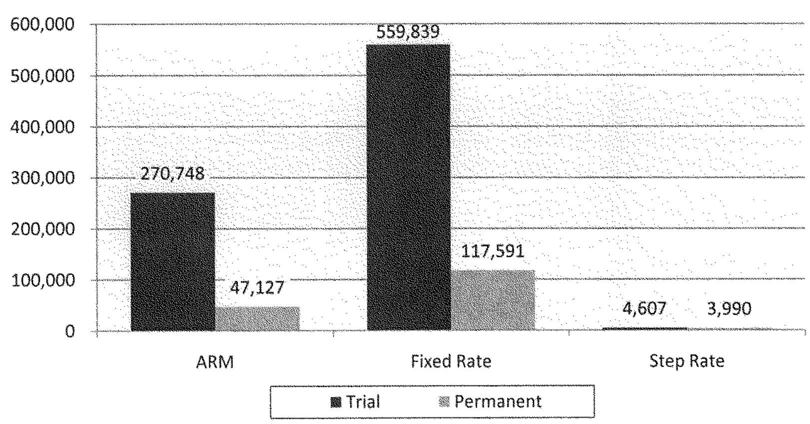
Based on certified data provided by Fannie Mae, Treasury's agent for HAMP, the following statistical picture of HAMP emerges. As of March 8, 2010, there were 170,207 permanent modifications, of which 168,708 were active. This represents a conversion rate of 23.1 percent of eligible trials to permanent modifications. Only 9.7 percent of eligible trials (71,397 trials) converted to permanent modifications within the typical anticipated three-month trial period; many more converted after extended trial forbearance. Of the 1,499 permanent modifications that ceased to be active, 1,473 had redefaulted, and 26 were paid off. An additional 835,194 unique borrowers were actively in trial modifications.[124]

a. HAMP Modified Loan Characteristics

Most active HAMP modifications (trial and permanent) have been on loans in GSE pools. There are 572,650 active modifications on GSE loans, 340,877 on loans in private-label securitization pools, and 90,375 on whole loans held in portfolio. Unfortunately, this data has little analytical use because there is no baseline for comparison, such as the number of each type of loan that is HAMP-eligible, or controls for loan characteristics.[125]

As of March 1, 2010, 67 percent of trials and 70 percent of permanent modifications involved fixed-rate mortgages, with adjustable-rate mortgages making up 32 percent of trials and 28 percent of permanent modifications. There were also a negligible number of step-rate mortgages. (See Figure 7, below.)

FIGURE 7: PRE-MODIFICATION LOAN TYPE OF COMPLETED HAMP MODIFICATIONS[126]



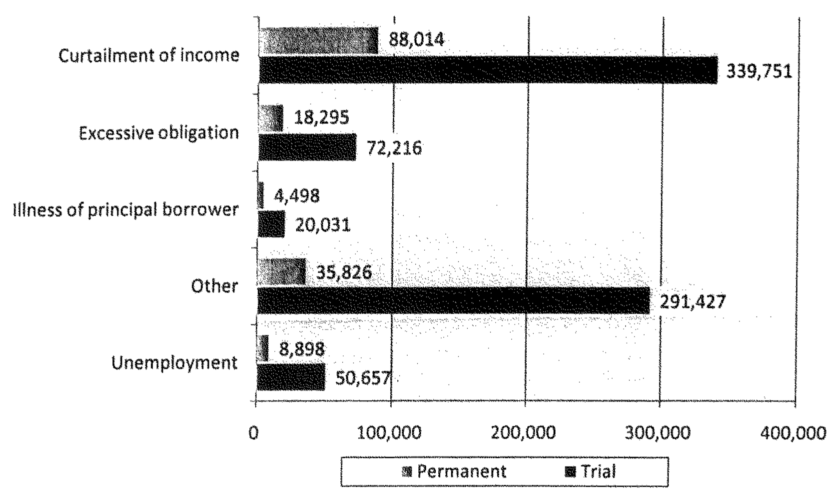
Borrowers listed a variety of hardship reasons when requesting HAMP modifications. By far the most common was "curtailment of income," which was reported by 41 percent of borrowers in trial modifications and 52 percent of borrowers with permanent modifications. This category reflects reduced employment hours, wages,

[124] *Id.*
[125] *Id.*
[126] *Id.*

salaries, commissions, and bonuses and is distinct from unemployment, which was reported by six percent of trial modification borrowers and five percent of permanent modification borrowers. Other significant categories of hardship reported were "excessive obligation," reported by eight percent of trial modification borrowers and 11 percent of permanent modification borrowers. Additionally, 35 percent of trial modifications and 21 percent of permanent modifications reported "other" for the hardship reason.[127] (See Figures 8 and 9, below.)

It is notable that curtailment of income is the predominant hardship basis, as this implies that general economic conditions, rather than mortgage rate resets on subprime or payment-option or interest-only loans, are driving the mortgage crisis at present. Until recent program changes, HAMP eligibility generally required employment. This raised concerns as to whether HAMP, which was designed in the winter of 2009 when unemployment rates were lower, was capable of dealing with emerging causes of foreclosure.[128]

FIGURE 8: TOP FIVE HARDSHIP REASONS FOR HAMP TRIAL AND PERMANENT MODIFICATIONS [129]



[127] *Id.*

[128] For further discussion of the impact of the newly announced changes designed to assist unemployed borrowers, see Section C(1)g.

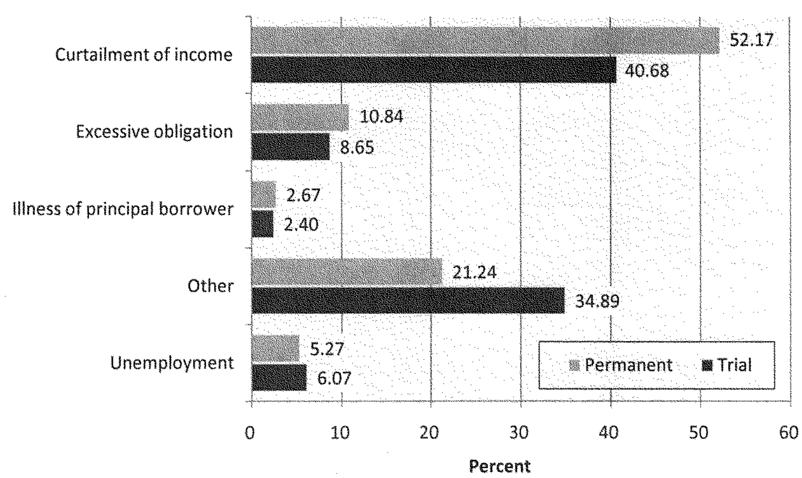
[129] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

FIGURE 9: ALL HARDSHIP REASONS FOR HAMP TRIAL AND PERMANENT MODIFICATIONS [130]

	Trial	Permanent
Abandonment of property	54	29
Business failure	6,091	1,199
Casualty loss	961	97
Curtailment of income	339,751	88,014
Death of borrower	2,361	987
Death of borrower family member	2,024	922
Distant employment transfer	323	55
Energy environment costs	949	199
Excessive obligation	72,216	18,295
Fraud	841	1,200
Illness of borrower family member	3,494	1,521
Illness of principal borrower	20,031	4,498
Inability to rent property	911	212
Inability to sell property	287	42
Incarceration	230	31
Marital difficulties	12,569	2,431
Military service	207	135
Other	291,427	35,826
Payment adjustment	6,203	1,455
Payment dispute	1,569	518
Property problem	552	104
Servicing problems	1,095	205
Transfer of ownership pending	273	25
Unable to contact borrower	20,118	1,810
Unemployment	50,657	8,898

[130] *Id.*

FIGURE 10: TOP FIVE HARDSHIP REASONS FOR HAMP TRIAL AND PERMANENT MODIFICATIONS AS PERCENTAGE OF TRIAL AND PERMANENT MODIFICATIONS [131]



[131] *Id.*

FIGURE 11: ALL HARDSHIP REASONS FOR HAMP TRIAL AND PERMANENT MODIFICATIONS AS PERCENTAGE OF TRIAL AND PERMANENT MODIFICATIONS [132]

	Trial Modification	Permanent Modification
Abandonment of property	0.01	0.02
Business failure	0.73	0.71
Casualty loss	0.12	0.06
Curtailment of income	40.68	52.17
Death of borrower	0.28	0.59
Death of borrower family member	0.24	0.55
Distant employment transfer	0.04	0.03
Energy environment costs	0.11	0.12
Excessive obligation	8.65	10.84
Fraud	0.1	0.71
Illness of borrower family member	0.42	0.9
Illness of principal borrower	2.4	2.67
Inability to rent property	0.11	0.13
Inability to sell property	0.03	0.02
Incarceration	0.03	0.02
Marital difficulties	1.5	1.44
Military service	0.02	0.08
Other	34.89	21.24
Payment adjustment	0.74	0.86
Payment dispute	0.19	0.31
Property problem	0.07	0.06
Servicing problems	0.13	0.12
Transfer of ownership pending	0.03	0.01
Unable to contact borrower	2.41	1.07
Unemployment	6.07	5.27

[132] *Id.*

For the modifications that have converted to permanent modifications, the median (mean) front-end DTI—the ratio of monthly housing debt payments to monthly income—declined by 14 (17.11) percent, from 45.02 (47.97) percent to 31.02 (30.86) percent, in line with the program's goal. Under HAMP, the front-end DTI is calculated based on the first-lien payment only and does not include housing costs resulting from second liens. The median (mean) back-end DTI ratio—the ratio of total monthly debt payments to monthly income—declined by 16.6 (16.6) percent from 76.44 (86.52) percent to 59.84 (69.92) percent.[133] Back-end DTI calculations include all payments to creditors, which in addition to first-lien payments could include payments on debts such as home equity lines of credit, credit cards, auto loans, and student loans. (See Figures 12 and 13, below.) These changes indicate that HAMP modifications are substantially reducing borrowers' monthly debt service burdens and making homeownership relatively more affordable, yet even with reduced mortgage payments, the typical HAMP modification recipient still has an extremely high debt burden overall and a relatively high housing debt burden. A 31 percent front-end DTI is a fairly high percentage of monthly income to spend on housing, particularly if a homeowner carries a second lien, as junior liens are not considered in the 31 percent front-end DTI calculation. More notably, the program can still leave borrowers saddled with very high levels of total debt, as back-end debt is not even considered in the HAMP modification. HAMP is improving affordability, but it leaves many borrowers with permanent modifications still paying

[133] *Id.*

a large percentage of income for housing and other debts. This calls into question the sustainability of many permanent modifications, particularly as the loan payments rise after the five-year modification period expires.

FIGURE 12: FRONT-END DEBT-TO-INCOME RATIOS PRE- AND POST-HAMP MODIFICATIONS [134]

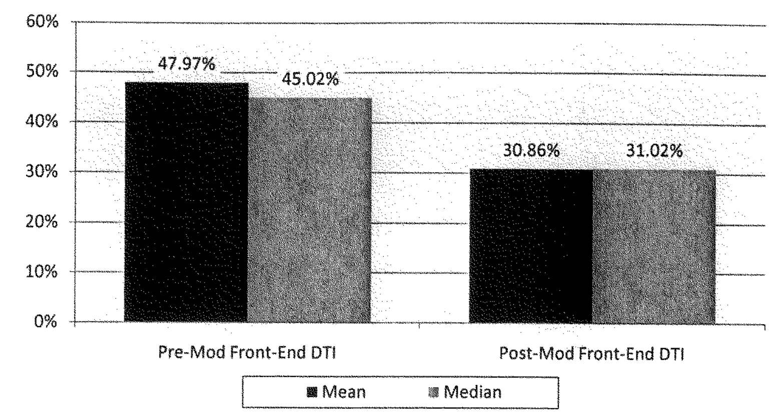
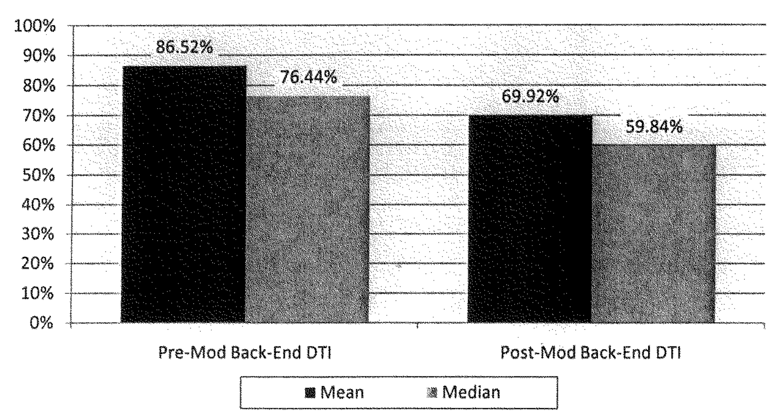


FIGURE 13: BACK-END DEBT-TO-INCOME RATIOS PRE- AND POST-HAMP MODIFICATIONS [135]

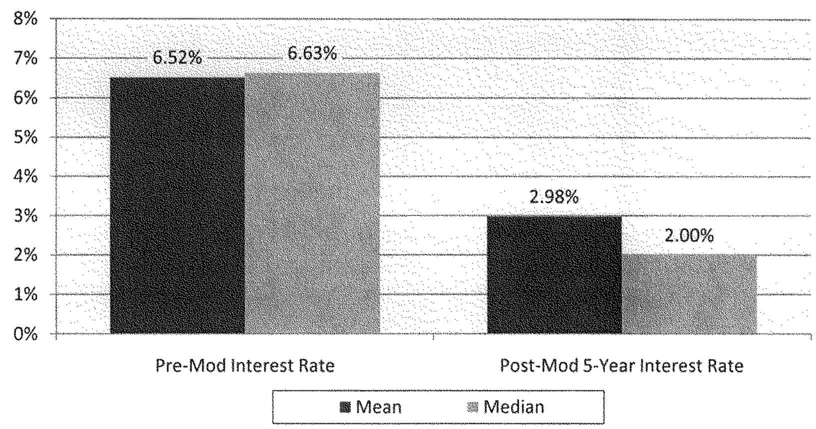


The reduction in DTI in HAMP modifications was achieved almost exclusively through reductions in interest rate, rather than term extensions or principal reductions. In fact, 100 percent of HAMP modifications involved interest rate reductions. Median (mean) interest rates were dropped by 4 (3.54) percentage points, from 6.625 (6.52) percent to 2 (2.98) percent, a 70 (54) percent re-

[134] *Id.*
[135] *Id.*

duction in the rate.[136] (See Figure 14, below.) Interest rates may rise after five years, however, calling into question the long-term sustainability of HAMP permanent modifications.

FIGURE 14: INTEREST RATES PRE- AND POST-HAMP MODIFICATIONS [137]



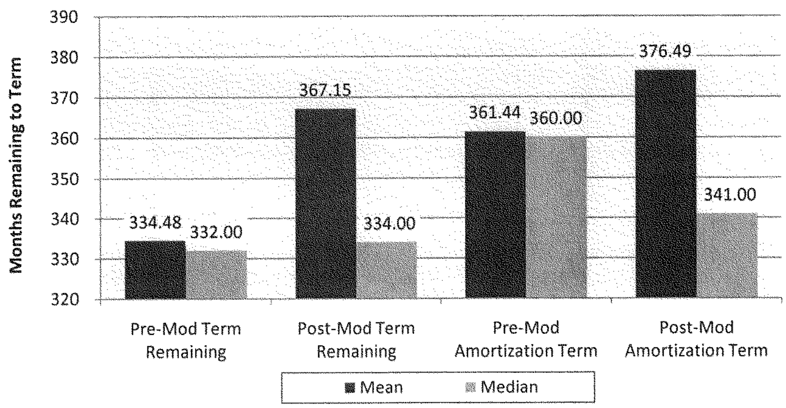
Term extensions were de minimis; the median (mean) term remaining before modification was 332 (334.48) months, and after the trial period, the median (mean) term remaining was 334 (367.15) months, indicating a median (mean) term extension of 2 (32.67) months. There were 78,906 permanent modifications or 47 percent of total featured term extensions, while 8,674 or 5 percent of total modifications involved reductions in remaining terms.[138] For loans with term extensions the median extension was 92 months, while the median term reduction was only one month.[139] Terms remained unchanged for 81,128 permanent modifications or 48 percent of all permanent modifications.[140] A portion of the term reductions, however, is attributable to the time lapse between the start of the trial modification and the permanent modification date, so the actual number and percentage of modifications with term extensions excluding the trial period might be lower.

Amortization periods changed relatively little. Before modification, the median (mean) amortization period was 360 (361.44) months, and post-modification, the median amortization period dropped to 341 months while the mean rose to 376.49 months, indicating that amortization periods on a small number of permanent modifications were significantly increased.[141] (See Figure 15, below.) The amortization period increased in 78,906 modifications or 47 percent of the total and decreased in 8,674 modifications or

[136] *Id.*
[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] *Id.*
[141] *Id.*

5 percent of the total, and remained unchanged for 81,128 modifications or 48 percent of the total.[142]

FIGURE 15: TERM AND AMORTIZATION PERIODS FOR PERMANENT HAMP MODIFICATIONS [143]



Principal forbearance was rare and principal forgiveness rarer still. Principal was forborne on 46,959 permanent modifications (27.8 percent of total) while only 10,521 (6.2 percent of total) had principal forgiven. Additionally, 10,381 or 6.15 percent of modifications had both principal forgiven and forborne. When calculated based on all permanent modifications, the median (mean) amount of principal forborne was $0 ($18,836.48), and the median (mean) amount of principal forgiven was $0 ($3,572.06). When calculated only for the modifications with principal forbearance, however, the median (mean) amount forborne was $49,003.10 ($67,673.19) of post-modification unpaid principal balance, implying a sizable balloon payment at the maturity of the mortgage.[144] When calculated only for the permanent modifications with principal forgiveness, the median (mean) amount forgiven was $42,020.06 ($57,279.32) of the post-modification unpaid principal balance.

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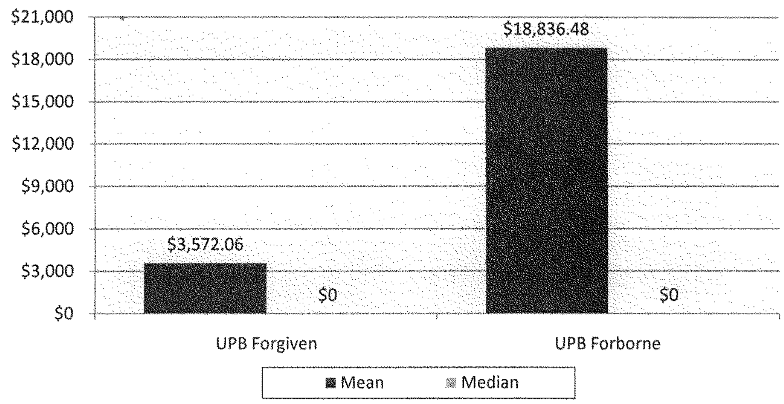
[142] *Id.*
[143] *Id.*
[144] *Id.*

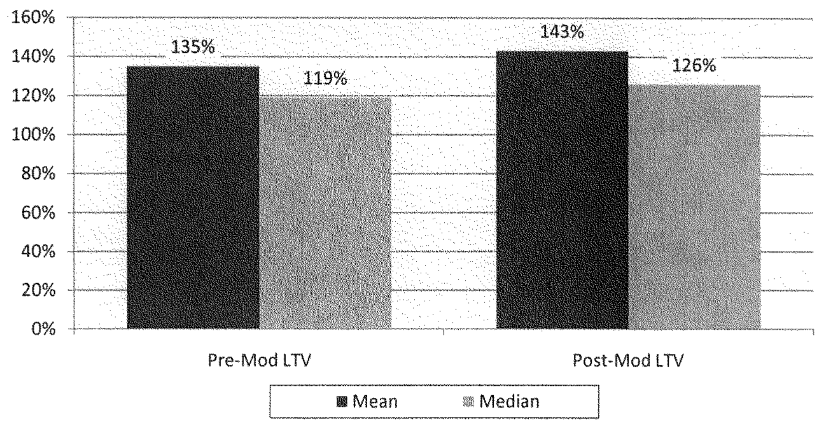
FIGURE 16: UNPAID PRINCIPAL BALANCE FORGIVEN AND FORBORNE IN PERMANENT MODIFICATIONS [145]



Before modification, the median (mean) LTV was 119.31 (134.83) percent. Modification increased the median and mean LTV modestly due to capitalization of arrearages and escrow requirements; borrowers' actual obligations did not increase as the result of modifications. Thus, post-modification, the median (mean) LTV was 125.88 (143.19) percent.[146] (See Figure 17.) Post-modification, 127,890 or 75.8 percent of permanent modifications were calculated as having an LTV of greater than 100, meaning the vast majority of borrowers receiving a HAMP permanent modification still have negative equity. Indeed, most HAMP permanent modification recipients remain deeply underwater. Fifty-one percent of HAMP permanent modifications have a *first lien* LTV of greater than 125 percent.[147] If junior liens were to be included, the percentage would be significantly higher. The continuing deep level of negative equity for many HAMP permanent modification recipients makes the modifications' sustainability questionable; even with more affordable payments, deeply underwater borrowers may remain tempted to strategically default or may be compelled to because core life events, such as death, divorce, disability, marriage, child birth, job loss, or job opportunities necessitate a move.

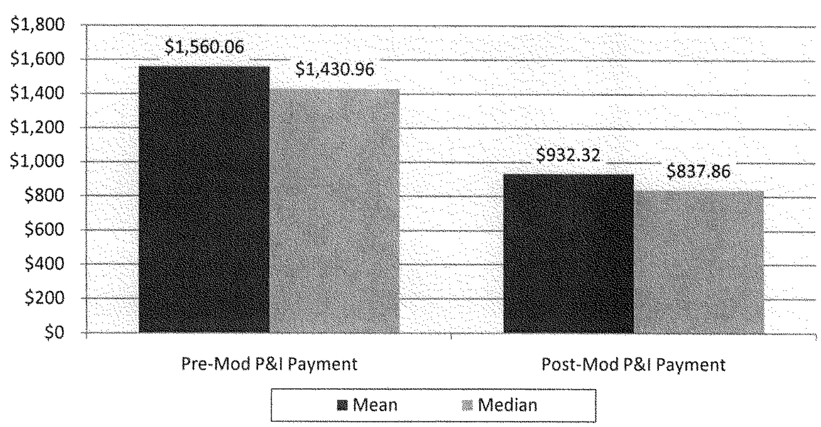
[145] *Id.*
[146] *Id.*
[147] *Id.*

FIGURE 17: LOAN-TO-VALUE RATIOS PRE- AND POST-HAMP FIRST-LIEN MODIFICATIONS [148]



The net result of the modifications was that median (mean) monthly principal and interest payments for the first lien dropped $518.88 ($627.74), from $1,430.96 ($1,560.06) to $837.86 ($932.32), a 41 (40) percent decline. As Figure 18 below shows, HAMP modifications resulted in a noticeable decrease in monthly principal and interest payments on first-lien mortgages for many borrowers, but as shown earlier, they generally resulted in minimal changes in principal balances.[149]

FIGURE 18: MONTHLY PRINCIPAL & INTEREST PAYMENT PRE- AND POST-HAMP MODIFICATIONS [150]



Overall, HAMP modifications succeed at making homeownership more affordable by reducing payments. But the Panel has concerns

[148] *Id.*
[149] *Id.*
[150] *Id.*

as to whether the modifications make homeownership sufficiently affordable to avoid foreclosure, given borrowers' broader circumstances. As noted previously, the program payment target of 31 percent DTI, without considering the existence of junior liens, leaves borrowers still paying a significant percentage of their income for housing. This is particularly problematic because most HAMP modification recipients are underwater. They are thus paying for the consumption value of housing and what amounts to a currently out-of-the-money put option on the house.[151]

This points to the problem with the lack of principal forgiveness in HAMP up to this point. Lack of principal forgiveness means that homeowners will continue to be underwater. It also means that more of each payment will be going to interest, rather than paying down principal, and it may mean that some borrowers have to pay for a longer period of time. All of these factors increase the redefault risk on modified mortgages, and to the extent that a permanent modification is not sustainable, it merely delays a foreclosure and the stabilization of the housing market.

HAMP's original emphasis on interest rate reduction, rather than principal reduction, benefits lenders and servicers at the expense of homeowners. Lenders benefit from avoiding having to write down assets on their balance sheets and from special regulatory capital adequacy treatment for HAMP modifications. Mortgage servicers benefit because a reduction in monthly payments due to an interest rate reduction reduces the servicers' income far less than an equivalent reduction in monthly payment due to a principal reduction. Servicers are thus far keener to reduce interest rates than principal. The structure of HAMP modifications favors lenders and servicers, but it comes at the expense of a higher redefault risk for the modifications, a risk that is borne first and foremost by the homeowner but is also felt by taxpayers funding HAMP.

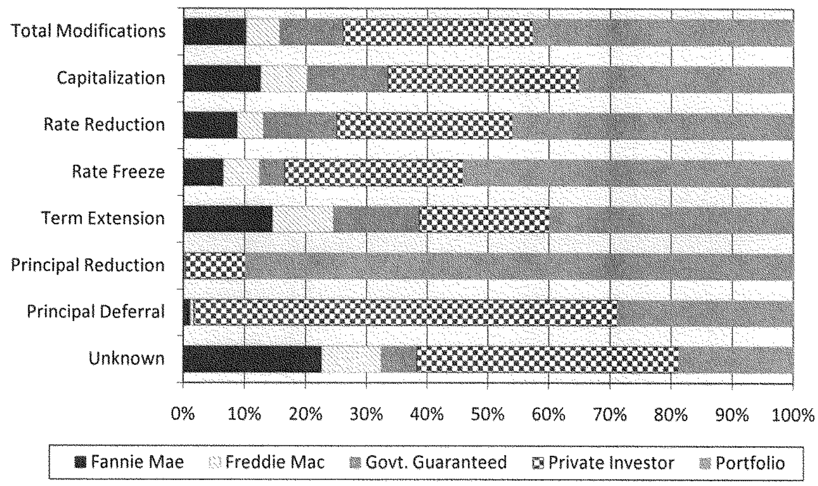
b. Impact of Loan Ownership on Modifications

Data from the OCC/OTS Mortgage Metrics Report indicate that ownership of loans affects the features of modifications done outside of HAMP. There are important variations in pre-modification characteristics depending on loan ownership—Fannie Mae securitized pools, Freddie Mac securitized pools, private-label securitized pools, and loans held directly by financial institutions. Portfolio loans accounted for 43 percent of the modifications despite being a smaller share of all loans. Private-label securitized loans accounted for another 31 percent of all modifications, again a percentage disproportionately large to market share. Yet on the OCC/OTS data from the first three quarters of 2009, 90 percent of principal forgiveness modifications were on loans held directly in financial institutions' portfolios, rather than securitized, while 70 percent of principal forbearance modifications were done on private-label securitized loans, with the rest being almost entirely portfolio loans.[152] (See Figure 19, below.)

[151] *Id.*
[152] *See, e.g.,* Office of the Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report (First Quarter 2009),* at 23 (June 2009) (online at

Continued

FIGURE 19: MODIFICATION TYPE BY LOAN OWNERSHIP [153]



The OCC/OTS data indicate that securitization status affects the type of modification: securitized loans are more likely to have principal forborne rather than forgiven relative to portfolio loans. This is likely a function of servicer incentives. A servicer of a securitized loan is compensated primarily based on the principal balance outstanding. Therefore, the servicer has an incentive to forbear rather than forgive principal. Forbearing actually increases the servicer's income, while forgiveness decreases it. For loans held in portfolio, the concern is simply maximizing the value of the loan itself.

By and large, among modifications that have been approved, ownership of loans does not appear to affect HAMP modifications. There are notable variations in pre-modification characteristics depending on loan ownership. Yet, with two exceptions, these variations in pre-modification characteristics do not seem to have a noticeable effect on the modification process or on loans' post-modification characteristics.

The first exception is that the median time for conversion from trial to permanent modification is about a month shorter for loans held in portfolio than for any type of securitized loans.[154] Mean

files.ots.treas.gov/4820471.pdf) (hereinafter "OCC and OTS Mortgage Metrics Report—Q1 2009"); Office of the Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report (Second Quarter 2009),* at 25 (Sept. 2009) (online at files.ots.treas.gov/482078.pdf) (hereinafter "OCC and OTS Mortgage Metrics Report—Q2 2009"); Office of the Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report (Third Quarter 2009),* at 25 (Dec. 2009) (online at files.ots.treas.gov/482114.pdf) (hereinafter "OCC and OTS Mortgage Metrics Report—Q3 2009"). The OCC/OTS data do not generally include HAMP modifications because very few were permanent in the first three quarters of 2009.

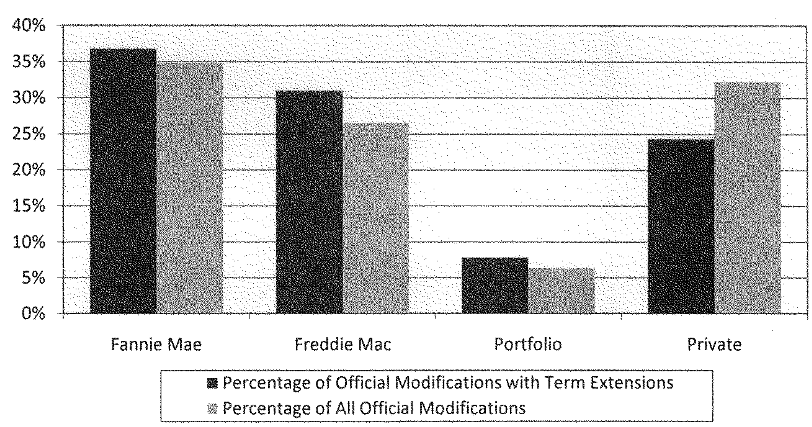
[153] OCC and OTS Mortgage Metrics Report—Q3 2009, *supra* note 152, at 23–25. The OCC/OTS data do not generally include HAMP modifications because very few were permanent in the first three quarters of 2009.

[154] The median Fannie Mae and Freddie Mac loan takes 122 days to convert to permanent status, while the median private-label securitized loan takes 120 days. Treasury mortgage market data provided to Panel staff (Mar. 23, 2010). The median portfolio loan takes only 92 days to convert. Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

conversion times, however, are roughly comparable.[155] This would indicate that while some portfolio loans are taking a significant time to convert, most of them are converting much more quickly than securitized loans. The quicker conversion of portfolio loans presents an opportunity to learn about factors affecting conversion speed and thus for improving HAMP.[156] The Panel, therefore, urges Treasury to investigate this variation in conversion speed in more depth.

The other noticeable difference is that servicers are constrained in their ability to extend the term of private-label securitized loans. The mean term extension on private-label securitized permanent modifications is five months, whereas the mean term extension for Fannie Mae, Freddie Mac, and portfolio loan modifications is between 44 and 48 months.[157] This is likely a function of contractual restrictions on private-label servicers in the pooling and servicing agreements (PSAs) governing the servicing of the securitized mortgages. Virtually all PSAs restrict servicers' ability to extend the term of a mortgage beyond the final maturity date of any other loan in the pool.[158] As most mortgages in a pool are originated within a year of each other, this means that private-label securitized loans have little flexibility in terms of term extension. Thus, as Figure 20 shows, private-label securitized loans represented a substantially smaller percentage of permanent modifications with term extensions than they do of total permanent modifications.

FIGURE 20: TERM EXTENSION BY LOAN OWNERSHIP COMPARED WITH OVERALL DISTRIBUTION OF LOAN OWNERSHIP



Limitations on the ability to extend maturity dates do not appear to affect the ability of servicers to reduce DTI to 31 percent; even when maturity dates cannot be extended, amortization periods

[155] Mean conversion times are 132 days for Fannie Mae, 128 days for Freddie Mac, 133 days for private-label securitized loans, and 132 days for portfolio loans. Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

[156] This may be a function of financial institutions simply being able to manage processes and make decisions with loans in their portfolios more quickly.

[157] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

[158] Levitin & Twomey, *supra* note 78.

often can be. Curiously, however, mean and median amortization terms on private-label securitized loans dropped for permanent modifications, whereas medians were largely flat and means increased substantially for other types of loans. This movement, however, likely reflects variations in pre-modification loan characteristics as private-label securitized loans had, on average, substantially longer amortization periods pre-modification, likely reflecting the inclusion of so-called 30/40 loans, with 30-year terms and 40-year amortization periods.[159]

If amortization extensions are compensating for lack of term extensions in private-label securitized loans, it raises the concern that these loans are being restructured to have balloon payments at the end. An important lesson of the housing market crash of the Depression, recognized by the 1931 President's Conference on Home Building and Home Ownership, was that balloon loans pose inherent default risks because of the sizable backloaded payment.[160] To the extent that HAMP encourages forbearance or amortizations longer than terms, it increases the default risk on the modified loans.

c. HAMP Modification Application Denials and Trial Modification Cancellations

Starting in February 2010, servicers began to report the reason why HAMP trial modifications were denied or cancelled; however, the data have not been reported consistently. Treasury indicates that fallout reasons are reported only for 31 percent of disqualified or cancelled modifications, and some reported data appear to be erroneous, such as "trial plan default" being reported as a reason for a modification application being denied, when a default can only occur once a trial modification has commenced. There is also particularly thin data on modification denials. Denial reasons were reported for only 4,900 modification applications as opposed to 83,763 cancelled trial modifications.[161]

The leading denial reason, accounting for 61 percent of denials, is "trial plan default," a clearly erroneous designation for a denial code, because a borrower can only default once a trial has started; these borrowers were not in a trial modification. Another 19 percent of applications were denied because the property was not owner occupied at the time of origination, and 9 percent because the loan was already paid off or the default cured. No reason for denial was submitted for 10 percent of denials. This means that for 71 percent of denials, no valid reason was provided.[162] (See Figure 21, below.)

Similarly, for modification cancellations, no reason was provided in 72 percent of the cases. In 11 percent of the cases, the borrower turned out to have a current DTI ratio of under 31 percent; in 7 percent of cancellations, the borrower failed to submit complete paperwork; in 4 percent of cancellations the borrower defaulted on the trial modification; in less than 3 percent of cancellations, the

[159] *See* OCC and OTS Mortgage Metrics Report—Q3 2009, *supra* note 152, at 24.
[160] *Home Finance and Taxation, President's Conference on Home Building and Home Ownership,* at 7 (James M. Gries & James Ford eds., 1932).
[161] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).
[162] *Id.*

NPV calculation was negative.[163] (See Figure 21, below.) The cancellations due to ineligible DTI or NPV outcomes are a function of some servicers doing stated-income trial modifications. For those servicers doing verified income trial modifications, the modifications would be denied, rather than initially approved and then subsequently cancelled.

Notably, the reported data do not indicate that borrowers were responsible for most trial modification failures. Payment defaults, failure to submit paperwork, and borrower refusal of modification offers accounted for 12 percent of trial modification cancellations. HAMP program parameters—mortgage type eligibility, property type requirements, occupancy requirements, DTI requirements, NPV requirements, and excessive forbearance—accounted for 16 percent of trial modification cancellations.[164] (See Figure 22, below.)

The Panel is deeply concerned about the unacceptable quality of the denial and cancellation reasons and strongly urges Treasury to take swift action to ensure that homeowners are not denied the opportunity for a modification and shuffled off to foreclosure without a servicer at least accounting for why the modification was denied or cancelled. If a HAMP participating servicer operating under a contract with the federal government cannot provide a valid reason for a trial modification denial, the servicer should be subject to meaningful monetary penalties for noncompliance and the foreclosure stayed until an independent analysis of the application or trial can be performed, with the servicer paying the cost of that independent evaluation necessitated by its noncompliance. It is not enough that a servicer is not paid when a modification fails to convert to permanent modification status. If a servicer fails to comply with program requirements, it should be subject to meaningful penalties. Collection and analysis of HAMP denial and cancellation data is critical for both ensuring the program's fairness and improving the program.

[163] *Id.*
[164] *Id.*

FIGURE 21: TOP FIVE HAMP CANCELLATION AND DISQUALIFICATION REASONS [165]

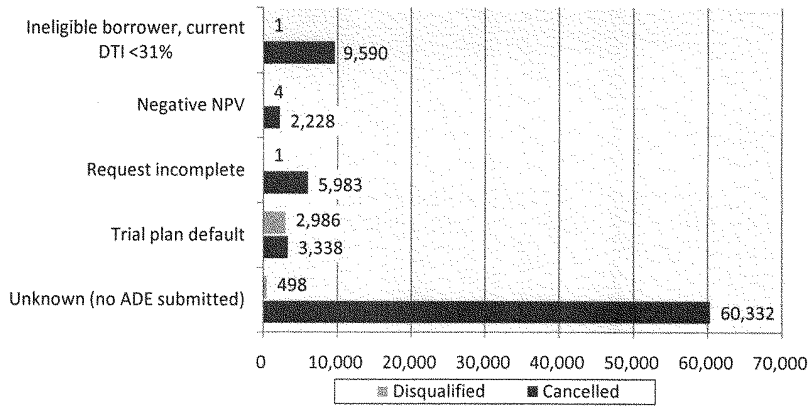


FIGURE 22: ALL HAMP CANCELLATION AND DISQUALIFICATION REASONS [166]

	Cancelled	Disqualified
Default not imminent	5	0
Excessive forbearance	885	0
Ineligible borrower, current DTI less than 31%	9,590	1
Ineligible mortgage	554	0
Investor guarantor not participating	18	0
Loan paid off or reinstated	14	422
Negative NPV	2,228	4
Offer not accepted by borrower, request withdrawn	707	2
Other ineligible property (i.e., property condemned, property greater than 4 units)	16	34
Previous permanent HAMP modification	2	0
Property not owner occupied	91	952
Request incomplete	5,983	1
Trial plan default	3,338	2,986
Unknown (no ADE submitted)	60,332	498

[166] *Id.*

d. Conversion Rates

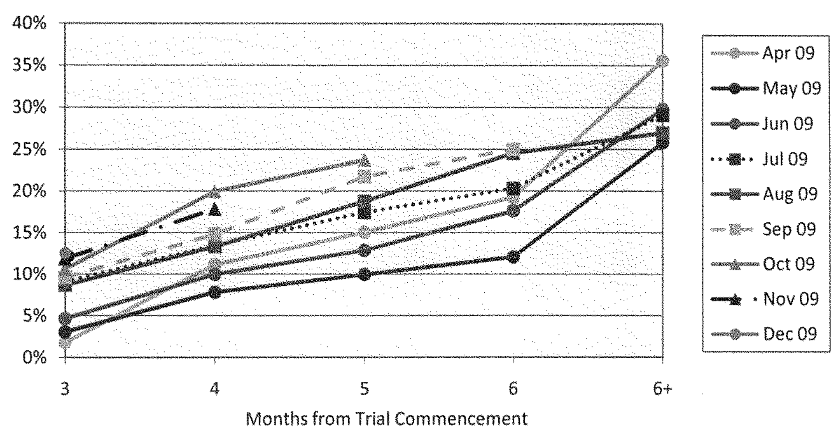
In its previous foreclosure report in October 2009, the Panel underscored serious concern about the low rate at which trial modifications were converting to permanent modification status. The Panel emphasized that the volume of sustainable, permanent modifications was the metric by which HAMP should be evaluated, not the volume of temporary trial modifications or permanent, but unsustainable modifications.[167]

HAMP trial-to-permanent modification conversion rates have improved drastically since the October 2009 report and have been higher for more recent vintages of trial modifications (see Figure 23 below), but they are still far too low for the program to help a significant number of homeowners, much less stabilize the housing market. In October 2009, the conversion rate was 1.26 percent.[168] As of the beginning of April, the rate stood at 23.13 percent. Al-

[165] *Id.*
[167] October Oversight Report, *supra* note 17, at 93.
[168] *Id.*, at 48.

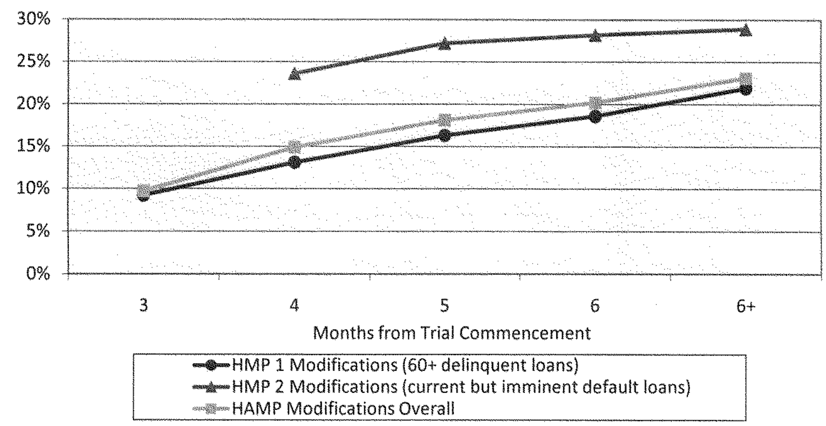
though the improvement is dramatic, less than one in four trial modifications has converted to permanent modification status after the requisite three-month trial period. Moreover, it has taken substantially longer than three months for most of the conversions to occur. Conversions, when they have occurred, have taken 4.36 months on average. Only 9.7 percent of eligible trial modifications converted to permanent modifications after three months. The reasons for delayed conversion are unclear to the Panel.[169] (See Figure 23, below.)

FIGURE 23: CUMULATIVE CONVERSION RATE BY VINTAGE BY MONTHS FROM TRIAL COMMENCEMENT (HMP 1 AND HMP 2 COMBINED)[170]



[169] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).
[170] *Id.*

FIGURE 24: CUMULATIVE PERCENTAGE OF CONVERSION-ELIGIBLE TRIAL MODIFICATIONS CONVERTED TO PERMANENT MODIFICATION STATUS BY MONTHS POST-TRIAL COMMENCEMENT [171]



There is a notable difference in conversion rates between the HMP 2 program for loans that are current, but where default is imminent, and the HMP 1 program for loans that are 60+ days delinquent.[172] HMP 2 modifications have had substantially better conversion rates than HMP 1 modifications. (See Figure 24, above.) HMP 2 modifications also converted more quickly than HMP 1 modifications. The average HMP 2 modification took 3.86 months to convert, whereas the average HMP 1 modification took 4.49 months to convert.[173] This suggests that early intervention, before a borrower is seriously delinquent, is more likely to be successful in terms of conversion.

The Panel is hopeful that Treasury will continue to improve HAMP conversion rates but emphasizes that unless conversion rates continue to rise dramatically, the total number of borrowers assisted by HAMP will be low—in the hundreds of thousands, not millions. At the current conversion rate, the 835,194 active trial modifications as of the end of February 2010 will yield only 193,431 permanent modifications.[174] This would mean that in the course of its first year, HAMP would have commenced trial modifications that would yield a total of 363,638 permanent modifications. If conversion rates were at 100 percent, HAMP would only have commenced trial modifications yielding around 1 million permanent modifications.

e. Use of Stated vs. Verified Income

The 22 largest servicers participating in HAMP can be divided into two groups. Twelve servicers currently ask borrowers to state their incomes at the start of a trial modification. This group in-

[171] *Id.*
[172] To date, there have been 842,022 HMP 1 modifications commenced, of which 611,862 are eligible for conversion to permanent status. For HMP 2, there have been 252,042 modifications commenced, of which 124,128 have become eligible for conversion to permanent status.
[173] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).
[174] *Id.*

cludes the nation's four largest mortgage servicers—Bank of America, JPMorgan Chase, Wells Fargo, and CitiMortgage. The other servicers in the stated-income group are Aurora Loan Services, Bayview Loan Servicing, Green Tree Servicing, Nationstar Mortgage, OneWest Bank, Saxon Mortgage Services, Select Portfolio Servicing, and Wachovia Mortgage, which is owned by Wells Fargo. The 10 remaining large servicers that participate in HAMP verify borrowers' income prior to the start of a trial modification. The servicers in this group are: American Home Mortgage Servicing, Bank United, Carrington Mortgage Servicing, CCO Mortgage, GMAC Mortgage, HomEq Servicing, Litton Loan Servicing, Ocwen Financial Corp., PNC Bank, and U.S. Bank.[175]

Using data through February 2010, the Panel compared the performance of servicers that use stated income with that of servicers that use verified income. Unsurprisingly, the data show that stated-income servicers have been enrolling a larger percentage of eligible borrowers in trial modifications, but they have also been converting a smaller percentage of those trial modifications into permanent modifications. In aggregate, the stated-income servicers have enrolled 35 percent of eligible borrowers in trial modifications, compared with 24.3 percent for the verified-income servicers. But, the stated-income servicers have only converted 12.6 percent of those trial modifications into permanent modifications, while the verified-income servicers have converted 28.0 percent.[176] These data suggest that Treasury's decision to begin requiring all participating servicers to verify borrowers' income upfront will result in fewer trial modifications but a higher conversion rate.

Looking at the data on a servicer-by-servicer basis, however, reveals a picture that is significantly more complicated than the aggregate data might indicate. Servicers that are lagging behind the rest of their respective groups include Bank of America, which collects stated income, and American Home Mortgage Servicing, which verifies income. Servicers that are significantly outpacing their respective groups include Select Mortgage Servicing, a stated-income servicer, and GMAC Mortgage, a verified-income servicer.[177] So while in aggregate there appears to be a correlation between how servicers collect income and their performance results, other factors that vary by servicer also appear to be having a large effect, a matter Treasury should investigate.

f. Redefaults

Treasury has stated that its estimate for HAMP permanent modification redefaults is 40 percent within the five years,[178] and

[175] *Id.*

[176] These conversion rates were calculated using total active modifications, rather than active modifications that are currently eligible for conversion because the Panel did not receive the latter data for each servicer. Conversion rates that are calculated using only active modifications that are eligible for conversion will be higher than the rates shown here. MHA Servicer Performance Through February 2010, *supra* note 110, at 7; Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

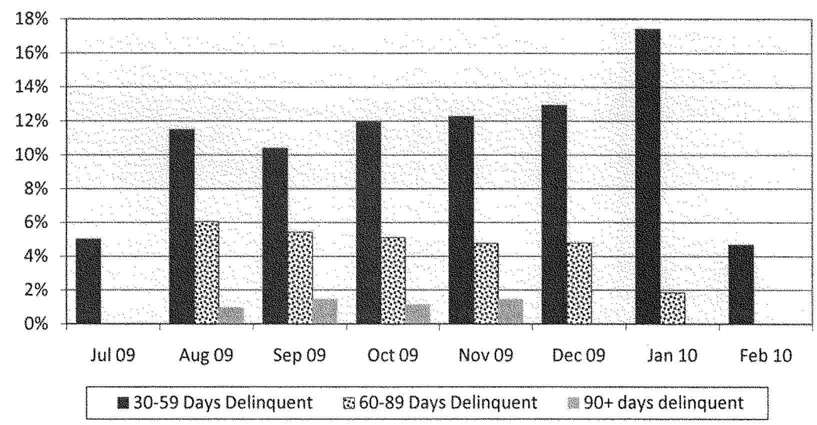
[177] MHA Servicer Performance Through February 2010, *supra* note 110, at 7; Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

[178] Congressional Oversight Panel, *Questions for the Record for U.S. Department of the Treasury Assistant Secretary Herbert M. Allison, Jr.*, at 3 (Oct. 22, 2009) (online at cop.senate.gov/documents/testimony-102209-allison-qfr.pdf) (hereinafter "Assistant Secretary Herbert Allison QFRs").

the Panel has previously expressed concern that the redefault rate could be significantly higher, if adjustments for actual market conditions are made to Treasury's models.[179]

It is generally too early to draw firm conclusions about the performance of HAMP permanent modifications. The initial signs are not encouraging, however. Overall, for permanent modifications for which there is full information,[180] 16.85 percent of HAMP modifications were 30–59 days delinquent, 5.94 percent were 60–89 days delinquent, and 1.3 percent were 90+ days delinquent. (See Figure 25, below.) Additionally 1,473 permanent modified mortgages, or 0.8 percent of permanent modifications were foreclosed. These rates reflect only a few months of loan performance; they are not annual rates.[181]

FIGURE 25: REDEFAULT RATES BY VINTAGE OF PERMANENT MODIFICATIONS [182]



Because servicers do not follow uniform foreclosure timelines in handling defaulted loans, the foreclosure rate is not the best measure of HAMP permanent modifications' performance at present. Instead, 90+ days delinquency combined with foreclosure is the most uniform metric available.[183] This measure covers all seriously delinquent loans. There are only data available on this level of delinquency for modifications commenced before December 2009; modifications commenced in December 2009 or later have not yet had three payments come due.

There were 31,164 modifications commenced before December 2009. All but 20 were commenced in the four months between August and November 2009. Of these, 1,715 were 90+ days delinquent or foreclosed as of March 1, 2010.[184] This means the combined seri-

[179] *See* October Oversight Report, *supra* note 17, at 93.

[180] Treasury provided the Panel with data as of March 1, 2010. Because some permanent modifications are commenced mid-month, there is only full data on delinquency rates starting a month beyond the delinquency period. Thus, 30-day delinquency rates are for modifications commenced through January 2010, 60-day rates are through December 2009, and 90+ day rates are through November 2009.

[181] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

[182] *Id.*

[183] *Id.*

[184] *Id.*

ous delinquency and foreclosure rate is 5.5 percent for a third of a year. Annualized on a straight-line basis, this translates to a 16.5-percent serious delinquency and foreclosure rate.

If the trend is projected over five years, this translates to a high cumulative serious delinquency and foreclosure rate. This projection, however, assumes that redefault rates will remain constant over time. There is no experience yet to show whether that assumption is too pessimistic or optimistic. There are factors that could potentially weigh in either direction. For example, if unemployment lessens or the real estate market recovers or there is significant inflation, redefault rates will likely decline. Moreover, it is possible that the redefaults will be front-loaded and taper off as the weakest cases redefault quickly, leaving sounder borrowers remaining.

On the other hand, there are factors that suggest the straight-line projection is reasonable or even overly optimistic. The recovery in employment rates and rise in real estate values are likely to be measured in years, not months, which means that help may not come until after the home is lost. Indeed, unemployment may continue to rise and real estate values may continue to fall, either of which would increase the odds of redefault. As strategic defaults increase, social inhibitions against walking away from underwater properties may lessen, thereby increasing the rate of redefaults. While weaker borrowers might be more likely to redefault quickly, a redefault rate of one in 20 within just the first three months of modifications converting to permanent modification status is particularly worrisome because these families have just passed a financial screening and have not had time for other things to go wrong. Moreover, beyond a five-year horizon, the very structure of HAMP modifications might lead to increased redefaults, as the fixed low-interest rate will start to increase, whereas borrowers' income and other expenses will not necessarily keep step.[185]

There is still too little data to draw firm conclusions about redefault rates on HAMP permanent modifications, but the existing data are worrisome. When the total picture of HAMP is taken into account, low conversion rates plus potentially high redefault rates mean that the total number of sustainable, permanent modifications generated by HAMP will be quite limited. Even if Treasury's estimates for conversion and redefault rates—75 percent and 40 percent, respectively—are accurate, and HAMP met Treasury's goal of making trial offers to 4 million borrowers, the program would only result in 1.2 million sustainable permanent modifications.

E. Foreclosure Mitigation Program Success

1. Treasury's Definition of "Success" and Program Goals

The MHA program's chief objective is to "help borrowers avoid foreclosure by modifying troubled loans to achieve a payment the borrower can afford."[186] Treasury estimates that HARP may reach up to four to five million eligible homeowners for loan refi-

[185] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).
[186] U.S. Department of the Treasury, *Borrower Frequently Asked Questions*__What is "Making Home Affordable" all about? (July 16, 2009) (online at www.financialstability.gov/docs/borrower__qa.pdf).

nancing.[187] Its goal for HAMP is to offer three to four million home owners lower mortgage payments through modifications through 2012.[188]

While the targeted number is clear, the meaning of the target itself has shifted over time. Treasury was initially elusive in stating whether the goal was three to four million permanent modifications (a substantial impact), three to four million trial modifications (a short-term solution), or three to four million trial modification offers (a relatively meaningless measure of program effectiveness, as a modification offer alone does nothing to prevent a foreclosure or promote affordability unless a trial commences). As noted earlier in Section C, the modification is for only a five-year period and not effectively a permanent modification over the entire life of the loan.

In his speech announcing the Making Home Affordable program, President Obama noted that the plan "will help between seven and nine million families restructure or refinance their mortgages so they can . . . avoid foreclosure," and of this amount "as many as three to four million homeowners [will be able] to modify the terms of their mortgages to avoid foreclosure."[189] On the same day as President Obama's speech, HUD Secretary Shaun Donovan also stated that "this modification plan does a number of things to make sure that up to 3 to 4 million families can stay in their homes and have affordable mortgages."[190] Thus, it can reasonably be inferred from these initial statements of the program's scope that the goal was to not just offer the potential for a mortgage modification but actually ensure that three to four million families remained in their homes through permanent modifications. In the latter half of the program's first year, however, Treasury finally clarified (or changed) the definition of its target as "allow[ing] 3 to 4 million families the chance to stay in their homes"[191] and began including the more defined target in its MHA Monthly Program Reports. Indeed, Treasury acknowledged the confusion around its target and the lack of precision in its own statements in a response to the most recent SIGTARP report.[192]

Seth Wheeler, Treasury senior advisor, testified before the Panel that the trial modification goal would mean a run rate of 20,000 to 25,000 trial modification starts per week.[193] Treasury's use of trial modification starts per week as a benchmark goal discounts

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[187] MHA Detailed Program Description, *supra* note 47.

[188] U.S. Department of the Treasury, *Making Home Affordable Program: Servicer Performance Report Through January 2010,* at 2 (Feb. 18, 2010) (online at www.financialstability.gov/docs/press/January%20Report%20FINAL%2002%2016%2010.pdf) (hereinafter "MHA Servicer Performance Through January 2010").

[189] The remaining four to five million were estimated to be helped through HARP. White House, *Remarks by the President on the Home Mortgage Crisis* (Feb. 18, 2009) (online at www.whitehouse.gov/the-press-office/remarks-president-mortgage-crisis).

[190] White House, *Press Briefing* (Feb. 18, 2009) (online at www.whitehouse.gov/the-press-office/press-briefing-with-treasury-secretary-geithner-hud-secretary-donovan-and-fdic-chai) (hereinafter "White House Press Briefing").

[191] Congressional Oversight Panel, Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *Transcript: COP Hearing with Treasury Secretary Timothy Geithner,* at 47–48 (Sept. 10, 2009) (hereinafter "September COP Hearing Transcript") (publication forthcoming).

[192] Factors Affecting Implementation of HAMP, *supra* note 25.

[193] Congressional Oversight Panel, Written Testimony of Seth Wheeler, senior advisor, U.S. Department of the Treasury, *Philadelphia Field Hearing on Mortgage Foreclosures,* at 3 (Sept. 24, 2009) (online at cop.senate.gov/documents/testimony-092409-wheeler.pdf) (hereinafter "Testimony of Seth Wheeler").

the importance of a trial modification's conversion to a permanent modification. Treasury and HUD recognize the importance of permanent mortgage modifications in ensuring long-term foreclosure prevention, as they announced a joint Mortgage Modification Conversion Drive in November 2009 to provide further assistance to homeowners navigating the paperwork required for conversion. At the time, Treasury noted that 375,000 of the borrowers in trial modification were scheduled to convert by year-end, but permanent modifications remained at a mere 66,465 through December 2009.[194]

As of the MHA Program update through February 2010, the number of active HAMP modifications is 835,194, with 168,708 of these being permanent modifications, more than double the December 2009 number but still below the conversion drive target.[195] In a recent interview, Secretary Geithner was asked explicitly if he considered the number of permanent modifications as of December 2009 to be a mark of program success, to which he avoided a clear answer and merely indicated the importance of noting the "substantial cash flow relief [being provided to] . . . more than three quarters of a million Americans."[196] Three quarters of a million Americans on a primarily trial basis, that is.

HAMP is providing many homeowners with cash flow relief, but if that relief is only temporary, then the potential for continued foreclosures remains high. Also, temporary modifications that fail to convert prevent homeowners from using the time to prepare themselves legally and financially for foreclosure, and they then owe the difference between the original payment amount and the reduced trial payment amount for their time in a trial modification.[197] The low conversion rates have been driven by misstated owner-occupied status and income, as borrowers may have overstated or understated income depending on their motives, and servicers were not required to obtain documentation until the permanent modification stage. Further, some borrowers may be deciding that foreclosure or other alternatives are better options than the permanent modification.

The Panel is also concerned with Treasury's presentation of MHA performance data. Previously, the performance data listed "permanent modifications;" however, Treasury's recent reports have combined "permanent modifications" with "pending permanent modifications" in the calculation or presentation of some data. Pending modifications should not be counted as if they are already permanent. If, as Treasury suggests, virtually all of the pending modifications will convert, then they should be reflected as "permanent modifications" only when the expected conversion occurs. If Treasury wishes to note the number of "pending permanent modifications," it should do so in a separate entry and not combine them with fully converted modifications, including in the calculation of

[194] Administration Kicks Off Modification Drive, *supra* note 13; U.S. Department of the Treasury, *Making Home Affordable Program: Servicer Performance Report Through December 2009,* at 3 (Jan. 19, 2010) (online at financialstability.gov/docs/report.pdf) (hereinafter "MHA Servicer Performance Through December 2009").

[195] Treasury mortgage market data provided to Panel staff (Mar. 23, 2010).

[196] *This Week with Jake Tapper* (ABC News television broadcast Feb. 7, 2010) (online at abcnews.go.com/ThisWeek/week-transcript-treasury-secretary-timothy-geithner/story?id=9758951).

[197] Factors Affecting Implementation of HAMP, *supra* note 25, at 15 fn 13.

related numbers, such as conversion rates. Similarly, Treasury should be more explicit in its presentation of "permanent modifications cancelled." The reports should explicitly state the number of modifications that have redefaulted and the number that have been paid off, rather than combining the two.

2. Ineligible Borrowers—What about the remaining delinquent loans?

In its most recent HAMP update report, Treasury noted that not all 60+ days delinquent loans qualify for modification under HAMP.[198] This raises the question of how a borrower becomes HAMP-eligible. To apply for a HAMP mortgage modification, a borrower must meet the following characteristics: be the owner-occupant of a one- to four-unit house, have an unpaid principal balance that is equal to or less than $729,750,[199] have a first-lien mortgage originated on or before January 1, 2009, have a monthly mortgage payment greater than 31 percent of monthly gross (pre-tax) income, and be able to document that the monthly mortgage payment lacks affordability due to financial hardship.[200] The loan also has to be delinquent, or default must be reasonably foreseeable.[201]

In recent testimony before the House Committee on Oversight and Government Reform's Domestic Policy Subcommittee, Phyllis R. Caldwell, chief of Treasury's Homeownership Preservation Office, noted that HAMP provides homeowners with the opportunity to stay in their homes and aids in community stability. In addressing those who do not meet HAMP eligibility, she stated:

> However, it will not reach the many borrowers who do not meet the eligibility criteria and was not designed to help every struggling homeowner. We unfortunately should expect millions of foreclosures that HAMP cannot prevent due to long-term unemployment, jumbo mortgages, and other factors, as President Obama made clear when he announced the program last February.[202]

As noted in Figure 26, below, Treasury's internal estimates reveal that of the 6.0 million borrowers who are currently 60+ days delinquent, only 1.8 million, or 30 percent of those in delinquency, are even eligible for HAMP.[203] The exclusions from HAMP participation are also noted in Figure 26. FHA and Veterans Affairs (VA) loans are excluded, as they have separate programs aimed at providing modification options to borrowers.[204] The non-owner occu-

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[198] MHA Servicer Performance Through February 2010, *supra* note 110, at 5.

[199] This unpaid principal balance relates to a one unit house. The balance limit increases with each additional unit. A two unit, three unit, and four unit house must have unpaid principal balances no more than $934,200; $1,129,250; and $1,403,400, respectively. Introduction of HAMP, *supra* note 21, at 3.

[200] U.S. Department of the Treasury, *Making Home Affordable Program, Borrower Frequently Asked Questions* (Mar. 9, 2010) (online at www.makinghomeaffordable.gov/borrower-faqs.html#19).

[201] Introduction of HAMP, *supra* note 21, at 2.

[202] Testimony of Phyllis Caldwell, *supra* note 14, at 6.

[203] MHA Servicer Performance Through February 2010, *supra* note 110.

[204] U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, *Press Release: HUD Secretary Donovan Announces New FHA–Making Home Affordable Loan Modification Guidelines* (July 28, 2009) (online at www.makinghomeaffordable.gov/pr__07302009.html); U.S. Department of Veterans Affairs, *VA HAMP Frequently Asked Questions* (Jan. 27, 2010) (online at www.homeloans.va.gov/docs/VA__HAMP__FAQ__for__Servicers.pdf).

pied home loan and vacant properties exclusions ensure that speculators or house flippers do not benefit from poor investing decisions.[205] Jumbo loans are excluded to prevent benefits going to wealthy homeowners, those who have enough home equity to refinance, or those who irresponsibly purchased more house than they could afford.[206] The exclusion of loans originated after January 1, 2009 is likely due to tighter underwriting standards in place at that time, and loans with negative NPV are excluded since servicers are not required to modify such loans.

FIGURE 26: HAMP INELIGIBLE 60+ DAYS DELINQUENT LOANS AS OF FEBRUARY 2010 [207]

First lien, 60+ days delinquent loans	6,000,000
Less: Non-participating HAMP servicer loans	(800,000)
Less: FHA or VA loans	(800,000)
Less: Non-owner occupied at loan origination	(800,000)
Total HAMP eligible 60+ days delinquent loans	3,600,000
Less: Jumbo non-conforming loans and loans originated after 1/1/2009	(200,000)
Less: DTI less than 31 percent	(800,000)
Less: Negative NPV	(400,000)
Less: Vacant properties and other exclusions	(400,000)
Total estimated HAMP eligible 60+ days delinquent loans	1,800,000

The exclusions for non-participating HAMP servicers and homeowners with DTI less than 31 percent are more questionable. Currently, there are 800,000 homeowners with delinquent loans unable to modify their loans through HAMP because their servicers are not participating in the program.[208] This number is nearly four times larger than the number of HAMP permanent modifications achieved to date. The voluntary nature of HAMP means that a large number of homeowners are unable to receive assistance because of the identity of their servicer. The identity of a borrower's servicer is completely out of the borrower's control; borrowers cannot select their servicer or bargain for the terms under which their loan is serviced. Treasury should encourage participation by all servicers or offer alternatives to borrowers with non-participating servicers.[209] HAMP excludes borrowers whose pre-modification front-end DTI is below 31 percent as well as borrowers who cannot lower their DTI to 31 percent without decreasing their NPV to less than what it would be in foreclosure. From the pre-modification perspective, DTI is assessed on a per loan basis; thus, if a borrower has multiple loans with DTI less than 31 percent, the borrower is ineligible for HAMP, even though the total mortgage debt burden is greater than the 31 percent threshold.[210] These two "disqualifiers" would allow for an additional 1.6 million eligible HAMP loans. If Treasury estimates that in its present state HAMP can assist a maximum of 1.8 million borrowers, then the basis for its cur-

[205] MHA Detailed Program Description, *supra* note 47, at 3.
[206] White House Press Briefing, *supra* note 190.
[207] MHA Servicer Performance Through February 2010, *supra* note 110.
[208] MHA Servicer Performance Through February 2010, *supra* note 110.
[209] For data on three mortgage modification programs established by servicers that chose not to participate in HAMP, *see* Annex V, *infra*.
[210] Testimony of Adam Levitin, *supra* note 83.

rent goal of three to four million trial modification offers becomes questionable.[211] Doubt then emerges as to the attainability of Treasury's goal, as the scope of borrowers even eligible is roughly half of the target.

3. Best Estimates for Program Reach

Treasury's stated target of offering 3 to 4 million trial modifications has spurred government agencies to formulate their own estimates for the number of homeowners who will actually receive permanent modifications and lasting assistance based on Treasury's estimates and their own assumptions. The Congressional Budget Office (CBO) and OMB have estimated that $22 billion and $49 billion, respectively, will be disbursed through HAMP to servicers for permanent modifications. CBO also estimates that each permanent modification will cost between $20,000 to $40,000. Thus, using CBO's estimate per permanent modification and both CBO's and OMB's total HAMP outlay estimates, the number of permanent modifications through HAMP will be approximately 550,000–1.1 million (CBO) and 1.22–2.45 million (OMB).[212] These estimates are less than the number of foreclosures in 2009 alone. With nearly two million foreclosure filings in 2008, 2.8 million in 2009, and the expectation for even more in 2010, the comparatively much smaller estimates for foreclosures prevented by HAMP becomes a central part of the discussion of HAMP's effectiveness.[213]

SIGTARP reported that a Treasury official has estimated a total of 3 million trial modifications will be initiated and between 1.5 and 2 million will become permanent modifications. If there are 3 million trial modification starts, of which 50 to 75 percent convert and 40 percent (trial and permanent) redefault, then potentially HAMP will produce only 900,000 to 1.2 million permanent modifications, which is not even half of the number of foreclosures in 2009 alone. SIGTARP noted the importance of using Treasury's current 1.5 to 2 million permanent modification estimate as a basis for program effectiveness.[214]

The Panel has also made estimates. Treasury's own internal assumptions are that 50 to 66 percent of trial modifications will convert to permanent status and 40 percent of all modifications will redefault within five years.[215] As stated above, using Treasury's own assumptions, as of February 2010 the Panel's best estimate for foreclosures prevented by HAMP is approximately 900,000 to 1.2 million, or 15 to 20 percent of the total population of 60+ day delinquencies. Assuming the current roll rate of 23 percent holds and redefaults of 60 percent—comparable to the levels seen in OCC/OTS statistics over five-year periods[216]—Treasury will prevent only

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[211] MHA Detailed Program Description, *supra* note 47.

[212] Congressional Budget Office, *Report on the Troubled Asset Relief Program—March 2010* (Mar. 2010) (online at www.cbo.gov/ftpdocs/112xx/doc11227/03-17-TARP.pdf). Panel Staff calculation of $49 billion and $22 billion divided by 20,000 and 40,000.

[213] Factors Affecting Implementation of HAMP, *supra* note 25.

[214] *Id.*

[215] Assistant Secretary Herbert Allison QFRs, *supra* note 178, at 26.

[216] Sixty percent represents the redefault rate for all modifications by OCC/OTS institutions. Although the most robust historical data are available for this combined metric, the eventual redefault rate within HAMP could prove to be lower or higher than this general number. Many of the modifications in the OCC/OTS calculation did not reduce payments. Data included in the Q4 2009 OCC/OTS report indicate that payment decreases are correlated with lower redefault rates. For loans with payment reductions, the redefault rate was 38.6 percent, with a redefault

276,000 foreclosures, or less than four percent of the total 60+ day delinquencies. The Panel is hopeful that the recently announced program expansions and initiatives will help expand MHA's reach. But as the array of estimates noted above on the number of permanent modifications likely to stem from HAMP shows, foreclosures prevented by HAMP will still likely be eclipsed by the number of actual foreclosures filed in any given year of the program's existence.

4. Short-term vs. Long-term Success

As mentioned above, Treasury's numerical targets focus on short-term results, which they are largely on track to achieve. However, short-term results do not necessarily guarantee long-term mortgage foreclosure mitigation success. Just as the target for trial modifications initiated per week and trial modifications offered reflect short-term successes, redefaults and low rates of conversion to permanent modification reveal short-term failures. To gauge accurately the long-term success of its foreclosure mitigation programs, Treasury must assess all available metrics, both short- and long-term, ultimately ensuring that taxpayer dollars spent produce sustainable changes.

As discussed in Section D, HAMP utilizes various cost sharing and incentive payments. The key factor in these payment streams and incentives is that the loan must convert from trial to permanent modification before funds are disbursed. Thus, trial modification offers that never reach active status and trial modifications that fail to convert to permanent status involve costs to only the borrower and lender—time and forgone original loan amounts in favor of preventing foreclosure. Redefaults, on the other hand, also involve direct costs to taxpayers, as TARP funds have already been expended once the modification has become permanent.

Redefault risk is the possibility that a borrower will still default despite initial mortgage modification.[217] Treasury has estimated the average initial redefault rate for HAMP-modified loans to be 40 percent and defines redefault as a loan being 90+ days past due at any point during the five-year life of the HAMP modification. Treasury utilized the 40 percent redefault estimate in its cost estimates for both trial and permanent modifications and for all five years of potential HAMP participation.[218]

For non-HAMP mortgages serviced by national banks and federally regulated thrifts, the average redefault rates were 36 percent, 45 percent, and 53 percent for redefault occurrences six months, nine months, and twelve months after modification, respectively.[219]

rate of 26 percent for loans with a payment decrease of ten percent or more. It should be noted, however, that these redefault rates only cover the first nine months of the loan modification. On the other hand, the OCC/OTS number may underestimate HAMP's eventual redefault rate, as the OCC/OTS calculation does not take into consideration sustained high unemployment and negative equity.

[217] Federal Reserve Bank of Boston, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization,* Public Policy Discussion Papers, No. 09–4, at 18 (July 6, 2009) (online at www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf).

[218] Assistant Secretary Herbert Allison QFRs, *supra* note 178, at 26.

[219] The OCC and OTS report covers approximately 65 percent of all mortgages outstanding in the United States at the time of publication. HAMP modification data will be included in future OCC and OTS Mortgage Metric Reports. OCC and OTS Mortgage Metrics Report—Q4 2009, *supra* note 82, at 32.

Treasury utilized a lower overall rate of 40 percent based on its belief that other modification programs did not result in payment reductions, whereas HAMP does.[220] While Treasury has pushed servicers to increase the number of trial modifications offered in order to meet the stated targets of the program, these efforts do little good if few reach permanent modification status, and for those that do, the projected redefault rate is such that nearly half could end up exactly where they started—facing foreclosure. As a result of redefaults, the final cost-per-permanent modification will be much higher than actual dollars spent on those modifications, as the funds spent on redefaulted loans will need to be included in total cash outlay.

As the HAMP results to date have shown, a sole focus on producing positive numbers for one metric hurts other data indicators of success. In the program's early stages, Treasury pushed for large numbers of trial modifications offered. While the trial offers and loans in trial modification jumped, the conversion rate suffered, as the bulk of time and energy was being spent on getting borrowers in the door but not on moving them to permanent status. Thus, in November 2009, Treasury and HUD kicked off a Mortgage Modification Conversion Drive aimed at improving the numbers for conversion from trial to permanent modification.[221] As noted above, conversion rates have improved in recent months. The push for conversions, though, will likely impact redefault rates in the future. If servicers and lenders have focused on conversion of all trials instead of conversion of those best prepared for long-term modification, it is possible and likely that some borrowers in permanent modification still do not have loan terms that can allow them to remain current on their monthly payments.

Treasury must ensure that its analysis of HAMP's effectiveness is not limited to one data point over another but incorporates an extensive analysis of all data—trial modifications, conversions, and redefaults. Short-term successes are only good when coupled with long-term sustainable results. Even if Treasury reaches its newly restated target of three to four million trial modifications offered, it will be for naught if conversion rates are not significant and redefault rates are too high, ultimately creating a foreclosure mitigation program that does not effectively mitigate foreclosures. Long-term success requires long-term changes to the mortgage burdens that homeowners in or near default currently face.

F. How Disincentives for Servicers and Investors Undermine HAMP

When borrowers lose their homes to foreclosure, they are not the only people who suffer. Neighbors see the values of their own homes decline. Local governments lose property tax revenue. And the investors who own these mortgages also take a large loss, in many cases equal to about half of their investment,[222] because

[220] Assistant Secretary Herbert Allison QFRs, *supra* note 178, at 26.

[221] Administration Kicks Off Modification Drive, *supra* note 13.

[222] Board of Governors of the Federal Reserve System, *Speech by Chairman Ben S. Bernanke at the Federal Reserve System Conference on Housing and Mortgage Markets: Housing, Mortgage Markets, and Foreclosures,* Washington, D.C. (Dec. 4, 2008) (online at www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm).

homes in foreclosure tend to sell for less money than would be generated either by a performing mortgage or from a pre-foreclosure sale.

HAMP was explicitly designed to ensure that modified loans provide a larger return to investors than a foreclosure sale would. Servicers participating in the program run a test, known as the NPV test, that determines whether the modification is economically advantageous to the investors. If it is not, the servicer is not required to modify the loan.[223] In addition to that test, HAMP provides various additional financial incentives to servicers and investors to provide loan modifications.[224] In short, HAMP offers incentives to do what should already be in the investors' financial interests. So the following question arises: why is HAMP not resulting in more loan modifications? It appears that in many cases the program's incentive structure is not sufficient to overcome other disincentives that are affecting the decisions made by servicers and investors. This section of the report discusses how those disincentives may be undermining HAMP's effectiveness.

1. Why Servicers may be Ambivalent about HAMP

Since HAMP began, housing counselors and borrowers have recounted stories of servicers losing their paperwork, lacking adequate staff, failing to tell borrowers why they are being denied, and in some cases failing to follow the program's rules.[225] Although this information is anecdotal, it has come with enough frequency and consistency to raise questions about whether servicers are fully committed to HAMP's success. As David Berenbaum, chief program officer of the National Community Reinvestment Corporation (NCRC), which provides housing counseling to at-risk borrowers, testified at a recent congressional hearing: "NCRC counselors observe that the haphazard quality of loan modifications reflects financial institution ambivalence about the HAMP program."[226]

There are several potential reasons why this may be. First, a servicer's financial interest in a defaulted loan is based on very different criteria than an investor's. The servicer is indifferent to the net present value of the loan; instead, the servicer is concerned with maximizing its revenue stream from the loan and minimizing its expenses on the loan. This means that residential mortgage servicing suffers from a severe principal-agent problem, particularly in the case of private-label securitization.[227] Residential mort-

[223] HAMP Guidelines, *supra* note 106, at 5.
[224] *Id.*, at 11–12.
[225] *See, e.g.,* Congressional Oversight Panel, Written Testimony of Philadelphia Legal Assistance Supervising Attorney, Consumer Housing Unit, Irwin Trauss, *Philadelphia Field Hearing on Mortgage Foreclosures* (Sept. 24, 2009) (online at cop.senate.gov/documents/testimony-092409-trauss.pdf); Congressional Oversight Panel, Written Testimony Deborah Goldberg, director, Hurricane Relief Project, National Fair Housing Alliance, *Philadelphia Field Hearing on Mortgage Foreclosures* (Sept. 24, 2009) (online at cop.senate.gov/documents/testimony-092409-goldberg.pdf) (hereinafter "Testimony of Deborah Goldberg"); Testimony of David Berenbaum, *supra* note 29, at 23.
[226] Testimony of David Berenbaum, *supra* note 29, at 23.
[227] Levitin & Twomey, *supra* note 78. *See also* National Consumer Law Center, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and Its Consequences* (Oct. 2009) (online at papers.ssrn.com/sol3/papers.cfm?abstract__id=1502744) (hereinafter "Puzzles of Servicer Behavior"). It should be noted that securitization can be done without this sort of principal-agent problem. For example, in commercial mortgage securitization (or CMBS structures), loans are transferred to a special

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gage servicer compensation structures fail to align servicers' incentives with investors'.[228] The incentive payments to servicers under HAMP are themselves an acknowledgment that servicers are not properly incentivized to perform modifications even when modifications would yield a positive net present value for investors.

In addition, as the Panel discussed in its October 2009 report, servicers may face impediments to loan modifications in the form of contractual barriers. Servicers of securitized loans operate under the terms of PSAs, which are contracts between the servicers and the investors.[229] These contracts contain provisions that may encourage servicers, working with the securitization trustee, to disqualify certain homeowners who would otherwise qualify for a HAMP modification. For example, although PSAs rarely prohibit loan modifications,[230] they typically restrict the servicer's ability to extend the term of a loan, usually to a maximum of one year.[231] Such a restriction might preclude HAMP modifications that would otherwise allow the borrowers to stay in their homes. In addition, PSAs often restrict the servicer's ability to grant principal reductions.[232] Under HAMP, servicers must make reasonable efforts to have such contractual restrictions revised, but the program otherwise defers to the PSAs' terms.[233] Treasury should make public information regarding servicers' efforts to have contractual restrictions revised.

Furthermore, second-lien mortgages are sometimes held by the same institution that is acting as servicer for the first-lien loan. It is unknown how frequently this is the case; many second-lien loans might be held by a bank other than the servicer of the first-lien loan. But when a servicer both services the first lien and holds the second lien, and the first lien defaults, there is an inexorable conflict of interest, as the same financial institution is representing two adverse interests, one of which is its own. In such a situation, however, the conflict of interest is actually more likely to result in a modification of the first-lien loan, as it benefits the bank at the expense of the mortgage-backed security investors.[234]

To the extent that servicer conflicts of interest are inhibiting mortgage modifications, it is important to note that there is little supervisory structure for servicers. Servicers are nominally supervised by securitization trustees, but securitization trustees have little ability or incentive to intervene. The securitization trustee has no way of knowing whether a servicer also holds a second lien on a property it is servicing. Accordingly, there is no way a securitization trustee can monitor servicers for conflicts of interest,

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servicer if they go 60 days delinquent, and the default servicer's compensation is based on the ultimate recovery of the defaulted loan. Thus, if the default servicer can get the loan to reperform, it will be worth more than if it redefaults. *See* Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities,* 82 S. Cal. L. Rev. (2010).

[228] Servicers usually have some "skin in the game" through their relationship as an affiliate of the securitization sponsor. In these cases, the servicers have liability for early payment defaults and the residual tranche. The residual, however, is often resecuritized, and when the defaults surpass a minimum level, the residual will be out of the money and will not align servicer and investor incentives.

[229] *See* October Oversight Report, *supra* note 17.

[230] Testimony of Adam Levitin, *supra* note 83, at 10.

[231] October Oversight Report, *supra* note 17.

[232] Testimony of Adam Levitin, *supra* note 83, at 10.

[233] HAMP Guidelines, *supra* note 106.

[234] Levitin & Twomey, *supra* note 78.

and even if the trustee could, the trustee has little ability to fire a servicer over a conflict of interest; at most, the trustee could bring litigation against the servicer, but would have to front the expenses of the litigation for the trust and would receive no benefit from doing so.[235]

Securitization trustees are large corporate trust departments at a handful of financial institutions. They have very limited duties prescribed by contract, and they do not have general fiduciary duties to mortgage-backed securities (MBS) investors. Moreover, securitization trustees often have close, long-standing business relationships with particular servicers and securitization sponsors. Securitization trustees might, therefore, be reluctant to jeopardize these relationships by aggressively monitoring servicer behavior. There is only downside to a securitization trustee for bringing action against a servicer, not upside. Thus, servicers are largely left to their own devices in dealing with conflicts of interest.[236]

Finally, outside parties such as credit rating agencies and bond insurers may provide servicers with additional disincentives to modify mortgages. Credit rating agencies rate mortgage servicers, as they do other financial institutions, based on a variety of factors, including their financial condition and their management.[237] These ratings can impact a servicer's profitability. If the servicer's ratings fall, it will have to pay a higher price for mortgage servicing rights. As a result, servicers have a strong incentive to follow the performance criteria established by the credit rating agencies. The National Consumer Law Center has concluded that while the credit rating agencies have generally been supportive of more loan modifications, they also encourage servicers to move loans quickly through the foreclosure process.[238] This may explain why borrowers have frequently reported receiving foreclosure notices in the midst of the modification process,[239] even though HAMP prohibits foreclosure sales while borrowers are being evaluated for modifications.[240] Bond insurers, which stand to lose money when securitized mortgages stop paying, may also have influence over servicers. Their interventions can lead servicers to make decisions regarding modifications that might not otherwise be in their own financial interests.[241]

2. Accounting Rules Provide Investors a Disincentive to Modify Loans

Because of the accounting treatment of loan modifications, investors may also have cause to be ambivalent about HAMP. Under generally accepted accounting principles (GAAP), once the terms of a loan are contractually modified, the modified loan is accounted for as a "troubled debt restructuring." A troubled debt restructuring occurs when the terms of a loan have been modified due to the borrower's financial difficulties, and a long-term concession has

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[235] *Id.*
[236] *Id.*
[237] *See* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, at 764, 15 Housing Policy Debate (2004) (online at www.msfraud.org/Articles/abuseopportunism.pdf).
[238] Puzzles of Servicer Behavior, *supra* note 227, at 2.
[239] Testimony of David Berenbaum, *supra* note 29, at 19.
[240] Testimony of Phyllis Caldwell, *supra* note 14, at 11.
[241] For a more detailed discussion of the role played by bond insurers, *see* Puzzles of Servicer Behavior, *supra* note 227, at 15–16.

been granted to the borrower. Examples of such concessions include interest rate reductions, principal forbearance, principal forgiveness, and term extensions, all of which may be used to modify loans in HAMP.[242] Under GAAP, a loss is to be recognized if the difference in cash flows to be received under the modified loan is less than the cash flows of the original loan.[243] In addition, the loss is required to be recognized at the time the loan is contractually modified as opposed to being recognized over the term of the loan. The accounting for loans that are not accounted for as troubled debt restructurings is generally less severe, since under those circumstances GAAP provides an entity more discretion to determine when a loan should be written off.[244]

Depository institutions that own mortgages are generally reluctant to take write-downs because doing so requires them to boost their regulatory capital ratios, which hurts both their ability to make new loans and their profitability. That is particularly true today, since banks' capital structures have already been weakened by a variety of factors, including write-downs already taken on residential and commercial real estate loans, losses taken on other loans due to the recession, and recent actions by Fannie Mae and Freddie Mac to require banks to buy back mortgages that the banks had previously sold to them.[245]

Accounting issues are not exclusive to first liens. There have been calls for the holders of second-lien loans to write off those loans, at least to the extent they are underwater.[246] Such calls may mistakenly presume that the entire value of an underwater second-

[242] *See* Accounting Standard Codification (ASC) 310–40–15, *Troubled Debt Restructurings by Creditors* (formerly Statement of Financial Standards (SFAS) 15) (online at asc.fasb.org/section&trid=2196900%26analyticsAssetName=subtopic__page__section%26nav__type=subtopic page). ASC 310–40–15–5 states that a loan the terms of which have been modified is a troubled debt restructuring "if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider."

[243] By nature of the modified terms of the loan under HAMP, (i.e., reduction of interest to be received and/or principal forbearance or forgiveness) the entity's future cash flows to be received will be less than the current loan payoff amount. *See* ASC 310-10-35, *Receivables—Measurement of Impairment* (formerly SFAS 114). ASC 310-10-35-24 states that "[i]f the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense." (online at asc.fasb.org/section&trid=2196791%26analyticsAssetName=subtopic__page__section%26nav__type=subtopic__page).

[244] Except if the loan is classified as troubled debt restructuring, the accounting for loan losses for residential mortgage loans is provided by ASC 450–20–25, Contingencies-Loss Contingencies (formerly SFAS 5). An estimated loss from a loss contingency shall be accrued by a charge to income *if both* of the following conditions are met (emphasis added):

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- The amount of loss can be reasonably estimated. In addition, banking regulatory guidelines have instituted an initial loan review whereby loans are classified as either special mention, substandard, doubtful or loss. If the loan is 180 cumulative days past due, the loan should be classified as a loss and the loan balance is either charged off or a reserve is established equal to 100% of the loan balance (with a corresponding charge to bad debt expense). *See, e.g.,* Federal Deposit Insurance Corporation, *Uniform Retail Credit Classification and Account Management Policy* (Dec. 3, 2009) (online at www.fdic.gov/regulations/laws/rules/5000-1000.html).

[245] Agreements between banks and government-sponsored enterprises such as Fannie Mae and Freddie Mac include provisions that require the banks to buy back mortgages that do not meet Fannie Mae's and Freddie Mac's underwriting standards.

[246] *See* Letter from Rep. Barney Frank, *supra* note 41.

lien loan is its hold-up value—the value that could be extracted from homeowners or first-lien holders by being able to block a refinancing of the first-lien mortgage. There is additional value, however, beyond hold-up value, to the extent that the loan is still performing—a realistic possibility, especially for Home Equity Lines of Credit (HELOCs), where balances are simply allowed to accrue. If the lien were to be discharged in a foreclosure sale, and the debt charged off for regulatory accounting purposes, the bank would still hold an enforceable unsecured debt. The market value of such debt is far less than face value, but to the extent the debt were sold or recovered, it would represent a recovery on charged-off debt.

There is tension between Treasury's goals of mitigating foreclosures and Treasury's goal of maintaining adequate capital levels at large banks. Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo have all signed up for the Second Lien Modification Program. Combined, as of the third quarter in 2009, these four banks held $442.1 billion in second-lien mortgages. At the end of that same quarter, these four banks' total equity capital was $459.1 billion.[247]

3. Servicers and Investors may be Waiting for a Better Offer from the Government

One additional disincentive, which may affect the actions of both servicers and investors, involves the possibility that the government will offer them a better deal at some point in the future. When HAMP was first announced in February and March 2009, it referenced but included little specificity about plans to modify second liens, to modify loans in geographic areas where home prices have fallen precipitously, and to encourage alternatives to foreclosure in cases where modifications are infeasible.[248] Additional incentive payments were announced later.[249]

Given this history, it was not unreasonable for the mortgage industry to wonder whether Treasury would again offer a better deal at some point in the future. As Mr. Berenbaum of the National Community Reinvestment Coalition testified at a recent congressional hearing, "Some institutions may be going through the motions and not seeking permanent modifications in which they have to make significant financial sacrifices because they may be waiting for additional government subsidies or even outright purchases of their distressed loans."[250] About a month after those comments, Treasury announced in late March that participating servicers and investors will be eligible to receive numerous additional incentive payments,[251] and they will be paid retroactively.[252] Such changes could inadvertently bolster the perception that a better offer may again be forthcoming, although to be fair it is probably impossible for Treasury to avoid this perception as long as it is taking actions aimed at preventing more foreclosures. Treasury must be mindful

[247] Federal Deposit Insurance Corporation, Statistics of Depository Institutions (online at www2.fdic.gov/sdi/). This figure is based on reporting by the banks, not their holding companies, and therefore may not include all second liens held by affiliates.
[248] MHA Detailed Program Description, *supra* note 47.
[249] Apr. 2009 MHA Update, *supra* note 33; Foreclosure Alternatives and Home Price Decline Protection Incentives, *supra* note 116.
[250] Testimony of David Berenbaum, *supra* note 29, at 23.
[251] MHA Enhancements to Offer More, *supra* note 59.
[252] Treasury conversation with Panel staff (Mar. 26, 2010).

of this tension as it moves forward in implementing the recently announced changes.

G. Treasury Progress on Key Recommendations from the October Report

The Panel has been examining various issues of the foreclosure crisis and the adequacy of Treasury's responses to these issues for the last year. Foreclosures started rising in July 2007, and by the end of 2008, 1.24 million homes had been lost to foreclosure, and 3.28 million more foreclosures had started.[253] Treasury announced its first major foreclosure mitigation initiative—the Homeowner Affordability and Stability Plan—in February 2009. Since then, the foreclosure problem has continued to grow. In response, Treasury has introduced or expanded six major MHA programs (HAMP, 2MP, HPDP, HAFA, Hardest Hit Fund, and the FHA refinance option) and released 13 new supplemental directives or additional MHA program guidelines as well as two revised supplemental directives. These additional programs and guidelines have helped moderate certain aspects of the foreclosure crisis, but Treasurys response to the overall problem has not kept pace with the growing number of foreclosures, and more importantly, significant issues remain.

The Panel explained in its October report that the key problems of the MHA programs related to scope, scale, and permanence. The Panel then provided a list of specific recommendations for addressing these problems: transparency, streamlining the process, program enhancements, and accountability.[254] This section will review the Panel's key recommendations from the October report, new programs and changes to existing programs that Treasury has implemented in the last six months related to these key recommendations, and the extent to which these changes address the Panel's key findings and recommendations. Overall, although Treasury has made some progress in addressing the Panel's concerns, additional changes are needed in order to address the foreclosure crisis in a sufficient, comprehensive way. However, the Panel notes that many of Treasury's new programs and program changes are still in the process of being implemented or are in their early stages. The Panel will continue to monitor these programs as data become available in order to evaluate the effectiveness of the MHA.

1. Transparency

Panel Recommended. In October, the Panel reported evidence of eligible borrowers being denied HAMP modifications incorrectly, misinterpretations of program guidelines, and difficulties encountered by borrowers and their counselors in understanding the NPV models as well as the reasons that HAMP applications were being denied. As a result, the Panel made several recommendations related to the transparency of the MHA programs in order to promote fairness and clarity. The details of the programs should be com-

[253] *See* HOPE NOW, *1.77 Million Homeowners Receive Mortgage Loan Workout Solutions According to the HOPE NOW Alliance,* at 4 (Sept. 1, 2009) (online at www.hopenow.com/press_release/files/July%20Data%20Release_Final.pdf) (providing numbers of foreclosure starts and foreclosure sales that include Q3 2007 through Q4 2008).

[254] October Oversight Report, *supra* note 17, at 111–12.

pletely above board both internally and externally so that servicers, borrowers, and housing counselors understand their roles or responsibilities within the program and so that the public, Congress, and oversight bodies can meaningfully evaluate the structure, effectiveness, and success of the MHA programs.

The Panel recommended that Treasury should be more transparent by disclosing denial codes, providing additional information on the appeals process for loan modification denials, and releasing its NPV model so that borrowers and their housing counselors can easily determine if the borrowers were eligible for HAMP modifications and can appeal if they believe the borrowers were denied incorrectly. Information on program eligibility, denials, and the appeals process should be clear, meaningful, easily understood, and communicated in a timely manner.[255]

Treasury Action Since October. In September, Treasury released denial codes or "Not Approved/Not Accepted Reason Codes," which servicers must provide to Fannie Mae, as Treasury's program administrator, for each mortgage loan evaluated for HAMP that did not enter a trial period, fell out of a HAMP trial, or did not result in a permanent HAMP modification on or after December 1, 2009.[256] In November, Treasury further clarified that whenever servicers are required to provide denial codes to Fannie Mae, servicers must also provide written notification to borrowers of the reasoning for their program eligibility determinations (sending the notice within 10 business days of making their decision), effective January 1, 2010.[257] Treasury noted that explanations should relate to one or more of the denial codes and must be written in clear, non-technical language, and it included model clauses for various denial codes as examples.[258] When a borrower is denied because the NPV calculation is negative, the servicer must include a list of certain input fields that were considered in the NPV decision and must explain that the borrower can request the values used to populate these NPV fields. However, Treasury did not provide additional guidance on the appeals process available to borrowers that were ultimately denied HAMP modifications. And, although Treasury has planned to release an augmented version of its NPV calculator for housing counselor use only—the Counselor HAMP Screen or CHAMPS—it is unclear when or whether such release will occur. Treasury explained that the current version of CHAMPS had a high rate of false positives and false negatives because of the sensitivity of the model to certain inputs such as LTV (a value which will likely be different for the borrower and the servicer and that can lead to dramatically different results) so that it has trepidation

[255] October Oversight Report, *supra* note 17, at 47, 62–63, 111. The Panel noted that this recommendation applied equally to HARP.

[256] U.S. Department of the Treasury, *Home Affordable Modification Program—Data Collection and Reporting Requirements Guidance,* Supplemental Directive 09–06, at 2, 14–15 (Sept. 11, 2009) (online at www.hmpadmin.com/portal/docs/hamp_servicer/sd0906.pdf).

[257] HAMP Borrower Notices, *supra* note 5, at 2. *See also* Introduction of Home Affordable Foreclosure Alternatives, *supra* note 118, at 5 (requiring servicers to provide written communication of its decision not to offer a HAFA short sale or deed-in-lieu of foreclosure in accordance with the guidelines in Supplemental Directive 09–08); HAMP—Update and Resolution of Active Trial Modifications, *supra* note 20, at 5 (requiring servicers to provide written communication of its ineligibility decision in accordance with the guidelines in Supplemental Directive 09–08 and to provide Incomplete Information Notices with a specific date by which the information must be received from the borrower that is not less than 30 days from the date of the notice).

[258] HAMP Borrower Notices, supra note 5, at 2–4.

around providing the model and has not reached a firm conclusion on whether it will ultimately release CHAMPS.[259]

Evaluation. Treasury has made significant progress in establishing guidelines for written communications from servicers to borrowers of the reasons for ineligibility determinations including denials of HAMP trial periods, HAMP permanent modifications, and HAFA short sales or deeds-in-lieu of foreclosure. Servicers are directed to send these borrower notices within 10 business days of the date of their determinations, making these notices timely. Treasury also explained that these notices must be written in clear, non-technical language and provide examples or model clauses that are straightforward and easy to understand. These guidelines should bring greater clarity to the reasons for servicer denials of HAMP trial periods or permanent modifications or HAFA short sales or deeds-in-lieu of foreclosure. However, the denial code and borrower notice guidelines are still in the process of being implemented. Although the denial codes were released in September 2009 and the borrower notice guidelines were released in November 2009 and were effective January 1, 2010, Treasury told the Panel that servicer reporting of denial codes was only beginning to happen. In February 2010, Treasury reiterated to servicers the need to report denial codes, and it expects to have the numbers in the next few months.[260] In addition, it is unclear whether borrowers have actually been receiving borrower notices in a timely manner or whether the denial codes have been useful or sufficient in addressing fairness concerns; have provided greater understanding to borrowers; or have resulted in a simpler, more straightforward, or more efficient appeals process. It is important for Treasury, either directly or through its program contractors (Fannie Mae as program agent and Freddie Mac as compliance agent), to monitor the activities of the program participants, audit them, and enforce program rules, guidelines, and requirements.[261] Only when the rules are enforced in a thorough and even-handed manner will the transparency that the structure of the MHA programs attempts to achieve come to fruition. The Panel will continue to monitor these program updates as additional information becomes available.

Regarding the net present value model, the Panel applauds Treasury's efforts to rigorously test the augmented version of its NPV calculator and agrees with Treasury's assessment that it should not release a model that results in misleading false positives and false negatives. However, the Panel continues to believe that borrowers and counselors should have access to an accurate version of the NPV model and is hopeful that Treasury redoubles its efforts to make such access possible in the near future. Also, although Treasury has released a white paper related to its base net present value model,[262] borrowers and housing counselors still only have limited access to the inputs used by servicers (who only have to release certain inputs) and have very little insight into

[259] Treasury conference call with Panel staff (Mar. 24, 2010).
[260] *Id.*
[261] For additional discussion of accountability and program compliance, see Section G.4.
[262] *See* U.S. Department of the Treasury, *Home Affordable Modification Program: Base Net Present Value (NPV) Model v3.0 Model Documentation* (Dec. 8, 2009) (online at www.hmpadmin.com/portal/docs/hamp_servicer/npvmodeldocumentationv3.pdf).

how material these inputs are or whether corrections to any inaccurate values are likely to change the outcome of the NPV calculation (servicers only have to re-run NPV calculations if the correction is material).[263] Thus, Treasury has not made meaningful progress in addressing the Panel's concern about the secrecy around the NPV model.

2. Streamlining the Process

Panel Recommended. In October, the Panel found significant variation among servicers in terms of program implementation, performance, borrower experience, and the numbers of successful trial and permanent modifications. As a result, the Panel recommended that Treasury should standardize and streamline the loan modification process to ensure uniformity as well as to enhance the effectiveness of its programs. Greater uniformity will help ease frustration for borrowers, housing counselors, and lenders/servicers. In addition, standardization will remedy different forms and procedures from lender to lender, facilitate borrower education, enhance the effectiveness of housing counselors, and promote program efficiency (e.g., by increasing the likelihood or timeliness of mortgage modifications).[264]

Treasury Action Since October. Treasury has issued several supplemental directives related to streamlining and standardizing income documentation that make it easier for borrowers to compile documentation packages, for borrowers to understand the HAMP modification process, and for servicers to process HAMP applications. In October, Treasury updated borrower underwriting requirements and introduced revised model documentation (e.g., a standard MHA Request for Modification and Affidavit form), effective March 1, 2010.[265] In November, Treasury standardized the amount of information that must be communicated in writing to borrowers whenever servicers made HAMP eligibility decisions, effective January 1, 2010.[266] In January 2010, Treasury made a significant program change requiring full verification of borrower eligibility prior to the offer of any HAMP Trial Period Plan with an effective date on or after June 1, 2010 (servicers can currently offer HAMP Trial Periods to borrowers based on stated or verified income).[267] And,

[263] HAMP Borrower Notices, *supra* note 5, at 3; *see also* Testimony of David Berenbaum, *supra* note 29, at 24, 29 (voicing continued frustration with the opacity of the NPV analysis and stating that the Administration should establish rules for a fair appeals process); House Oversight and Government Reform, Subcommittee on Domestic Policy, Written Testimony of Julia Gordon, senior policy counsel, Center for Responsible Lending, *Foreclosures Continue: What Needs to Change in the Government Response?,* at 12, 15 (Feb. 25, 2010) (online at oversight.house.gov/images/stories/Hearings/Domestic_Policy/2010/022510_Foreclosure/022410_Gordon_COGR_testimony_022510_final.pdf) (hereinafter "Testimony of Julia Gordon") (stating that Treasury needs to provide homeowners and their advocates access to the NPV analysis and an independent, formal appeals process for those that believe their HAMP applications were not handled correctly); State Foreclosure Prevention Working Group, *Analysis of Mortgage Servicing Performance: Data Report No. 4,* at 4 (Jan. 2010) (online at www.csbs.org/Content/NavigationMenu/Home/SFPWGReport4Jan202010FINAL.pdf) (hereinafter "State Foreclosure Prevention Working Group: Data Report No. 4").

[264] *See* October Oversight Report, *supra* note 17, at 63–64, 111.

[265] *See* U.S. Department of the Treasury, *Home Affordable Modification Program—Streamlined Borrower Evaluation Process,* Supplemental Directive 09–07 (Oct. 8, 2009) (online at www.hmpadmin.com/portal/docs/hamp_servicer/sd0907.pdf).

[266] *See* HAMP Borrower Notices, *supra* note 5.

[267] *See* HAMP—Update and Resolution of Active Trial Modifications, *supra* note 20; *see also* Testimony of Phyllis Caldwell, *supra* note 14, at 3 (providing that greater upfront documentation will ensure that HAMP does not experience a backlog of trial modifications going forward).

in March 2010, Treasury provided additional guidance on borrower outreach and communication (e.g., clarifying the requirement for servicers to proactively solicit all borrowers that are potentially eligible for HAMP prior to initiating foreclosure actions, defining reasonable solicitation efforts for servicers, providing a timeframe for borrowers to return the necessary HAMP documentation, explaining servicers' responsibilities for borrowers already in foreclosure, and requiring servicers to consider borrowers in bankruptcy for HAMP if the borrower requests such consideration) with an effective date of June 1, 2010.[268]

Evaluation. Treasury has taken several steps to streamline the HAMP modification process and bring greater uniformity and standardization to the MHA programs. Treasury has standardized several HAMP requirements by providing model documentation and model clauses for borrowers and servicers, clarifying underwriting requirements for servicers including several clear examples of acceptable forms of income verification, clarifying responsibilities and timelines for borrowers and servicers, and defining ambiguous terms such as "reasonable solicitation efforts." In addition, Treasury's recent announcement requiring servicers to verify income before offering borrowers trial plans with effective dates on or after June 1, 2010 should improve the process by reducing the backlog of HAMP trial periods awaiting permanent modification, increasing the conversion rate, and reducing false expectations for borrowers.[269] However, it is unclear whether borrowers are benefiting from these program changes at this time.

In attempting to streamline its process and increase the number of borrowers being assisted, Treasury should be cognizant that the potential exists for the program to end up propping up bad loans to unqualified borrowers, who will ultimately redefault. Although the Panel does not believe this is currently the case, it does believe that the problems that created the current housing problems should not be repeated in the name of foreclosure prevention. However, Treasury must also balance this caution with the need to design foreclosure prevention programs that will actually be used by servicers, lenders, and borrowers, and that reflect the circumstances these groups face. Whether or not Treasury is able to strike this balance of effectiveness and fiscal prudence will greatly determine the success or failure of HAMP.

Some housing counselors note continued frustration and problems regarding the HAMP program: Foreclosure proceedings do not always stop during the modification process, communication is difficult, servicers continue to lose information, transitions from trial periods to permanent modifications have been slow, the quality of loan modifications have been haphazard, the NPV analysis is still not transparent, and denials appear to be arbitrary and hamper appeals.[270] Many of these programs are still in the process of being

[268] Supplemental Directive 10–02, *supra* note 48.
[269] HAMP—Update and Resolution of Active Trial Modifications, *supra* note 20.
[270] Testimony of David Berenbaum, *supra* note 29, at 19, 21–24, 28–29 ; *see also* State Foreclosure Prevention Working Group: Data Report No. 4, *supra* note 263, at 4 (noting that Treasury's new HAMP requirements were added to an already overloaded system; the secrecy of the NPV model makes it difficult for homeowners, counselors, and states to evaluate the likelihood of HAMP eligibility and to monitor implementation; and homeowners still need access to a real-time escalation and appeals process).

implemented or are in their early stages and should address some of the continued borrower concerns or complaints in the next several months. It should be noted that repeated changes to program guidelines can place implementation burdens on servicers.[271] Treasury must monitor and audit the activity of program participants, and it must ensure compliance with new programs, rules, and requirements.[272] The issues that these program changes were designed to target will not be addressed, adequately or at all, if the new rules are not followed. The Panel will continue to monitor these program changes as additional results become available.

3. Program Enhancements

Panel Recommended. The Panel noted several specific areas of concern in its October report related to meeting affordability goals and reaching a larger number of at-risk borrowers. The Panel suggested that Treasury should consider specific program improvements or modifications such as incorporating more local information into its NPV models (where reliance on statewide average would be inappropriate), modifying DTI eligibility requirements to accommodate more borrowers (i.e., borrowers that would be above the 31 percent DTI eligibility threshold when including modified capitalized arrearages), and appointing ombudsmen or designating case staff to help borrowers communicate more effectively with servicers.[273] The Panel also suggested the development of a web portal to improve borrower-servicer communication in both its March and October reports.[274]

Treasury Action Since October. Treasury does not appear to have made any program changes related to incorporating more local information into NPV calculations or allowing DTI flexibility with arrearages.[275] The current NPV calculation remains unchanged. And, Treasury has decided to peg the DTI at 31 percent over the next five years, without flexibility for modified capitalized arrearages. However, Treasury has made a program change to accommodate more at-risk borrowers by modifying DTI flexibility in order to assist more unemployed homeowners that will be implemented "in the coming months." [276]

In addition, Treasury has made some progress in facilitating communications between borrowers and servicers. In November 2009, Treasury released guidelines requiring servicers to provide a written notification to every borrower explaining its determinations regarding HAMP program eligibility (e.g., its decision not to offer a Trial Period Plan, its decision not to offer a permanent HAMP modification, or the risk to the borrower of losing eligibility), effective January 1, 2010.[277] These notices must include both "a toll-free number through which the borrower can reach a servicer representative capable of providing specific details about the . . . reasons for a non-approval determination" and the HOPE Hotline

[271] *See, e.g.,* Factors Affecting Implementation of HAMP, *supra* note 25, at 21–24.
[272] For additional discussion of accountability and program compliance, see Section G.4.
[273] October Oversight Report, *supra* note 17, at 6, 55, 111–12.
[274] *See* October Oversight Report, *supra* note 17, at 6, 111. Such a web portal would also help streamline and unify the loan modification process.
[275] Testimony of Phyllis Caldwell, *supra* note 14, at 1 ("HAMP defines a standard for an affordable and sustainable modification across the industry, set at 31% of gross monthly income").
[276] MHA Enhancements to Offer More, *supra* note 59, at 1.
[277] HAMP Borrower Notices, *supra* note 5, at 1.

Number so that the borrower knows how to reach a HUD-approved housing counselor for assistance at no charge.[278] The Making Home Affordable website also clearly says that borrowers can speak with HUD-approved housing counselors at no cost when they need help with the Making Home Affordable program.[279]

At the Panel's Philadelphia Field Hearing in September 2009, Mr. Wheeler testified that Treasury planned to work with servicers and Fannie Mae to develop a web portal that would "serve as a centralized point for modification and applications" and allow "borrowers to check the status of their applications."[280] In March 2010, Treasury stated that it had not released and was still considering whether it should release such a web portal. Treasury cited the availability of other solutions to the lost document problems such as increased servicer capacity or private market programs as reasons that a web portal might not be necessary.[281] For example, Phyllis Caldwell, chief of Treasury's Homeowner Preservation Office, testified before the House Committee on Oversight and Government Reform that HUD-approved housing counselors would be able to take advantage of HOPE NOW's new web portal—the HOPE LoanPort—"to help borrowers collect the necessary HAMP documents, upload the completed package directly to servicers and track the status of a borrower's application."[282]

Evaluation. Treasury still needs to address the Panel's recommendation to include more appropriate information in NPV calculations (and thus, more proper determinations of HAMP eligibility). Treasury has made some progress in reaching more at-risk borrowers through its assistance to unemployed homeowners, but Treasury could accommodate even more at-risk borrowers by allowing more flexibility in its DTI requirements (i.e., by considering modified capitalized arrearages).[283] In addition, Treasury has made some progress in facilitating communications between borrowers and servicers and in helping borrowers understand the reasons their HAMP applications have been denied. However, it is unclear whether borrowers are receiving Borrower Notices or how many people are following up on the additional information in the Borrower Notices by contacting either the servicers directly through the toll-free number provided or HUD-approved housing counselors through the HOPE Hotline for explanations or assistance in communicating with servicers. It is also unclear whether the HUD-ap-

[278] Id., at 4.

[279] U.S. Department of the Treasury, *MakingHomeAffordable.gov: Help for American's Homeowners* (online at makinghomeaffordable.gov) (accessed April 13, 2010) (hereinafter "MHA Website").

[280] Testimony of Seth Wheeler, *supra* note 193, at 6.

[281] Treasury conference call with Panel staff (Mar. 24, 2010).

[282] Testimony of Phyllis Caldwell, *supra* note 14, at 12. HOPE NOW launched its web portal—HOPE LoanPort—in December 2010 and announced the expansion of the web portal to over 100 key markets in February 2010. *See* HOPE NOW, *HOPE NOW Expanding HOPE LoanPort Housing Counselor Web Portal To Over 100 Key Markets* (Feb. 24, 2010) (online at www.hopenow.com/press__release/files/HOPE%20LoanPort%20Release__02__24__10.pdf); HOPE NOW, *HOPE NOW Launches the HOPE LoanPort To Assist At-Risk Homeowners* (Dec. 10, 2010) (online at www.hopenow.com/press__release/files/HOPE%20%20LoanPort%20National%20Release%20__12__10__09.pdf). HOPE NOW is an industry-created alliance between housing counselors, mortgage companies, investors, and other mortgage market participants.

[283] For additional discussion of the problems of unemployment and the temporary assistance to unemployed homeowners, see Section C(1)g.

proved housing counselors have sufficient capacity or adequate training to properly handle borrower requests for assistance.

Some housing counselors say that the special counselor hotline and institutional reforms such as the HAMP escalation process "have not been effective."[284] These housing counselors claim that communication with servicers is difficult. For example, counselors are only able to talk with servicers' customer service representatives that often have erroneous information regarding the loan or are unable to properly convey the details of the conversation or the complexities of the loan modifications to the negotiators who have underwriting discretion and can modify the loan. In addition, many financial institutions are selling distressed loans after modifications have started, further complicating counselors' efforts.[285]

In addition, as noted above, Treasury has not yet released and is still considering whether it should release a web portal to enhance borrower-servicer communication because of the availability of private market programs as well as increased servicer capacity. It is unclear, however, whether solutions such as the HOPE LoanPort are sufficient to address the numerous complaints from borrowers and servicers about documents not being submitted or documents being lost, misplaced, or mishandled. It is also unclear how servicers have sufficient capacity to prevent problems with lost documentation, slow conversions, or slow response times considering the backlog of HAMP trial period plans awaiting conversion to permanent modifications and continued complaints with servicer competence and capacity.[286] Treasury has acknowledged these problems and the need for a solution, and Treasury's plan to develop a web portal provided a viable solution.[287] Treasury has been working toward this goal since at least September 2009, and the Panel hopes that Treasury continues its efforts to develop and release a web portal to enhance the modification process.

Overall, despite making some progress in facilitating borrower-servicer communication, even Treasury officials admit that they "need to do more" and that they "continue to work with servicers to improve their capacity to both evaluate eligible borrowers and provide conversion decisions in a timely manner."[288] As part of its continued efforts to improve borrower-servicer communications, Treasury should monitor and audit participating servicers to ensure that they are complying with the Borrower Notice rules that became effective on January 1, 2010. The structure that Treasury has implemented will not be able to facilitate borrower-servicer communications or address the concerns, or improve the experi-

[284] Testimony of David Berenbaum, *supra* note 29, at 22.

[285] Testimony of David Berenbaum, *supra* note 29, at 21–22.

[286] House Oversight and Government Reform, Subcommittee on Domestic Policy, Written Testimony of Ronald M. Faris, president, Ocwen Financial Corporation, *Foreclosures Continue: What Needs to Change in the Administration's Response?*, at 2 (Feb. 25, 2010) (online at oversight.house.gov/ images/stories/Hearings/Domestic_Policy/2010/022510_Foreclosure/022210_DP___Ronald_M._Faris_OCWEN_022510.pdf) (reasoning that many homeowners are having problems obtaining HAMP modifications because of "a lack of sufficient capacity and expertise in the industry to effectively handle the unprecedented numbers of distressed homeowners in need of assistance"); State Foreclosure Prevention Working Group: Data Report No. 4, *supra* note 263, at 2, 12–13 (discussing the apparent backlog of loss mitigation efforts and resolutions, even after servicers increased the number of employees dedicated to loss mitigation efforts).

[287] Treasury conference call with Panel staff (Mar. 24, 2010).

[288] Testimony of Phyllis Caldwell, *supra* note 14, at 3.

ences of, borrowers or servicers in the absence of compliance by program participants.

4. Accountability

Panel Recommended. The Panel recommended that strong accountability was necessary for the success and credibility of the foreclosure mitigation programs.[289] Treasury must clearly define and communicate its goals and requirements as well as its measurements for success. Without clear goals and measurements, Treasury and its agents and third parties (e.g., oversight bodies, Congress, and the public) will not be able to evaluate the adequacy or success of its programs overall or of individual participants. Treasury must also effectively monitor or oversee program participants and ensure compliance through established enforcement mechanisms that provide a clear message of the consequences (both positive and negative) for servicer actions. Only then will servicers be able to understand the link between cause and effect. Toward this goal of enhanced credibility, Treasury has chosen to use Fannie Mae as financial agent and HAMP program administrator and Freddie Mac as compliance agent.[290] These agents provide structural accountability to its MHA programs.

In its capacity as financial agent and HAMP program administrator, Fannie Mae must register and execute servicer participation agreements with servicers.[291] Fannie Mae must collect a variety of loan-level data from servicers related to HAMP trial periods (to establish loans for processing and report activity during the trial period), loan setup for approved HAMP modifications, monthly activity for all HAMP loans, and additional data elements such as borrower information (e.g., full name, race, ethnicity, sex, and credit score), NPV model inputs, loan data, property characteristics, reasons for any denial of HAMP eligibility for trial periods or permanent modifications, and the status of loans that did not receive HAMP modifications.[292] Servicers and investors must seek approval from Fannie Mae if they want to deviate from the standard payment reduction guidance when offering HAMP loan modifications.[293] Finally, following the modification of an eligible mortgage, Fannie Mae is responsible for making incentive compensation payments and reimbursements upon the request of the servicers and in accordance with HAMP guidelines and directives.[294]

In its capacity as HAMP compliance agent, Freddie Mac must conduct independent compliance assessments (both on-site and remote) to evaluate loan-level data and confirm adherence to HAMP requirements including evaluation of borrower and property eligibility, compliance with underwriting guidelines, execution of the

[289] October Oversight Report, *supra* note 17, at 112.
[290] *See* Introduction of HAMP, *supra* note 21, at 1, 25; *see also* U.S. Department of the Treasury, *Making Home Affordable Program, Housing Counselor: Frequently Asked Questions,* at 1–2 (Dec. 29, 2009) (online at www.hmpadmin.com/portal/docs/counselor/counselorfaqs.pdf) (hereinafter "MHA Housing Counselor: FAQs"); Government Accountability Office, *Treasury Actions Needed to Make the Home Affordable Modification Program More Transparent and Accountable,* GAO–09–837, at 38 (Jul. 2009) (online at www.gao.gov/new.items/d09837.pdf) (hereinafter "GAO Report on HAMP").
[291] *See* Introduction of HAMP, *supra* note 21, at 1, 19.
[292] *Id.,* at 19–21, 27–38.
[293] MHA Housing Counselor: FAQs, *supra* note 290, at 9.
[294] *Id.,* at 1–2.

NPV model/modification processes, completion of borrower incentive payments, investor subsidy calculations, and data integrity.[295] Freddie Mac must provide its servicer assessment to Treasury after the completion of the review. Freddie Mac also provides its assessment to the servicer, who will be able to submit concerns or disputes through an issue/resolution appeal process.[296] Finally, Freddie Mac must penalize those servicers that fail to comply with HAMP requirements (or manage any corrective action) and report compliance violations to Treasury and other regulatory agencies.[297]

As the Panel noted in the October report, Treasury should release comprehensive performance metrics, the results of these performance metrics by lender/servicer, and a rigorous framework including appropriate, meaningful sanctions or procedures to address non-compliance.[298] The public release of information by lender/servicer—and the impact of that release on their motivation in modifying mortgages—provides an element of procedural accountability. At the time of the October report, such data were unavailable. Treasury chose not to release information collected by Fannie Mae as the HAMP program administrator that would give the public a sense of individual servicer performance, such as average conversion time, the types of modifications being offered, redefault rates, and call response time. In October, Treasury was still in the process of implementing the compliance programs with Freddie Mac so compliance data were not available. The Panel requested the data so that it could evaluate lender/servicer performance as well as the details or effectiveness of the compliance review process, its enforcement mechanisms or sanctions, and the results of compliance audits or findings. The Panel also noted that the public release of such information was important so that third parties could conduct independent analyses and, as a result, contribute to the improvement of HAMP.

Treasury Action Since October. Related to structural accountability, Treasury has still not publicly released information related to its selection and use of Fannie Mae as financial agent and HAMP program administrator or Freddie Mac as compliance agent. For example, Treasury has still not disclosed the framework of procedures or performance metrics, specific compliance data, or the results of performance metrics by lenders/servicers. According to GAO, "Treasury has not yet finalized remedies, or penalties, for servicers who are not in compliance with HAMP guidelines," but plans to do so in April 2010, and has a HAMP compliance committee in place to review compliance issues and enforce appropriate remedies.[299]

Related to procedural accountability, Treasury has released additional information by lender/servicer: aggregate numbers of HAMP modification activity including estimated number of eligible loans,

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[295] *See* Introduction of HAMP, *supra* note 21, at 25–26; *see also* Testimony of Phyllis Caldwell, *supra* note 14, at 6–7.

[296] *See* Introduction of HAMP, *supra* note 21, at 26.

[297] *See* GAO Report on HAMP, *supra* note 290, at 38.

[298] October Oversight Report, *supra* note 17, at 112.

[299] House Committee on Oversight and Government Reform, Written Testimony of Gene L. Dodaro, acting comptroller general of the United States, Government Accountability Office, *Foreclosure Prevention: Is the Home Affordable Modification Program Preserving Homeownership?* (Mar. 25, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee__on__Oversight/2010/032510__HAMP/TESTIMONY-Dodaro.pdf).

trial plan offers extended, HAMP trials started, active trial modifications, permanent modifications, permanent modifications pending borrower acceptance, and modifications (including active trials and permanent modifications) by investor type (GSE, private, and portfolio).[300]

Evaluation. Treasury still needs to provide detailed public information related to its selection and use of Fannie Mae as financial agent and HAMP program administrator and Freddie Mac as compliance agent. The effectiveness of the financial agent/program administrator and compliance agent is instrumental to the success and accountability of HAMP, making the selection process for these agents especially important.

When considering the selection process, it should be noted that apart from their administrative responsibilities, Fannie Mae and Freddie Mac initiated more than 485,000 loan mortgage modifications as of December 2009.[301] These dual roles—as "doers" of mortgage modifications for loans that they own or guarantee and "overseers" of Treasury's mortgage modification program—may present competing interests or diminish the overall effectiveness of Fannie Mae's and Freddie Mac's ability to modify mortgages, engage in HAMP administration or oversight, or both.

In addition, Treasury must effectively monitor its HAMP contractors to ensure that its programs or guidelines are being properly followed or enforced.

Treasury should publicly release more data collected by Fannie Mae and Freddie Mac so that Congress, the TARP oversight bodies, and the public can better evaluate the effectiveness of HAMP. Review and analysis of the substantial amount of data being collected by Fannie Mae as program administrator and Freddie Mac as compliance agent are important in understanding the strengths and weaknesses of HAMP as well as particular areas in need of improvement.

The Panel cannot evaluate the effectiveness of Treasury's use of Fannie Mae as financial agent and HAMP program administrator or Freddie Mac as compliance agent without a better understanding of Treasury's selection and use of Fannie Mae and Freddie Mac. Unfortunately, it appears that compliance issues remain. For example, some housing counselors are still having difficulty with servicers that continue with foreclosure proceedings while modifications are in progress, "continue to exhibit widespread incompetence in receiving forms and storing information," are not equipped to deal with the foreclosure crisis, and delay the transition from trial modifications to permanent modifications.[302] Because of Fannie Mae's and Freddie Mac's crucial roles in administering and enforcing HAMP requirements, it is especially important that Treasury release data on the compliance audits done by

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[300] *See* MHA Servicer Performance Through January 2010, *supra* note 188. For additional discussion of the data provided by Treasury in its monthly reports, see Section G.5.

[301] FHFA Foreclosure Report, *supra* note 113, at 1.

[302] Testimony of David Berenbaum, *supra* note 29, at 19, 21–24, 28–29. *See also* Testimony of Julia Gordon, *supra* note 263, at 9–10 (providing that HAMP's "effectiveness has been hampered by lack of servicer capacity, a piece-by-piece rollout of complementary programs addressing second liens and short sales, inadequate compliance review, minimal public data available, and—perhaps most disturbingly—widespread violation of HAMP guidelines by participating servicers"); State Foreclosure Prevention Working Group: Data Report No. 4, *supra* note 263, at 3.

Freddie Mac to show whether servicers are properly following HAMP guidelines or whether Treasury and Freddie Mac are ensuring that HAMP requirements are enforced. Taxpayers should be able to see the consequences that result both from HAMP compliance and non-compliance.

Although Treasury has made some progress in increasing accountability through the amount of information that is publicly available by lender/servicer, the available data are cursory and need to be further refined. The Panel applauds Treasury for releasing information on the percentage of portfolios converting and the aggregate number of trial and permanent modifications by lender/servicer, but Treasury should release the results of performance metrics by lender/servicer so that the oversight bodies, Congress, and the public can measure how rigorously each participant is engaged in the program.[303]

When Secretary Geithner testified before the Panel in September 2009, in response to a question about the wide disparities among modification rates by servicers, he emphasized the importance of publicly releasing data on the number of modifications by servicer and the impact of such disclosure on the occurrence and timeliness of modifications:

> It is very helpful . . . to put into the public domain every month detailed numbers that allow the American people to see how many people these banks are reaching. And I am quite confident that will produce much, much faster modifications much more quickly because institutions do not want to live with the consequences of being so far behind the curve in what is possible in helping families get through this exceptional set of problems.[304]

According to the tables in the monthly servicer reports, identifying aggregate information by lender/servicer may have had an impact on increasing the number of trial modifications and the conversion of trial modifications to permanent modifications over the last six months. For example, in the October report on servicer performance, only eight servicers had active modifications that represented 20 percent or more of estimated HAMP-eligible loans, and only three servicers had active modifications that represented 33 percent or more of estimated HAMP-eligible loans.[305] By the March report on servicer performance, 18 servicers had active modifications that represented 20 percent or more of estimated HAMP-eligible loans, and 9 servicers had active modifications that represented 33 percent or more of estimated HAMP-eligible loans.[306] Further, the data show that the number of permanent modifications is growing for almost every servicer.[307] The absolute numbers in the monthly snapshot provide a sense of program success, but they do not provide particularly good data for measuring a servicer's

[303] See additional discussion of general data availability in Section G.5.
[304] September COP Hearing Transcript, *supra* note 191, at 47–48.
[305] *See* U.S. Department of the Treasury, *Making Home Affordable Program: Servicer Performance Report Through September 2009* (Oct. 8, 2009) (online at www.treas.gov/press/releases/docs/MHA%20Public%20100809%20Final.pdf) (hereinafter "MHA Servicer Performance Through September 2009").
[306] *See* MHA Website, *supra* note 279.
[307] *See Id.*

progress from the previous month or a servicer's performance in terms of the speed or timeliness of conversions.

The data in the monthly servicer reports do not show the increase in the number of active trial modifications from the previous month or the increase in the permanent modifications from the previous month by servicer, although these numbers can be ascertained by comparing the monthly reports. The data also do not show the number of new or cancelled trial or permanent modifications from the current month by servicer; these numbers are embedded in the total active trial modifications and permanent modifications and in the difference in the active modifications and the HAMP trials started. The pending permanent modification number is not particularly helpful, especially when the data do not show whether and to what extent the number of pending permanent modifications from the previous month successfully converted into permanent modifications in the current month. Finally, the data do not reveal how quickly servicers are converting loans from trial to permanent modifications. Thus, the data are of questionable value in motivating servicers to produce faster modifications.[308] Providing aggregate information is not responsive to the Panel's recommendation that Treasury should make available the results of performance metrics by lender/servicer.

5. General Data Availability

Panel Recommended. The Panel stressed in both its March and October reports that Treasury should make additional information available to the public to make the mortgage modification programs more credible, transparent, understandable, and effective. The Panel noted that Treasury should continue to enhance disclosures related to servicer participation and the number of loans that have been modified or denied modifications through HAMP or that have benefited from other Treasury programs such as the 2MP and the HAFA. In addition, Treasury should release more specific loan-level data, comparable to Home Mortgage Disclosure Act (HMDA) data releases, in a manner that is widely available and useful (or easily accessible) to the general public.[309]

Treasury Action Since October. Treasury has made additional information available in its monthly reports for the MHA loan modification program.

- As of October, Treasury was including basic information on the number of trial modifications, the number of trial period plan offers, and HAMP modification activity by servicer (e.g., estimated number of eligible loans, trial plan offers extended, and trial modifications started).[310]

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[308] For example, the increase in the numbers of active trial and permanent modifications could have resulted simply from servicer compliance with HAMP guidelines or requirements (either voluntarily or as a result of audits of servicer performance). Or, servicers motivated to enhance their public image through their commitment to the HAMP program or the number of successful modifications (HAMP or otherwise)—such as Citigroup or GMAC—can do so through their own press releases, public statements, or favorable press, rather than relying on Treasury's monthly snapshots. *See, e.g.,* Congressional Oversight Panel, Written Testimony of Vikram Pandit, chief executive officer, Citigroup, *COP Hearing on Assistance Provided to Citigroup under TARP,* at 11 (Mar. 4, 2010) (online at cop.senate.gov/documents/testimony-030410-pandit.pdf).

[309] *See* October Oversight Report, *supra* note 17, at 34–36, 109–12.

[310] *See* MHA Servicer Performance Through September 2009, *supra* note 305.

• In November, Treasury included state-specific trial modification and delinquency rate numbers; the number of active trial modifications; an overview of Administration Housing Stability Initiatives; and basic housing trends in mortgage rates, housing inventory, home prices, and sales since 1999.[311]

• In December, Treasury added the number of permanent HAMP modifications (cumulative and by servicer); HAMP modifications by investor type for the 20 largest servicers (GSE, private, portfolio); and the number of active trial and permanent HAMP modifications in the 15 metropolitan statistical areas (MSAs) with the highest program activity (with a citation to a website listing HAMP activity in all MSAs).[312]

• In January, Treasury included the number of permanent modifications pending borrower acceptance (cumulative and by servicer) and the number of total permanent modifications approved by servicers; information on permanent modifications by waterfall step (i.e., the percent of modifications involving interest rate reductions, term extensions, and principal forbearance), the predominant hardship reasons for permanent modifications (including curtailment of income, excessive obligation, unemployment, and illness of principal borrower), select median characteristics of permanent modifications (i.e., median percentage decrease in front-end DTI, median percentage decrease in back-end DTI, and dollar decrease in median monthly payments), and a breakdown of modification numbers for states and the 15 MSAs with highest HAMP activity (showing active trials, permanent modifications, and totals).[313]

• In February, Treasury added a report highlights section to describe overall progress, a graph showing the waterfall of HAMP-eligible borrowers, and an appendix of all non-GSE participants in HAMP.[314]

• In March, Treasury added the total number of HAMP trials that converted to permanent modifications, the number of permanent modifications pending, and the percentage to goal of 3–4 million modification offers to the HAMP snapshot; a comment that 32 percent of trials that started at least three months ago have been converted to permanent modifications by the servicer to the bar graph of cumulative HAMP trial started by month; and a graph of selected outreach measures (servicer solicitation of borrowers by servicers (cumulative) and page views on MHA.gov (in February 2010 and cumulative)).[315]

Treasury intends to provide additional information on servicer performance later in the year, including the results of performance metrics such as average time to answer borrower calls and the percentage of borrowers personally contacted, as such information becomes available.[316]

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[311] Levitin & Twomey, *supra* note 78.

[312] U.S. Department of the Treasury, *Making Home Affordable Program: Servicer Performance Report Through November 2009* (Dec. 10, 2009) (online at www.financialstability.gov/docs/MHA%20Public%20121009%20Final.pdf).

[313] MHA Servicer Performance Through December 2009, *supra* note 194.

[314] MHA Servicer Performance Through January 2010, *supra* note 188.

[315] MHA Website, *supra* note 279.

[316] Treasury conference call with Panel staff (Mar. 24, 2010); *see also* House Committee on Oversight and Government Reform, Written Testimony of Herbert M. Allison, assistant secretary, Office of Financial Stability, U.S. Department of the Treasury, *Foreclosure Prevention:*

Continued

Evaluation. Treasury's release of additional aggregate data by lender/servicer, aggregate data on the percentage of trials that started at least three months ago that have been converted to permanent modifications, aggregate data on the predominant reasons for HAMP modification, and aggregate data on modification characteristics is a positive step in providing greater transparency regarding the scope and effectiveness of the MHA programs. Treasury still needs to provide the public with significantly more information to ensure MHA transparency, accountability, and effectiveness.

As discussed above, Treasury should continue to enhance the amount of information available by lenders and servicers. Treasury could commit to release publicly the following:

- cumulative rate of conversion for eligible trials;
- monthly rate of conversion for eligible trials: percentage of trials eligible to convert in month X that converted;
- conversion rate by vintage of trial modifications and the percentage of modifications commenced in any given month that have converted;
- cumulative default rate and the number of defaults on permanent modifications;
- monthly rate of default and the number of defaults on permanent modifications;
- breakdown of reason for defaults on permanent modifications (if known);
- mean and median LTV of all permanent modifications;
- mean and median LTV of permanent modifications that have defaulted;
- percentage of permanent modifications with first-lien LTV that is (a) <100 percent, (b) 100–125 percent, and (c) >125 percent;
- percentage of permanent modifications where there is a junior lien on the property;
- number of second liens eliminated under 2MP;
- ownership breakdown of (a) trials, (b) permanent modifications, and (c) defaulted modifications (Fannie/Freddie/private label/portfolio);
- mean and median pre-modification front- and back-end DTI on permanent modifications;
- mean and median post-modification front- and back-end DTI on permanent modifications;
- mean and median post-modification front- and back-end DTI on defaulted permanent modifications;
- breakdown of trial modification denial and cancellation reasons by number and percentage on a cumulative and monthly basis; and
- information on any HAMP compliance actions taken, including the identity of the servicer, the reason for the action, and the sanctions imposed.

In addition, Treasury should disclose loan-level data, comparable to that provided in HMDA data releases, in a manner that allows easy access for outside parties. Treasury must ensure that modi-

Is The Home Affordable Modification Program Preserving Homeownership?, at 8–9 (Mar. 25, 2010) (online at oversight.house.gov/images/stories/Hearings/Committee__on__Oversight/2010/032510__HAMP/TESTIMONY-Allison.pdf).

fication application denial and cancellation data are fully and accurately reported by servicers. Congress and oversight bodies must have full access to program data to evaluate properly the success of HAMP. It is also critical that Treasury commit to providing regular publicly available data reports on the performance of all HAMP permanent modifications through the end of their five-year permanent modification period—that is, extending through 2017. The Panel looks forward to Treasury's release of more detailed public reports.

H. Conclusions and Recommendations

The Panel applauds Treasury for beginning to address the problems that the Panel has highlighted over the last year and in particular for taking steps to support borrowers dealing with unemployment, second liens, or negative equity. However, the Panel remains concerned about the timeliness of Treasury's response, the sustainability of mortgage modifications, and the accountability of Treasury's foreclosure programs.

Timeliness

The foreclosure crisis has thus far outpaced Treasury's efforts to deal with it. Since early 2009, Treasury has initiated half a dozen foreclosure mitigation programs, gradually ramping up the incentives for participation by borrowers, lenders, and servicers. Although Treasury should be commended for trying new approaches, its pattern of providing ever more generous incentives might backfire, as lenders and servicers might opt to delay modifications in hopes of eventually receiving a better deal. Further, loan servicers have expressed confusion about the constant flux of new programs, new standards, and new requirements.

The long delay in dealing effectively with foreclosures underscores the need for Treasury to get its new initiatives up and running quickly, but it also underscores the need for Treasury to get these programs right. Even if Treasury's recently announced programs succeed, their impact will not be felt until early 2011—almost two years after the foreclosure mitigation program was first launched.

Sustainability

Treasury's success will ultimately be measured not by the number of mortgages modified but by the number of homeowners who avoid foreclosure. The programs have made progress in helping some whose loans can be prudently modified. It appears, however, that Treasury's programs are vulnerable to several weaknesses that could undermine the long-term sustainability of mortgage modifications.

Treasury needs to support all three elements of successful modifications: commencing modifications, converting modifications to permanent status, and sustaining modifications. Of these three elements, the last has received the least attention, even though it is in many ways the most important. A modification that eventually redefaults represents only a stay, not a reprieve—a stay purchased at significant taxpayer expense.

Yet, even those families who are able to qualify for a modification and manage to make every payment on time may face difficulty after five years; although the modifications are called permanent, in fact, the interest rates and therefore the payments can rise after five years. The phase-out of modification terms could create significant sustainability challenges for families who have otherwise been successful under the terms of the modification, especially for those families still underwater on their properties. Unless housing prices recover to a sufficient degree—which appears unlikely—or the economy rebounds notably, these families may find themselves back in an all too familiar situation of desperation.

Although the federal government has played and will continue to play a key role in foreclosure prevention, it cannot solve the problem alone, and it should embrace a broad sense of partnership with state, local, and private programs.

At the same time, Treasury must consider whether its definition of "affordability" adequately captures the many financial pressures facing families today. It should examine the appropriateness of the present 31 percent DTI requirement and should consider whether DTI standards should account for local conditions, arrearages, second liens, and other borrower debt.

Accountability

As always, Treasury needs to take care to communicate its goals, its strategies, and its measures of success for its programs. Its stated goal of modifying three to four million mortgages has proven too vague, since a modification offer does not always translate into a foreclosure prevented. Treasury's goals should include specific metrics to measure the success of each of its foreclosure prevention programs.

The Panel is concerned that the sum total of announced funding for Treasury's individual foreclosure programs exceeds the total amount set aside for foreclosure prevention. It is unclear whether this indicates that Treasury will scale back particular programs or will scale up its entire foreclosure prevention effort. Treasury must be clearer about how much taxpayer money it intends to spend and where.

Treasury should also clarify the answers to important questions about the FHA refinancing program. If the program allows private lenders to offload their poorly performing mortgages onto taxpayers, then this would represent an inappropriate backdoor bailout. Treasury should ensure that the program does not simply shift risk from private lenders to the federal government.

The Panel also offers the following operational recommendations to Treasury:

- Focus on launching the long overdue CHAMPS system and the foreclosure web portal as soon as possible.
- Release more information to borrowers about how their eligibility for HAMP is calculated, including the inputs used when borrowers are denied due to having an NPV-negative loan.
- Prohibit HAMP-participating servicers from proceeding with a foreclosure unless a valid denial or cancellation reason is reported, and impose meaningful monetary sanctions for failure to properly report denial and cancellation reasons.

- Exercise greater oversight of Fannie Mae and Freddie Mac on compliance and oversight issues. In particular, the inconsistent use of denial codes has made it difficult to gather reliable data on the programs' effectiveness. Servicers should be subject to strong penalties for failure to follow denial code reporting guidelines.
- Thoroughly monitor the activities of participating lenders and servicers, audit them, and enforce program rules, guidelines, and requirements.
- Release greater information on compliance results and sanctions.
- Enforce new borrower outreach and communication standards and timelines.
- Continue to expand and improve data collected and publicly reported, specifically the list of items included in Section G.5. Treasury should also release information on the status of borrowers who received the January 31 notice of the expiration of the trial modification period; a new category for those who are appealing their status under the January 31 notice; a new category for borrowers offered contingent permanent modifications, pending receipt of their hardship affidavit or tax verification form per the January 28 supplemental directive; the number of trial modifications that have been in place for three months or more, broken down by month; the reasons why trial and permanent modifications were canceled; the reasons why homeowners were denied permanent modifications after initiating trial modifications; and a separate category on escalation reviews and the results of Fannie Mae audits.

Treasury has made progress since the Panel's last foreclosure report, but its programs still are not keeping pace with the foreclosure crisis. Even as Treasury struggles to get its foreclosure programs off the ground, the crisis continues unabated. In 2009, 2.8 million homeowners received a foreclosure notice. The long delay in successfully addressing the foreclosure crisis has served no one well, and further delays would cause even more pain.

ANNEX I: STATE OF THE HOUSING MARKETS AND GENERAL ECONOMY

1. Housing Market Indicators

An analysis of Treasury's foreclosure mitigation efforts must consider broader questions: Is the housing market recovering? What is the supply and demand situation? What are the trends in delinquencies and foreclosures? How many more foreclosures can we expect in coming years? What other factors could change the foreclosure situation? Without the answers to these questions, it is hard to say whether or not Treasury is conducting an effective foreclosure mitigation effort that will make a significant difference. Unfortunately, the data described here paint a fairly bleak picture of the future of the housing market and call into question whether Treasury's efforts are likely to have a large impact, considering the vast scale of the housing market's problems.

a. Home Prices

The present level and trends in home prices greatly affect the success of any foreclosure mitigation effort.

The following section looks at three home value indices—the highly regarded S&P/Case-Shiller and FHFA indices, and a more recent and controversial but still useful index from the online real estate database Zillow. It then considers home price trends in historical context by comparison to other housing booms and busts. Although the results differ because of different data sets, methodology, and assumptions, it is possible to see some broad trends in home prices. Nationally, home prices have fallen from a peak in 2006. Nationally, price declines continued in 2009, although the rate of decline has slowed and in recent months become essentially flat. There is significant local variation in housing price trends. Some metropolitan areas continue to see home prices fall, but other areas have seen upticks in prices. In all areas, however, housing prices are still significantly down from their peaks.

The S&P/Case-Shiller Home Price Index estimates price trends using repeat sales of the same homes (including sales of foreclosed properties) in order to control for differences in the tested sample. For this reason, it is often referred to as a "constant quality" index. However, because the index is based on repeat sales, it excludes new construction. S&P/Case-Shiller's national home price index rose 0.3 percent in January 2010 on a seasonally adjusted basis. While the index has now risen for four months in a row, it has declined 0.7 percent over the past year.[317]

The FHFA Purchase Only House Price Index is also a constant quality index with a similar methodology, although its sample is based only on properties with mortgages that were acquired by government-sponsored entities (GSEs) Fannie Mae and Freddie Mac. FHFA data are therefore based only on homes conforming to GSE standards, excluding properties that are either too expensive or those with less stringent standards, as well as excluding new construction. As the name implies, the Purchase Only House Price

[317] Standard & Poor's, *Home Prices in the New Year Continue the Trend Set in Late 2009 According to the S&P/Case-Shiller Home Price Indices* (Mar. 30, 2010) (online at www.standardandpoors.com/spf/CSHomePrice__Release__033056.pdf).

Index includes only data from actual purchases, not appraisals conducted in advance of refinancings. This index declined by 0.6 percent between December 2009 and January 2010 on a seasonally adjusted basis.[318] However, the index fell only 0.1 percent in the fourth quarter of 2009 overall and was down 1.2 percent for the entire year, somewhat less than the annual decline for the Case-Shiller index. The FHFA's All Transactions House Price Index, which includes property values from refinancing appraisals as well, declined 0.7 percent in the fourth quarter and 4.7 percent during all of 2009.[319]

The online real estate database Zillow.com compiles an index based on their home value estimates that covers approximately 75 percent of all homes in the United States, more than 80 million properties in all.[320] Unlike the other indices mentioned here, Zillow's index is based not on actual sales but on an appraisal-like methodology that uses comparable sale prices, characteristics of the individual home, past sales history, and tax-assessment data. Although Zillow's estimates have been criticized as being inaccurate for valuing individual homes,[321] the extremely large sample covered (including new construction) makes the index useful for comparison to the often widely divergent Case-Shiller and FHFA indices. The Zillow Home Value Index showed declines of 0.5 percent from January to February 2010, 1.5 percent from November 2009 to February 2010, and 5.4 percent from February 2009 to February 2010.[322]

Figure 27, below, shows the trends in national home prices over the past 10 years for the three indices.

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[318] Federal Housing Finance Agency, *U.S. Monthly House Price Index Declines 0.6 Percent From December to January* (Mar. 23, 2010) (online at www.fhfa.gov/webfiles/15565/MonthlyHPI32310.pdf).

[319] Federal Housing Finance Agency, *House Prices Fall Modestly in the Fourth Quarter* (Feb. 25, 2010) (online at www.fhfa.gov/webfiles/15454/finalHPI22510.pdf). For a discussion of the differences between the Case-Shiller and FHFA indices, *see* Charles A. Calhoun, *OFHEO House Price Indexes: HPI Technical Description* (Mar. 1996) (online at www.fhfa.gov/webfiles/896/hpi_tech.pdf).

[320] Stan Humphries, *Home Value Index vs FHFA and Case-Shiller,* Zillow (Feb. 19, 2010) (online at www.zillow.com/wikipages/Zillow-Home-Value-Index-vs-FHFA-and-Case-Shiller/) (accessed Apr. 12, 2010). Zillow provides estimates only for homes in areas where there is available and timely transaction data. Since there is no apparent common factor among the uncovered areas besides a lack of data, there is no reason to believe that the housing situation in these areas is significantly different from the situation in the covered areas.

[321] James Hagerty, *How Good are Zillow's Estimates?,* Wall Street Journal (Feb. 14, 2007) (online at online.wsj.com/public/article/SB117142055516708035-O6WPplch_duU0zq_zhjQaI19vIg_20080214.html).

[322] Zillow, *Real Estate Market Reports* (Feb. 1, 2010) (online at www.zillow.com/local-info/).

FIGURE 27: CHANGES IN HOME PRICE INDICES, 2000–2009

	S&P/Case-Shiller [323]	FHFA [324]	Zillow [325]	Average
2000	11.14%	5.89%	8.22%	8.42%
2001	6.74%	6.12%	6.53%	6.46%
2002	11.58%	7.07%	9.34%	9.33%
2003	10.48%	7.13%	10.62%	9.41%
2004	14.72%	8.72%	14.37%	12.60%
2005	13.88%	8.57%	11.70%	11.38%
2006	(0.15)%	2.37%	0.13%	0.78%
2007	(9.17)%	(2.13)%	(5.41)%	(5.57)%
2008	(17.27)%	(7.56)%	(11.63)%	(12.15)%
2009	(1.02)%	(2.78)%	(4.53)%	(2.78)%

[323] Data calculated from Standard & Poor's, *S&P Case-Shiller Homeprice Indices (Seasonally Adjusted Values for January 2010)* (Mar. 30, 2010) (online at homeprice.standardandpoors.com) (free registration required). *See also* Standard & Poor's, *Home Prices Continue to Send Mixed Messages as 2009 Comes to a Close According to the S&P/Case-Shiller Home Price Indices* (Feb. 23, 2010) (online at www.standardandpoors.com/servlet/BlobServer?blobheadername3= MDT-Type&blobcol=urldocumentfile&blobtable= SPComSecureDocument&blobheadervalue2= inline%3B+filename%3Ddownload.pdf&blobheadername2= Content-Disposition&blobheadervalue1= application%2Fpdf&blobkey= id&blobheadername1=content-type&blobwhere=1245206345483&blobheadervalue3= abinary%3B+charset%3DUTF-8 &blobnocache=true) (hereinafter "Home Prices Continue to Send Mixed Messages").

[324] Data compiled by Panel staff from Federal Housing Finance Agency, *HPI Historical Reports (2000–2009)* (online at www.fhfa.gov/Default.aspx?Page=195) (hereinafter "HPI Historical Reports (2000–2009)") (accessed Apr. 13, 2010).

[325] Data provided by Zillow staff.

Real estate is highly local, and individual areas can have home price trends that differ greatly from each other and the national average. Figure 28 shows the December 2009 changes in home prices for the top 20 metropolitan areas as measured by each of the three indices. It is apparent from these tables that certain metropolitan areas, such as Las Vegas and Miami, have suffered far greater drops in value than others, such as Dallas and Denver.

FIGURE 28: YEAR-OVER-YEAR CHANGE IN HOME PRICES, DECEMBER 2009

	S&P/Case-Shiller [326]	FHFA [327]	Zillow [328]	City Average
Atlanta	(4.00)%	(6.69)%	(1.11)%	(3.93)%
Boston	0.50%	(3.62)%	2.05%	(0.36)%
Charlotte	(3.80)%	(5.97)%	(3.51)%	(4.43)%
Chicago	(7.20)%	(8.38)%	(7.90)%	(7.83)%
Cleveland	(1.20)%	(2.71)%	(2.97)%	(2.29)%
Dallas [329]	3.00%	(1.27)%	–	0.87%
Denver	1.20%	(1.37)%	0.72%	0.18%
Detroit	(10.30)%	(9.13)%	(19.70)%	(13.04)%
Las Vegas	(20.60)%	(19.30)%	(21.22)%	(20.37)%
Los Angeles	0.00%	(4.59)%	0.64%	(1.32)%
Miami	(9.90)%	(14.02)%	(10.33)%	(11.42)%
Minneapolis	(2.30)%	(7.85)%	(4.78)%	(4.98)%
New York	(6.30)%	(5.84)%	(2.45)%	(4.86)%
Phoenix	(9.20)%	(16.01)%	(14.85)%	(13.35)%
Portland	(5.40)%	(4.93)%	(5.77)%	(5.37)%
San Diego	2.70%	(3.64)%	0.14%	(0.27)%
San Francisco	4.80%	(5.72)%	0.59%	(0.11)%
Seattle	(7.90)%	(9.60)%	(5.40)%	(7.63)%
Tampa	(11.00)%	(10.75)%	(11.04)%	(10.93)%
Washington	1.90%	(4.61)%	(1.41)%	(1.37)%
Index Average	**(4.25)%**	**(7.30)%**	**(5.70)%**	

[326] Home Prices Continue to Send Mixed Messages, *supra* note 323.

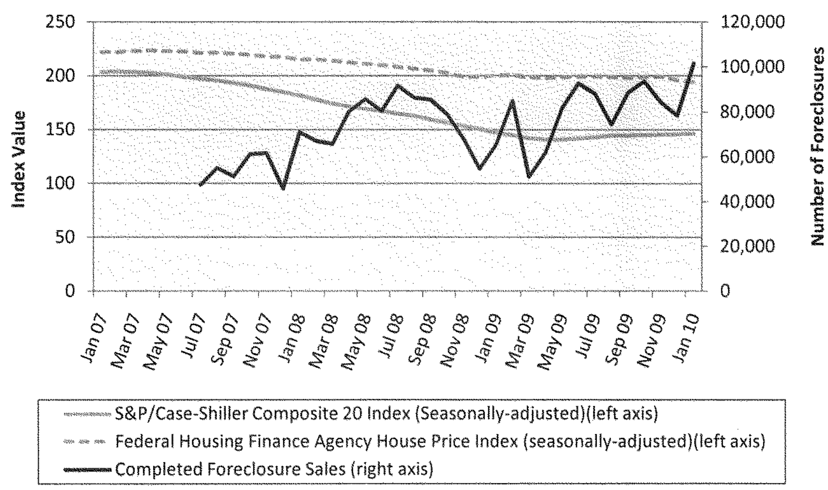
[327] Federal Housing Finance Agency, *Changes in FHFA Metropolitan Area House Price Indexes* (Feb. 25, 2010) (online at www.fhfa.gov/Default.aspx?Page=216&Type=summary).

[328] Data provided by Zillow staff.

[329] Zillow does not report data for Dallas because the transactions reported in that area are insufficient to ensure accuracy.

Figure 29, below, shows the FHFA Purchase Only Home Price Index, compared with the number of foreclosure completions over time. As might be expected, foreclosure completions and home prices tend to have an inverse relationship. It is not clear to what extent foreclosures drive housing price declines or vice versa, although it seems likely that the causation works in both directions, creating a negative feedback loop of foreclosures and housing price declines.

FIGURE 29: FORECLOSURE COMPLETIONS COMPARED TO CASE-SHILLER AND FHFA [330]



It is interesting to note, though, that despite the high and rising level of foreclosure completions last year, home prices declined relatively little during 2009, implying that there is significant demand counteracting the downward pressure on prices caused by foreclosures. It is likely that government interventions in the housing market, such as the homebuyer tax credits, support for Fannie Mae and Freddie Mac, a large increase in FHA insurance underwriting, and Treasury and Federal Reserve purchases of mortgage-backed securities, as well as the Federal Reserve monetary policy aimed at keeping interest rates low, have fostered increased demand for home purchases by making them more affordable and by reducing the cost of mortgage finance. Some of these government interventions in the housing market are being scaled back or eliminated. The FHA has tightened its underwriting standards in response to reduced capitalization of its insurance fund,[331] and the Federal Re-

[330] Foreclosure completion data provided by the HOPE NOW Alliance. Standard & Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Seasonally Adjusted Composite 20 Index) (online at www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff__p-us__) (hereinafter "S&P/Case-Shiller Home Price Indices") (accessed Apr. 12, 2010); Federal Housing Finance Agency, *U.S. and Census Division Monthly Purchase Only Index* (Instrument: USA, Seasonally Adjusted) (online at www.fhfa.gov/Default.aspx?Page=87) (hereinafter "U.S. and Census Division Monthly Purchase Only Index") (accessed Apr. 12, 2010). The most recent data available for the housing indices are as of January 2010.

[331] *See* U.S. Department of Housing and Urban Development, *FHA Announces Policy Changes to Address Risk and Strengthen Finances,* HUD No. 10-016 (Jan. 20, 2010) (online at portal.hud.gov/portal/page/portal/HUD/press/press__releases__media__advisories/2010/HUDNo.10–016). *See also* Bob Tedeschi, *Mortgages—F.H.A. Lending Standards Tightened,* New York Times (Jan. 28, 2010) (online at www.nytimes.com/2010/01/31/realestate/31mort.html); Steve Kerch, *Shoring Up the FHA: Housing Agency Tightens Underwriting Policies, Raises Mortgage Pre-*

Continued

serve has ended its direct support of mortgage finance markets by winding down its purchases of agency mortgage-backed securities. By supporting the secondary mortgage market through its purchases of agency mortgage-backed securities, the Federal Reserve facilitated lower mortgage rates for both home purchasers and refinancers. The Federal Reserve purchased approximately $1.25 trillion of agency mortgage-backed securities since early 2009, but its program to buy such securities came to an end on March 31, 2010. The Federal Reserve's support for the MBS market has been described by Susan M. Watcher, Richard B. Worley Professor of Financial Management and Professor of Real Estate, Finance and City and Regional Planning at the University of Pennsylvania's Wharton School, as "the single most important move to stabilize the economy."[332] This support as well as Federal Reserve monetary policy contributed to the interest rate on 30-year mortgages declining from over six percent in late 2008 to below five percent in March 2009.[333] Lower rates have helped stave off some foreclosures both by enabling refinancings and by making interest rate resets on adjustable rate mortgages less severe. As government support for the housing market is withdrawn, the sustainability of home purchase demand is questionable.

Many mortgage bankers feared that the ending of the Federal Reserve MBS purchase program would cause the prices of the securities to decrease and their yields relative to Treasury securities to soar, causing mortgage interest rates to rise and the demand for home loans in an already weak market to fall.[334] After the program ended, 30-year fixed mortgage interest rates rose to 5.08 percent, the highest rate since the first week of January 2010.[335] However, analysts no longer expect the close of the Federal Reserve MBS purchase program to cause a major disruption in the housing market or a setback to its recovery. The Federal Reserve was clear on its intention to exit the market, and the market appears to have been able to absorb this news. Fannie Mae and Freddie Mac have forecasted that 30-year fixed mortgage interest rates should increase less than a quarter of a percentage point in the next three months.[336] Lawrence Yun, chief economist at the National Association of Realtors, has said that the private market for mortgage-backed securities has sufficiently recovered for the Federal Reserve program to end without much impact. He reasoned that consumers should not see much of a change as long as there are enough buy-

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miums, MarketWatch (Jan. 20, 2010) (online at www.marketwatch.com/story/fha-raises-fees-tightens-mortgage-underwriting-2010-01-20).

[332] Sewell Chan, *Fed Ends Its Purchasing of Mortgage Securities,* New York Times (Apr. 1, 2010) (online at www.nytimes.com/2010/04/01/business/01fed.html) (hereinafter "Fed Ends Its Purchasing of Mortgage Securities").

[333] *See* Federal Home Loan Mortgage Corporation, *Primary Mortgage Market Survey: Convention, Conforming 30-Year Fixed Rate Mortgage Series Since 1971* (online at www.freddiemac.com/pmms/pmms__archives.html) (weekly and monthly 30-year fixed-rate data).

[334] *See* Sara Lepro, *Why Fed's Exit Plan Isn't Roiling Mortgage Bonds,* American Banker (Mar. 22, 2010) (online at www.americanbanker.com/issues/175__54/mortgage-bonds-1016184-1.html) (hereinafter "Why Fed's Exit Plan Isn't Roiling Mortgage Bonds").

[335] *See* Federal Home Loan Mortgage Corporation, *2010 Weekly Mortgage Rates Data* (online at www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp) (accessed Apr. 12, 2010).

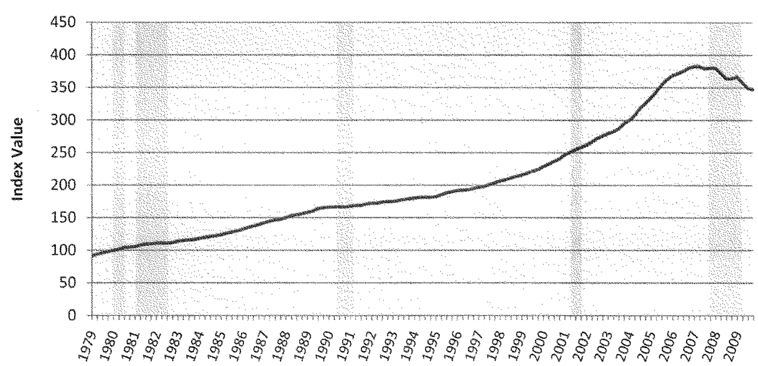
[336] *See* Federal Home Loan Mortgage Corporation, *March 2010 Economic and Housing Market Outlook* (Mar. 12, 2010) (online at www.freddiemac.com/news/finance/docs/Mar__2010__public__outlook.pdf); Federal National Mortgage Association, *Economics and Mortgage Market Analysis: Economic Forecast: March 2010* (Mar. 10, 2010) (online at www.fanniemae.com/media/pdf/economics/2010/Economic__Forecast__031710.pdf).

ers on Wall Street, and it appears that private investors are stepping in as the Federal Reserve exits.[337] Several market participants, including Christian Cooper of Royal Bank of Canada's RBC Capital Markets and Scott Colbert of Commerce Trust Co., agree that there are a number of people on the sidelines waiting to buy MBS securities.[338] In addition, Michael Fratantoni, vice president for single-family research at the Mortgage Bankers Association, has said that sharp increases in mortgage interest rates are not expected because the supply of mortgage-backed securities has not increased substantially. Messrs. Fratantoni and Yun have further stated, however, that mortgage interest rates may rise late in the year due to economic forces unrelated to the Federal Reserve purchase program, such as recovery in the job market.[339]

Figure 30 highlights the behavior of real estate prices in recent recessions, shown by the shaded bars. As mentioned earlier, both the lag with the general economy and the slower movement up and down can be seen.

FIGURE 30: FHFA HOME PRICE INDEX, 1975–2009 [340]

[Not seasonally adjusted]



The United States has experienced several regional housing price collapses over the past three decades. These past housing busts provide some sense as to the length of time it will take for housing prices to recover to their pre-collapse peaks. Historically, it has often taken over a decade for regional housing prices to recover from collapses, and on a time-value and inflation adjusted basis,

[337] Fed Ends Its Purchasing of Mortgage Securities, *supra* note 332.
[338] Why Fed's Exit Plan Isn't Roiling Mortgage Bonds, *supra* note 334.
[339] Fed Ends Its Purchasing of Mortgage Securities, *supra* note 332.
[340] Federal Housing Finance Agency, *U.S. and Census Divisions through 2009Q4* (All-Transactions Indexes: Not Seasonally Adjusted) (accessed Apr. 4, 2010) (online at www.fhfa.gov/webfiles/15436/4q09hpi_reg.txt) National Bureau of Economic Research, *Business Cycle Expansions and Contractions* (accessed Apr. 5, 2010) (online at www.nber.org/cycles/). The shaded areas represent periods of recession as defined by the National Bureau of Economic Research (NBER). The NBER has not yet determined whether the recession that began in December 2007 has ended nor established the date of its ending. The Panel's own estimate is that this recession ended at the end of Q2 2009, the last quarter of net decline in the U.S. Gross Domestic Product (GDP), and that is the date that is assumed here. National Bureau of Economic Research, Business Cycle Expansions and Contractions (accessed Apr. 5, 2010) (online at www.nber.org/cycles/); Bureau of Economic Analysis, Gross Domestic Product (accessed Apr. 5, 2010) (online at www.bea.gov/national/txt/dpga.txt).

these recoveries have taken even longer. Thus, it took over 13 years for housing prices in New England to recover after their 1988 collapse, 12 years for housing prices in California to rebound after falling from their 1989 peak, 17 years for Michigan housing prices to return to 1979 peak, and Texas housing prices have yet to recover from a 15-year decline that began in 1982. According to an FHFA study, the "median time required to return to prior peak prices was 10½ to 20 years." [341]

These historical precedents suggest that the housing price recovery time frame on a national basis may take a decade or more, and that in some particularly hard-hit areas, it may take as long as two decades for housing prices to recover to their pre-bust peaks. Moreover, if there is another collapse in housing prices, a "double-dip" that some economists fear, the housing price recovery could take even longer.

Historically, housing price recoveries have largely paralleled overall regional economic recoveries; as regional economies recovered, housing prices rebounded. But past regional housing busts were also often closely connected with regional employment conditions—the decline of defense contracting in New England and California in the late 1980s, the drop in oil prices in Texas in the mid-1980s, and the decline of the U.S. auto industry in 1980s Michigan. While unemployment is now a major factor contributing to mortgage defaults and depressed housing values, the decline in housing prices began in 2006, well before a national economic slowdown. That is to say, only part of the current housing bust is related to general economic conditions; part relates to housing prices that were elevated because lax underwriting expanded the pool of mortgage borrowers, thereby driving up demand and thus prices. Economic recovery will help buoy housing prices, but it is critical to recall that peak housing prices in 2006 were not driven by fundamentals, so they are unlikely to be restored solely by improvements in the overall economy.

b. Home Sales

The National Association of Realtors (NAR) reports that existing home sales dropped 0.6 percent between January 2010 and February 2010, after suffering 0.5 percent and 16.5 percent declines in January 2010 and December 2009, respectively. The February seasonally adjusted annual sales rate of 5.02 million units was down one percent from 5.05 million units in January, though still 7 percent above the level of February 2009.[342] In 2009 there were 5.2 million existing home sales, a 4.9 percent gain over the 4.9 million transactions recorded in 2008. This was the first annual sales gain recorded since 2005.[343]

The government's homebuyer tax credit programs, which will end on April 30, 2010, appear to have attracted significant interest

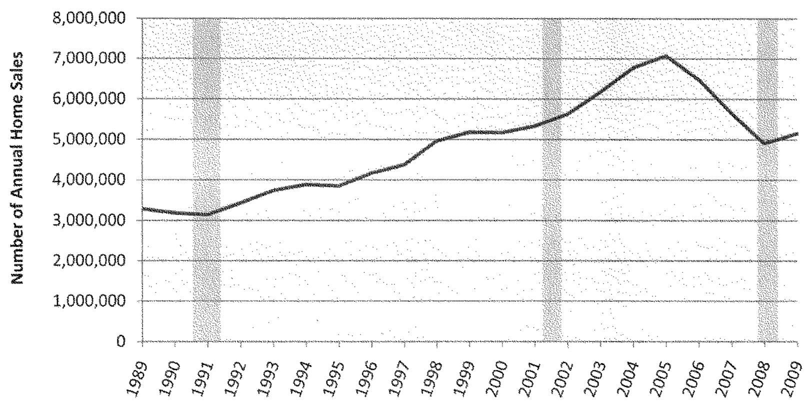
[341] Federal Housing Finance Agency, *A Brief Examination of Previous Housing Price Declines,* at 4 (June 2009) (online at www.fhfa.gov/webfiles/2918/PreviousDownturns61609.pdf).

[342] National Association of Realtors, *February Existing-Home Sales Ease with Mixed Conditions Around the Country* (Mar. 23, 2010) (online at www.realtor.org/press__room/news__releases/2010/03/ehs__ease) (hereinafter "February Existing-Home Sales Ease").

[343] National Association of Realtors, *December Existing-Home Sales Down but Prices Rise; 2009 Sales Up* (Jan. 25. 2010) (online at www.realtor.org/press__room/news__releases/2010/01/december__down) (hereinafter "December Existing-Home Sales Down").

from the home-buying public. Sales, however, did not grow in the early months of 2010 as many had expected. The last three months have seen declining existing home sales, indicating a weakening demand for homes and possibly a lack of qualified buyers. Bad weather in much of the country may have also deterred buyers. Some observers have suggested that the tax credits are not bringing new buyers into the market, but are simply moving up the timing of sales that would have happened anyway at a later date. If this is true, it is likely that sales will remain low for several months after the programs end.

FIGURE 31: EXISTING HOME SALES[344]

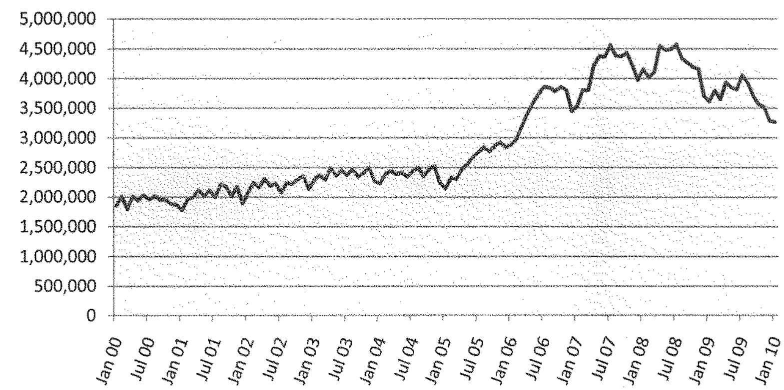


The inventory of homes for sale improved in February, increasing 9.5 percent after a 0.5 percent decline in January. February's unsold inventory totaled 3.59 million units, up from 3.27 million units in January. Whereas January marked the lowest unsold inventory level since March 2006, the February inventory level has returned to levels seen in September 2009. Inventory is now 5.5 percent below the February 2009 level, and 22 percent below the record high of 4.58 million units for sale in July 2008.[345] Due to the substantial amount of "shadow inventory" that is not currently being offered for sale but could be brought to market quickly, the potential exists for a rapid increase in inventory levels. This issue is discussed further in Annex I(1)i.

[344] The shaded areas represent periods of recession as defined by the National Bureau of Economic Research (NBER). National Bureau of Economic Research, *Business Cycle Expansions and Contractions* (online at www.nber.org/cycles/) (accessed Apr. 5, 2010) (hereinafter "Business Cycle Expansions and Contractions"); U.S. Department of Commerce, Bureau of Economic Analysis, *Gross Domestic Product* (accessed Apr. 5, 2010) (online at www.bea.gov/national/txt/dpga.txt) (hereinafter "Bureau of Economic Analysis Data—Gross Domestic Product"). The data is seasonally adjusted annual rate.

[345] December Existing-Home Sales Down, *supra* note 343; National Association of Realtors, *Existing-Home Sales Down in January but Higher than a Year Ago; Prices Steady* (Feb. 26. 2010) (online at www.realtor.org/press__room/news__releases/2010/02/ehs__january2010) (hereinafter "Existing-Home Sales Down in January"); February Existing-Home Sales Ease, *supra* note 342.

FIGURE 32: HOME SALE INVENTORY



Despite the lower raw inventory numbers, the slow pace of sales in February means that unsold inventory represented an 8.6-month supply of unsold homes, up from 7.8 months in January and 7.2 months in December. NAR reports that 35 percent of existing home sales in February were "distressed" properties, either short sales or foreclosure liquidations.[346] Such a large number of distressed sellers inevitably puts additional downward pressure on home prices.

c. Construction

New home construction data are an indicator of the overall state of the housing market, as well as a forecast of new housing supply that will come to market in future months. Indicators of new housing construction for February 2010 were mixed. Building permits and housing starts were significantly higher than similar figures for February of last year, signaling a modest revival of new housing construction during 2009. Housing completions, on the other hand, were considerably lower than in February 2009. This may be attributable to housing developments started toward the end of the bubble market. Figure 33, below, shows seasonally adjusted annual rates of various construction statistics.

FIGURE 33: NEW HOUSING CONSTRUCTION DATA (ANNUALIZED)[347]

Indicator	February 2010	January 2010	Change from 1/10–2/10	February 2009	Change from 2/09–2/10
Building Permits	612,000	621,000	(1.6)%	550,000	11.3%
Housing Starts	575,000	591,000	(5.9)%	574,000	0.2%
Housing Completions	700,000	659,000	2.2%	828,000	(34.8)%
New Home Sales[348]	308,000	309,000	(2.2)%	354,000	(13.0)%

[347] U.S. Department of Commerce, Bureau of the Census, *New Residential Construction in January 2010* (Feb. 17, 2010) (online at www.census.gov/const/newresconst__201001.pdf); U.S. Department of Commerce, Bureau of the Census, *New Residential Construction in February 2010* (Mar. 17, 2010) (online at www.census.gov/const/newresconst__201002.pdf).

[348] U.S. Department of Commerce, Bureau of the Census, *New Residential Sales in January 2010* (Feb. 24, 2010) (online at www.census.gov/const/newressales__201001.pdf); U.S. Department of Commerce, Bureau of the Census, *New Residential Sales in February 2010* (Mar. 24, 2010) (online at www.census.gov/const/newressales__201002.pdf).

[346] December Existing-Home Sales Down, *supra* note 343; Existing-Home Sales Down in January, *supra* note 345; February Existing-Home Sales Ease, *supra* note 342.

Given the current housing market conditions, the rise in new home construction is somewhat unexpected. While many view this as an optimistic sign of a housing recovery, some would argue that this new supply will only add to the worsening inventory absorption situation described in the section above and further depress home prices.

The discrepancy between the number of building permits issued and housing starts (both roughly 600,000) and the number of new homes sold (approximately 300,000) can be explained, in part, by the metrics through which the data is measured. Building permits and housing starts are measured by the total number of permits issued or units constructed, but the number of new home sales is only measured when a new home is sold to a third party.[349] Therefore, anyone who commissions a new home to be built for themselves on land they already own will be counted as having a building permit and a housing start, but not as having a new home sale.

d. Mortgage Rates

Prevailing mortgage interest rates are of interest to the Panel's evaluation of foreclosure mitigation efforts because these rates directly affect home affordability and indirectly drive property values. Current housing recovery efforts are being facilitated by historically low mortgage interest rates. However, an increase in mortgage interest rates is inevitable. Consequently, a housing recovery built on ultra-low long-term interest rates is unlikely to be sustainable. Since the amount that borrowers can afford to pay each month is relatively fixed, property values may fall when interest rates rise, because increasing interest rates put downward pressure on home prices. An increase in rates will in most cases lead to a decline in values and is likely to result in more delinquencies and foreclosures, because declines in borrowers' equity are correlated with defaults.[350] While mortgage interest rates are market-driven and influenced by many supply and demand factors, Federal Reserve interest rate policy has considerable influence. The yields on Treasury securities also influence these rates, since Treasuries provide a competitive investment for the bond buyers who provide funds for the mortgage market. Both of these issues are discussed in Annex I(1)i.

As of April 8, 2010, the interest rate on a 30-year fixed rate mortgage averaged 4.83 percent. This is similar to the rate of just over 5 percent in early January 2010 and up from the 4.65 percent average rate in late November 2009. Current mortgage interest rates vary by state from a low of 4.88 percent in Maine to a high of 5.33 percent in Oklahoma.[351] Nationwide, mortgage rates remain near historically low levels. This can be seen in Figure 34, which shows the average interest rates on 30-year fixed-rate mortgages since 1971. The shaded areas indicate officially designated recessions.

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[349] U.S. Department of Commerce, Bureau of the Census conversations with Panel staff (Mar. 30, 2010).

[350] *See, e.g.,* Stan Liebowitz, *New Evidence on the Foreclosure Crisis,* Wall Street Journal (July 3, 2009) (online at online.wsj.com/article/SB124657539489189043.html).

[351] Zillow, *Mortgage Rates* (online at www.zillow.com/Mortgage__Rates) (accessed Apr. 8, 2010).

FIGURE 34: MORTGAGE INTEREST RATES [352]

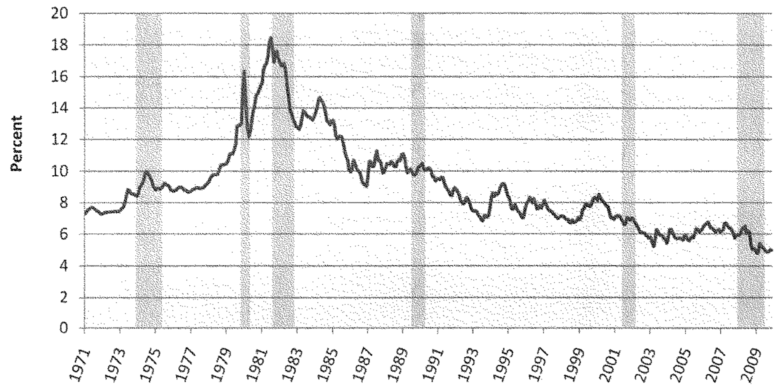


Figure 35, below, illustrates the mortgage interest rate spread over the yield of Treasury securities, an indicator of the market's perception of risk. In times of great uncertainty, such as late 2008, a classic financial panic, lenders demand larger spreads over low-risk Treasury securities in order to compensate for the increased risk of lending. Although the housing market has not appreciably improved since that time, the level of fear and confusion in the markets has subsided, leading to a decrease in spreads.

[352] Board of Governors of the Federal Reserve System, *Conventional Mortgages (Monthly)* (online at www.federalreserve.gov/releases/h15/data/monthly/h15__mortg__na.txt) (accessed Apr. 12, 2010). The shaded areas represent periods of recession as defined by the National Bureau of Economic Research (NBER). Business Cycle Expansions and Contractions, *supra* note 344; Bureau of Economic Analysis Data—Gross Domestic Product, *supra* note 344.

FIGURE 35: RECENT 30-YEAR FIXED RATE MORTGAGE RATE SPREADS [353]

e. Introductory Rate Resets

The resetting of the introductory rates on mortgages continues to be a major problem for the long-term prospects of the housing market, as the Panel has noted in previous reports. This concern was also raised by the National Fair Housing Alliance and by Litton Loan Servicing at the Panel's September 24, 2009 foreclosure mitigation field hearing.[354] Many loans in recent years were originated with extremely low introductory rates. After a period of several years, the rate would reset to a significantly higher above-market rate for the remainder of the term, either as a fixed-rate loan or more commonly as an adjustable-rate loan. By making housing appear to be more affordable, these low rates were a valuable marketing tool for lenders.

Many borrowers assumed that at the end of the introductory term, they would be able to refinance into another mortgage. While this may have seemed like a reasonable assumption in a rising market, refinancing is a difficult proposition when a property has fallen in value. In such an environment, in order to qualify for refinancing a borrower may have to contribute additional equity in order to meet loan-to-value standards. The recent decline in mortgage availability and the tightening of underwriting standards means many borrowers cannot find lenders to refinance their homes. Even if a lender is willing to refinance a property, prepay-

[353] This spread is the difference between the 30-year fixed-rate conventional mortgage rate and the yield on 10-year Treasury securities. Board of Governors of the Federal Reserve System, *Conventional Mortgages (Weekly)* (online at www.federalreserve.gov/releases/h15/data/Weekly__Thursday__/H15__MORTG__NA.txt) (hereinafter "Conventional Mortgages (Weekly)") (accessed Apr. 12, 2010); Board of Governors of the Federal Reserve System, *U.S. Government Securities/Treasury Constant Maturities/Nominal* (online at www.federalreserve.gov/releases/h15/data/Weekly__Friday__/H15__TCMNOM__Y10.txt) (hereinafter "U.S. Government Securities/Treasury Constant Maturities/Nominal") (accessed Apr. 12, 2010).

[354] Testimony of Deborah Goldberg, *supra* note 225, at 11; Congressional Oversight Panel, Written Testimony of Larry Litton, chief executive officer, Litton Loan Servicing, *Philadelphia Field Hearing on Mortgage Foreclosures,* at 4 (Sept. 24, 2009) (online at cop.senate.gov/documents/testimony-092409-litton.pdf).

ment penalties can make refinancing extremely expensive for the borrower.[355]

Over $1 trillion in mortgages will reset during the next three years, and resets will not peak until November 2011.[356] Option Adjustable Rate Mortgages (Option ARMs), in which the borrower chooses between different payment options, usually including a negative amortization option that adds unpaid interest to the loan balance, will make up a large percentage of the resetting loans going forward. In the Panel's Philadelphia Field Hearing on Foreclosures, Deborah Goldberg of the National Fair Housing Alliance pointed out that many Option ARM borrowers are severely underwater.[357]

Option ARMs were not generally subprime loans, since they were made to prime credit borrowers.[358] Many, however, were part of the larger "Alt-A" category of loans underwritten with reduced documentation, including "stated," i.e. unverified, income.[359] The terms subprime, prime, and Alt-A are used to describe the creditworthiness of a borrower. Creditworthiness of the borrower is, aside from mortgage type, the most common method of categorizing mortgages. Prime mortgages are loans to borrowers with good credit (typically above FICO 620) and adequate income. Alt-A mortgages are also loans to borrowers with prime (A) credit. However, Alt-As usually do not require income documentation, which is useful for small business owners and independent contractors who have variable income, but makes the loans susceptible to fraud. Subprime mortgages refer to loans to borrowers with poor credit (below 620). The Prime, Alt-A, and Subprime categories do not indicate the mortgage type (e.g., fixed or floating rate, interest only or fully amortizing). Another system of categorizing loans is by conformance with Fannie Mae/Freddie Mac (GSE) standards. Conforming mortgages are, of course, loans that meet these standards and are eligible for inclusion in GSE securitization pools. Non-conforming loans can be excluded from GSE pools for a variety of reasons, including loan size, loan type, borrower credit, income, loan-to-value, and fees. One common type of non-conforming loan is the Jumbo, a loan that exceeds the conforming limit, which ranged from $417,000 to $938,250 depending on location. Exotic products are typically nonconforming, even if made to prime borrowers. Because there are so many reasons a loan can be non-conforming, one cannot judge a loan's riskiness on this factor alone, nor can one

[355] Prepayment penalties may be attached to loans, most often subprime, as a means of reducing the lender's prepayment risk, or loss of loan profitability and return predictability for investors; the borrower generally receives a lower interest rate in exchange for the penalty. Gregory Elliehausen, Michael E. Staten, and Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages,* 60 Journal of Economics and Business, Issues 1–2 (Jan.–Feb. 2008) (online at business.gwu.edu/research/centers/fsrp/2009/EffectPrepayment.pdf).

[356] Zach Fox, *Credit Suisse: $1 Trillion Worth of ARMs Still Face Resets,* SNL Financial (Feb. 25, 2010) (online at www.snl.com/interactivex/article.aspx?CDID=A-10770380-12086).

[357] Testimony of Deborah Goldberg, *supra* note 225, at 11.

[358] Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts,* 94 Cornell L. Rev. 1073, 1086 (Nov. 2009) (online at www.law.virginia.edu/pdf/olin/conf08/bargill.pdf).

[359] Credit Suisse, *Research Report: Mortgage Liquidity du Jour: Underestimated No More,* at 16 (Mar. 12, 2007) (online at www.scribd.com/doc/282277/Credit-Suisse-Report-Mortgage-Liquidity-du-Jour-Underestimated-No-More-March-2007).

equate the terms "conforming" with "prime," or "nonconforming" with "subprime."[360]

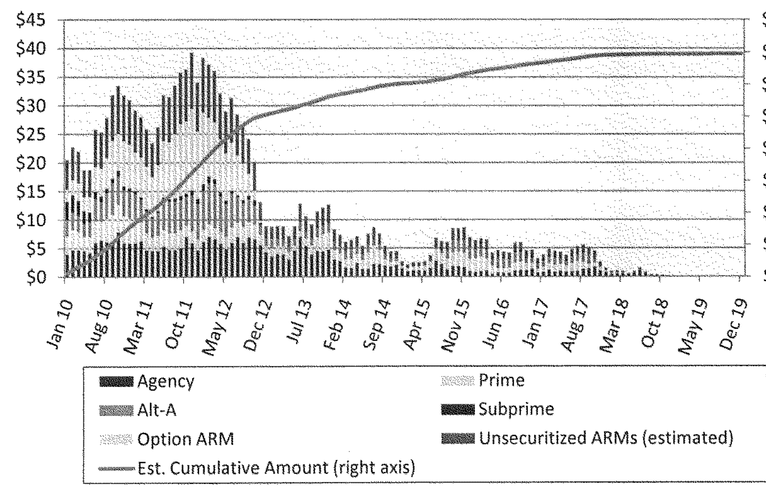
Interest-only loans comprise another category that will be resetting in large numbers. These loans, like Option ARMs, were a result of easy credit during the housing boom. Some of them will recast into fixed-rate mortgages at the end of the interest-only period, while others will become adjustable-rate mortgages. Currently, prevailing mortgage rates are low, so interest-only adjustable-rate borrowers facing resets this year might experience only a slight rise or even a decline in payments. However, the potential for rising interest rates as more of these mortgages reset could cause further stress on homeowners. A January 2010 report by Fitch Ratings estimated that $80 billion in prime and Alt-A interest-only loans would reset by the end of 2011. The report estimated that as a result of these resets, the average monthly payment would rise by 15 percent, and more if interest rates rise.[361] Data from First American CoreLogic prepared for the Wall Street Journal show that 500,000 interest-only loans are expected to reset in the next two years.[362]

Figure 36, below, is an updated version of the Credit Suisse interest rate reset chart that has appeared in earlier Panel housing reports.[363] Nearly all subprime mortgages have already reset, meaning that the foreclosure problem has moved from a subprime to a prime problem. It is worth noting the mortgage market for prime borrowers is much larger than the one for subprime, with prime loans comprising 68 percent of first-lien residential mortgages serviced by most of the largest mortgage servicers.[364]

[360] Kristie Lorette, *What is a Non Conforming Mortgage Loan* (online at www.ehow.com/about__6062372__non__conforming-mortgage-loan__.html) (accessed Apr. 12, 2010).
[361] Levitin & Twomey, *supra* note 78.
[362] Nick Timiraos, *Mortgage Increases Blunted,* Wall Street Journal (Mar. 29, 2010) (online at online.wsj.com/article/SB10001424052702303429804575150161178252530.html) (hereinafter "Mortgage Increases Blunted").
[363] *See* October Oversight Report, *supra* note 17, at 19.
[364] OCC and OTS Mortgage Metrics Report—Q4 2009, *supra* note 82, at 13.

FIGURE 36: MORTGAGE RATE RESETS[365]

[Dollars in billions]



Considering the large number of defaults caused by rate resets so far in this recession, and that the average loan-to-value ratio on option ARMs is 126 percent, meaning that these borrowers often have significant negative equity, it is reasonable to expect resets to be a major driver of delinquencies and foreclosures through the end of 2012 at least.[366] Mutual fund manager John Hussman has observed that:

> . . . the 2010 peak doesn't really get going until July–Sep (with delinquencies likely to peak about 3 months later, and foreclosures about 3 months after that). A larger peak will occur the second half of 2011. I remain concerned that we could quickly accumulate hundreds of billions of dollars of loan resets in the coming months, and in that case, would expect to see about 40% of those go delinquent based on the sub-prime curve and the delinquency rate on earlier Alt-A loans.[367]

On the other hand, some observers believe that the problem of defaults caused by interest rate resets will not be as severe as had been anticipated, at least as long as mortgage rates remain low, since many problematic loans have already defaulted, while others have been modified.[368]

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[365] Data provided by Credit Suisse Securities.

[366] Fitch Ratings, *Fitch: $47B Prime/Alt-A 2010 IO Loan Resets to Place Added Stress on U.S. ARM Borrowers* (Jan. 11, 2010) (online at www.businesswire.com/portal/site/home/permalink/?ndmViewId=news_view&newsId=20100111006615&newsLang=en).

[367] John P. Hussman, *Ordinary Outcomes of Extraordinary Recklessness,* Hussman Funds Weekly Market Comment (March 15, 2010) (online at hussmanfunds.com/wmc/wmc100315.htm).

[368] Mortgage Increases Blunted, *supra* note 362.

f. Negative Equity

The high percentage of borrowers with negative equity in their homes ("underwater" or "upside down") is a great concern for the future of the housing market and for foreclosure mitigation efforts. A recent study by First American CoreLogic found that negative equity was closely correlated with an increase in "pre-foreclosure activity," that is, delinquency.[369] The impact of negative equity, including its ability to "trap" borrowers in their current homes (discussed further in Section C.1(h)(i) and Annex I(1)k) was highlighted in the Panel's foreclosure mitigation field hearing by Dr. Paul Willen, senior economist at the Federal Reserve Bank of Boston. He testified that the "problem with negative equity is basically that borrowers can't respond to life events." Borrowers with positive equity simply have "lots of different ways they can refinance, they can sell, they can get out of the transaction." Dr. Willen also noted that even underwater borrowers who are current on their payments must be viewed as "at risk" borrowers.[370]

Although estimates vary, nearly one in four homeowners with mortgages are likely to be underwater. First American CoreLogic reported that more than 11.3 million, or 24 percent, of borrowers had negative equity at the end of the fourth quarter of 2009, up from 10.7 million, or 23 percent, at the end of the third quarter of 2009. An additional 2.3 million mortgages had less than five percent equity, or near negative equity. Together, negative equity and near negative equity mortgages accounted for nearly 29 percent of all residential properties with a mortgage nationwide. The aggregate value of negative equity in the fourth quarter of 2009 was $801 billion, up from $746 billion in the third quarter. The average negative equity of underwater borrowers in the fourth quarter was $70,700, up from $69,700 in the third quarter.[371] Thus, the problem of negative equity continues to spread to additional borrowers, and to intensify for those already facing negative equity.

Negative equity problems are worst in the Sunbelt bubble markets, as discussed in Annex II—Arizona, California, Florida, and Nevada. Recession-plagued Michigan, also discussed in Annex II, is high on the list as well. Figure 37, below, shows negative equity and near negative equity by state.

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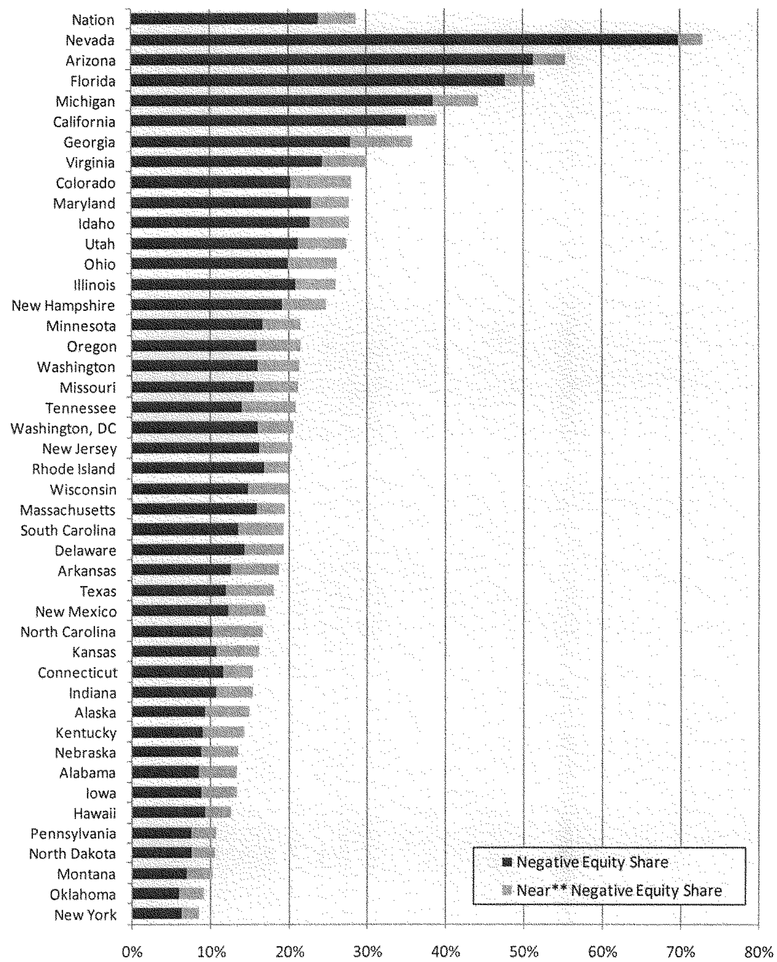
[369] First American CoreLogic, *Underwater Mortgages On the Rise According to First American CoreLogic Q4 2009 Negative Equity Data* (Feb. 23, 2010) (hereinafter "Underwater Mortgages On the Rise").

[370] Congressional Oversight Panel, Testimony of Dr. Paul Willen, senior economist, Federal Reserve Bank of Boston, *Transcript: Philadelphia Field Hearing on Mortgage Foreclosures,* at 109–110 (Sept. 24, 2009) (publication forthcoming).

[371] Underwater Mortgages On the Rise, *supra* note 369.

FIGURE 37: PERCENTAGE OF HOMES WITH NEGATIVE EQUITY [372]



In terms of individual metropolitan areas, cities in Florida and California [373] have the highest rates of negative equity. The areas with lowest rates are not geographically concentrated, but include many smaller cities in the Northeast, Midwest, and Northwest that did not undergo a great deal of housing appreciation during the bubble.[374]

[372] There is no negative equity data available for Louisiana, Maine, Mississippi, South Dakota, Vermont, West Virginia or Wyoming.

[373] Rates of negative equity are especially high in interior areas of California, such as the Central Valley.

[374] Negative equity data provided to the Panel by Stan Humphries, chief economist, Zillow (Feb. 23, 2010).

g. Second Liens

Loans secured by second or subordinate liens on a property can greatly complicate foreclosure mitigation. The loan balance on the first-lien mortgage generally cannot be written down unless the second lien is first extinguished.[375] Because of this, resolution of the second lien is a threshold issue in many foreclosure mitigation situations. Even after foreclosure, the borrower is often still liable for the second-lien debt. Not surprisingly, second-lien holders are not eager to extinguish these loans when there may be some residual value, even if the loan is apparently worthless because the amount owed on the first lien exceeds the current value of the home.[376]

Currently, 43 percent of borrowers have second liens on their homes. There is a strong correlation between the existence of second liens and delinquency. Treasury estimated in April 2009 that up to half of all at-risk borrowers had second liens. Although there is great variation in the rate of delinquency depending on the type of second lien, the year of origination, and the credit category or type of the loan, second-lien holders are consistently more likely to be delinquent than borrowers with only a first lien. For example, subprime loans made in 2006 with a simultaneous second lien[377] have a 62 percent rate of non-performance, while the same sort of subprime first mortgage borrowers without a second lien have a 52 percent rate of non-performance. In contrast, prime loans made in 2004, when the market was lower, with a subsequent second lien, have only a 5.6 percent rate of non-performance. However, this is still higher than the rate for the same sort of borrowers with only a single first mortgage, who have a 2.1 percent rate of non-performance.[378]

As of the end of 2009, the value of second-lien loans outstanding, including HELOCs, was $1.03 trillion. That was a decline of $100 billion from the peak outstanding balance of $1.13 trillion in 2007.[379] Due to accounting issues discussed in Section F.2, these figures may not reflect the true market value of the loans.

Of the approximately $1.03 trillion of second liens outstanding, 73.8 percent are held in banks' portfolios,[380] rather than being securitized or held by other institutions. Of those loans, approximately 58 percent are held by just four large banks—Bank of America, Citibank, JPMorgan Chase, and Wells Fargo.[381] Figures 38 and 39 illustrate that these four institutions all have significant exposure to second-lien loans, though that exposure has fluctuated significantly in recent years.

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[375] Second Liens—How Important?, *supra* note 36, at 1.

[376] James R. Hagerty, *Home-Saving Loans Afoot*, Wall Street Journal (Mar. 8, 2010) (online at online.wsj.com/article/SB10001424052748704706304575107770265900644.html).

[377] Simultaneous second liens are second lien debt originated at the same time as the first lien debt, as opposed to subsequent second liens, which are originated later.

[378] Second Liens—How Important?, *supra* note 36, at 6.

[379] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release Z.1*, at 96 (Mar. 11, 2010) (online at www.federalreserve.gov/releases/z1/Current/z1.pdf) (hereinafter "Federal Reserve Statistical Release Z.1").

[380] Federal Reserve Statistical Release Z.1, *supra* note 379, at 11 ($667.5 billion of $700 billion in second-lien loans held in bank portfolio).

[381] Second Liens—How Important?, *supra* note 36, at 10.

FIGURE 38: SECOND LIENS AS A PERCENTAGE OF TIER 1 CAPITAL[382]

	2005	2006	2007	2008	2009
Citigroup	23.8%	42.6%	46.7%	28.9%	21.0%
JPMorgan Chase	10.6%	17.4%	19.6%	14.6%	9.7%
Wells Fargo	58.3%	43.6%	50.0%	30.2%	22.4%
Bank of America	11.9%	12.0%	26.1%	29.2%	18.1%

[382] Data from SNL Financial. Second-lien data are limited to loans that do not revolve, such as home equity lines of credit. These loans are excluded because the some of the bank's exposure to revolving loans may never be tapped by the borrower.

FIGURE 39: SECOND LIENS AS A PERCENTAGE OF TIER 1 COMMON EQUITY[383]

	2005	2006	2007	2008	2009
Citigroup	26.5%	48.9%	66.3%	149.6%	25.5%
JPMorgan Chase	12.9%	20.7%	23.6%	22.9%	12.2%
Wells Fargo	68.5%	50.0%	58.7%	75.8%	32.1%
Bank of America	14.5%	15.2%	36.4%	55.8%	24.1%

[383] Data from SNL Financial. See note 381 for information regarding data limitations.

An interesting phenomenon that has come to light recently is that borrowers are often choosing to pay debt service on their second liens in preference to their first liens. This may seem counterintuitive, since first mortgages are traditionally thought to be much safer investments for lenders than second mortgages. Several explanations have been proposed. The recourse nature of many second mortgages makes it sensible for borrowers to continue paying those loans. Some have theorized that borrowers try to pay as many of their bills as possible, and therefore are neglecting the large first mortgage bill in order to pay other smaller expenses, such as a second mortgage. Another possible explanation is that HELOC borrowers are trying to maintain their access to credit by staying current on that loan.[384]

h. Delinquencies

Although not all delinquent borrowers end up in foreclosure, delinquencies are an important indicator of future foreclosures. They are also a useful indicator of the general economic well being of homeowners. The seasonally adjusted mortgage delinquency rate fell slightly during the fourth quarter of 2009 from 9.64 percent to 9.47 percent, according to the Mortgage Bankers Association.[385] Delinquency rates for the fourth quarter in 2006, 2007, and 2008 were 4.95 percent, 5.82 percent, and 7.88 percent, respectively. The modest decline in the fourth quarter of 2009 is thought to be significant because the rate usually increases in the fourth quarter due to the financial stress of holiday expenses.[386] However, the 2009 fourth quarter delinquency rate was still 1.59 percent higher on a year-over-year basis.[387]

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[384] Kate Berry, *The Shoe That Refuses to Drop: Home Equity Losses*, American Banker (Mar. 10, 2010) (online at www.americanbanker.com/issues/175__46/home-equity-losses-1015702–1.html).

[385] MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.

[386] Jann Swanson, *MBA Delinquency Survey Shows Signs of Stabilization. Progress Depends on Labor Market*, Mortgage News Daily (Feb. 19, 2010) (online at www.mortgagenewsdaily.com/02192010__mba__delinquency__survey__shows__signs__of__stabilization__progress__depends__on__labor__market.asp).

[387] 387 MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.

The type of loans that are delinquent is also of considerable interest to foreclosure mitigation efforts. The 90-day delinquency rate on prime loans, at 3.34 percent, is not surprisingly much lower than the rate for subprime loans. However, both rates rose in the fourth quarter of 2009. Figure 40 shows the 90-day delinquency rate over the last five years for prime, subprime, FHA, and VA loans, as well as the rate for all loans.[388] Although the subprime delinquency rate is very high, the rising delinquency rate on prime loans is more troubling, since there are far more prime loans outstanding, especially if Alt-A loans are included in the prime category, and they were supposedly made to much more creditworthy borrowers. "Prime" and "subprime" do not indicate loan structure or overall risk, only the creditworthiness of the borrower.[389]

FIGURE 40: SERIOUS DELINQUENCY RATE, 2005–2009 [390]

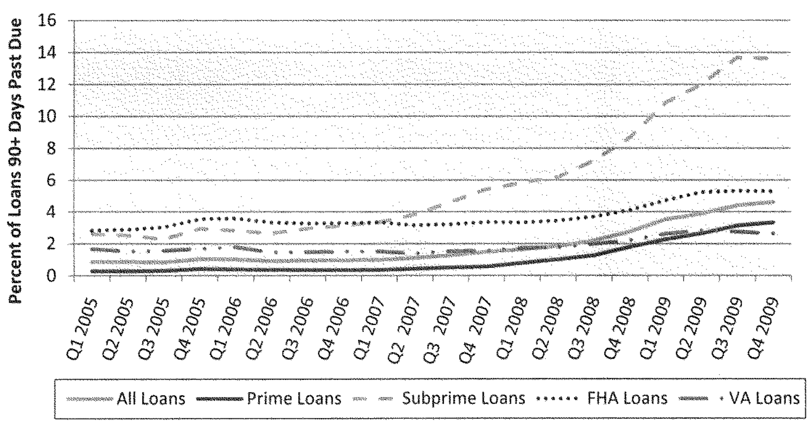
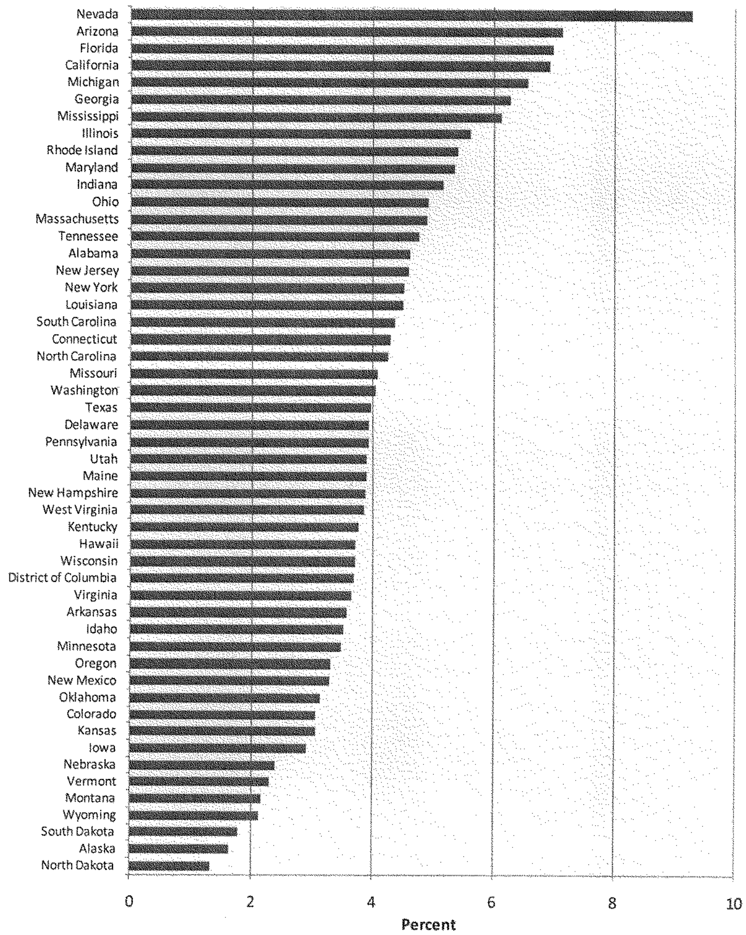


Figure 41, below, shows delinquency rates ranked by state. Figure 42, also below, is a map of 90-day delinquencies by county, with darker colors indicating higher delinquencies. It is clear from these two charts that the areas that boomed the most during the housing bubble, including most of Nevada, Arizona, Florida, and California, have the worst problems with delinquencies. Michigan also has a particularly high level of delinquencies. (See Annex II for additional discussion of the situation in these states.) It is also apparent that the areas that did not experience an extreme housing boom, such as the Plains states and portions of the Midwest and Northwest, are better off in terms of delinquencies.

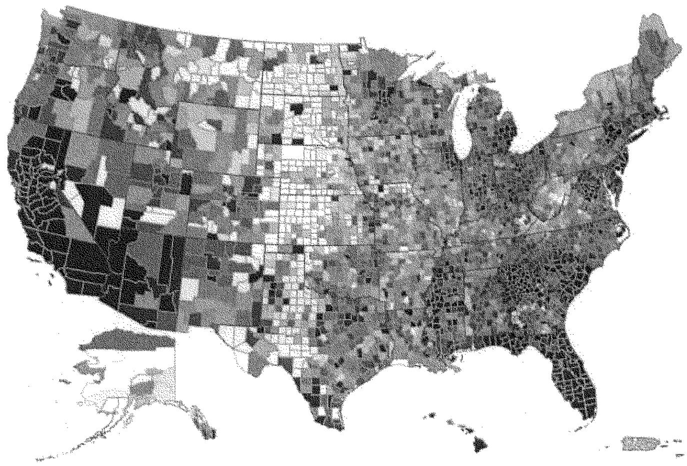
[388] MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.
[389] See further discussion in Annex I.1(e).
[390] MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.

FIGURE 41: STATES RANKED BY DELINQUENCIES [391]



[391] MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.

FIGURE 42: MORTGAGE DELINQUENCY RATE 90+ DAYS (AS OF Q4 2009) [392]



Darker shading indicates higher percentage. Data for the smallest 10 percent of the counties by population have been removed; the counties are shaded yellow because small-population statistics are prone to extreme values and erratic fluctuations.

i. Foreclosures

The foreclosure rate is the ultimate determinant of the success or failure of foreclosure mitigation efforts. It is also relevant because the REO by lenders as a result of foreclosures will eventually be sold, often at low prices, driving down comparable sale prices and overall property values. Outside influences, such as the date of mortgage rate resets, workloads at lenders, servicers, and foreclosure courts, and the timing of job losses, can cause the foreclosure rate to fluctuate.

The latest data indicate that February had the lowest year-over-year increase in foreclosure starts in four years.[393] While this may indicate an apparent improvement in market conditions, it remains to be seen whether the lower level of foreclosures can be sustained in the face of other trends, such as increasing negative equity and continuing high unemployment. It may also indicate that banks, courts, and others have reached their capacity to process foreclosures.[394]

More complete data are available as of the end of 2009. According to these data, the foreclosure process began on an additional 1.2 percent of all loans in the fourth quarter. While this was a significant drop from 1.42 percent in the third quarter, and the lowest rate for the year, it was still a considerably higher rate than any time during 2005–2008. Figure 43, below, shows foreclosure starts

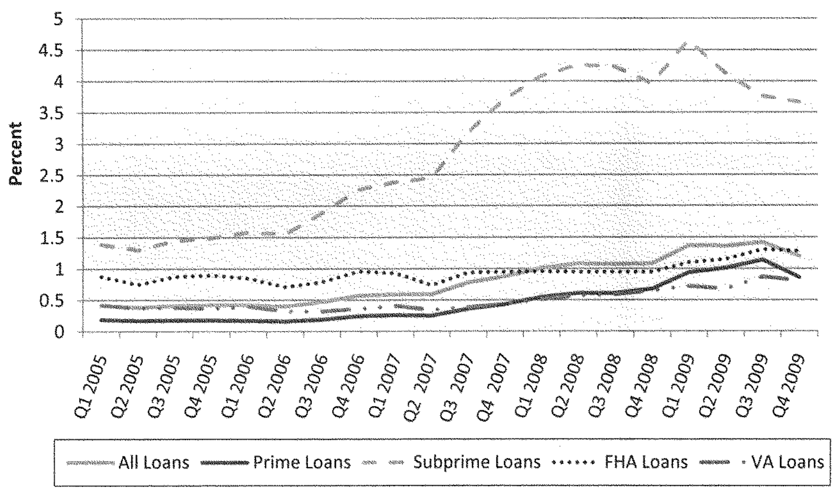
[392] Federal Reserve Bank of New York, *U.S. Credit Conditions* (online at data.newyorkfed.org/creditconditions/) (accessed Apr. 13, 2010).

[393] RealtyTrac, *U.S. Foreclosure Activity Decreases 2 Percent in February* (Mar. 11, 2010) (online at www.realtytrac.com/contentmanagement/pressrelease.aspx?channelid=9&itemid=8695).

[394] *See, e.g.* Kimberly Miller, *Florida's Foreclosure Backlog among Nation's Worst,* Palm Beach Post (Mar. 17, 2010) (online at www.palmbeachpost.com/money/real-estate/floridas-foreclosure-backlog-among-nations-worst-380990.html).

for various categories of loans. The subprime category was the worst performer at 3.66 percent, and the VA loan category was the best performer at 0.81 percent. All categories showed a similar downward trend in foreclosure starts in the fourth quarter.

FIGURE 43: FORECLOSURE STARTS BY LOAN CATEGORY, 2005–2009[395]



While starts have decreased across the board, the last quarter also saw the total inventory of loans in foreclosure rise from 4.47 percent to 4.58 percent of all loans. Foreclosure inventory increased by 1.28 percent during 2009, which indicates that foreclosure starts are adding to the stock of inventory faster than lenders are selling their real estate owned property. As Figure 44 below shows, subprime loans were most likely to be in foreclosure (15.58 percent). VA loans were least likely to be in foreclosure (2.46 percent), which reflects the low level of VA foreclosure starts in prior quarters.

[395] MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.

FIGURE 44: FORECLOSURE INVENTORY BY LOAN CATEGORY, 2005–2009[396]

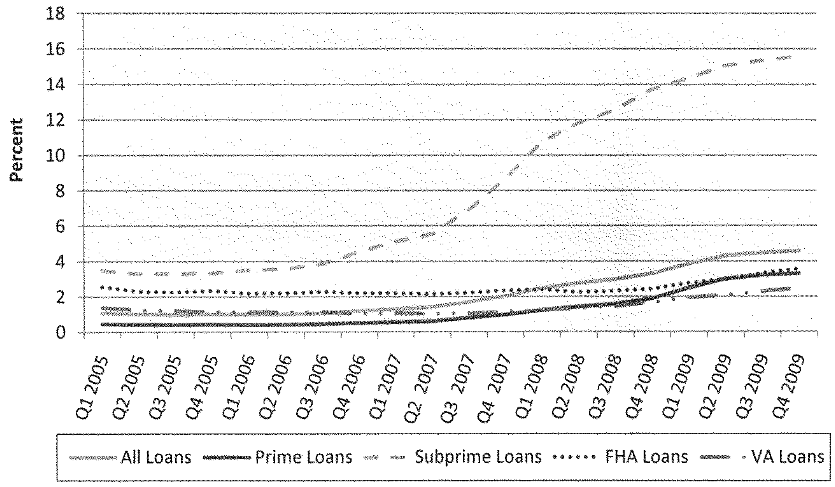
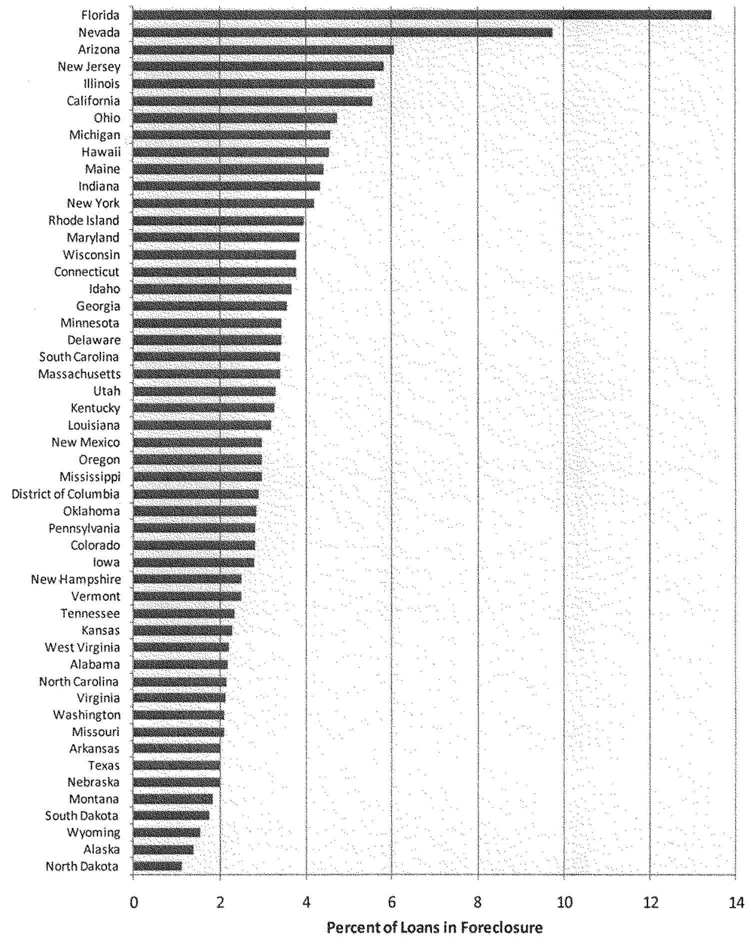


Figure 45 shows foreclosure inventory by state. Once again, Florida (13.34 percent), Nevada (9.76 percent), and Arizona (6.07 percent) topped the list, although New Jersey (5.82 percent) and Illinois (5.62 percent) edged out California (5.56 percent).[397] Ohio (4.72 percent) was next, followed by Michigan (4.56 percent).

[396] MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.

[397] Variations in local foreclosure procedures can significantly affect foreclosure timetables and therefore foreclosure inventory. For a given level of defaults, foreclosure inventory is likely to be higher in states with slower foreclosure procedures because foreclosure inventory accumulates rather than being converted into REO or sold to third-party buyers. Accordingly, foreclosure inventory levels do not necessarily correlate with default indicators, such as negative equity.

FIGURE 45: FORECLOSURE INVENTORY BY STATE [398]



Should lenders suddenly change their policies in a way that results in more REOs on their books (such as foreclosing more aggressively) or permit more short sales, the housing market may be hit by a glut of distressed home sales. This will almost certainly drive prices down further, and consequently, worsen negative equity and lead to more defaults. This also raises concerns about the capacity of lenders and servicers to work through this backlog without overwhelming their staffs and causing additional foreclosures and losses to investors that could have been prevented had these delinquencies been dealt with more promptly.

Some, such as Mr. Fratantoni, lay the blame at the feet of Treasury. “I think that it’s been pretty clear that these efforts to delay the foreclosure process—that’s precisely what they’re doing: They’re

[398] MBA National Delinquency Survey, *supra* note 1 (subscription required). *See also* February MBA Survey Results, *supra* note 1.

delaying; they're not resolving in many cases. And at some point there is going to be an effort to resolve these longer-run delinquencies," Mr. Fratantoni said. "We're starting to see that now with Treasury's program to streamline and encourage short sales. And I expect that's where more of these resolutions are headed in the months and years ahead."[399]

j. Short Sales/Deed-in-Lieu

One of the alternatives to foreclosure available to lenders is to allow an underwater borrower to complete a "short sale," or to sell the property for less than the loan balance.[400] Although the lender takes an immediate loss, a short sale allows the lender to avoid the expense and difficulty of a foreclosure. The lender also avoids the risks of a loan modification plan, such as the possibility of re-default, and the chance that the future state of the market will not meet expectations. Short sales can be a satisfactory solution for the borrower. The borrower is able to get out of the underwater mortgage with less damage to his or her credit rating, without putting up additional equity, and without being burdened by a workout plan that does not reduce indebtedness.

Short sales can be particularly beneficial to borrowers who have reason to move anyway, perhaps to start a new job or go back to school. In order to move, as discussed earlier in Section B and below in Annex I(1), these borrowers would otherwise have to either default or make up the negative equity with cash. If homeowners are not able to move, they may have difficulty finding work. Similarly, employers may have more difficulty hiring qualified candidates if the labor market lacks normal flexibility. Consequently, negative equity can have a significant negative macroeconomic effect beyond its effect on the housing market.

The National Association of Realtors reports that 14 percent of all January home sales were short sales.[401] Figure 46 shows short sales as a percentage of total sales over the past 16 months.

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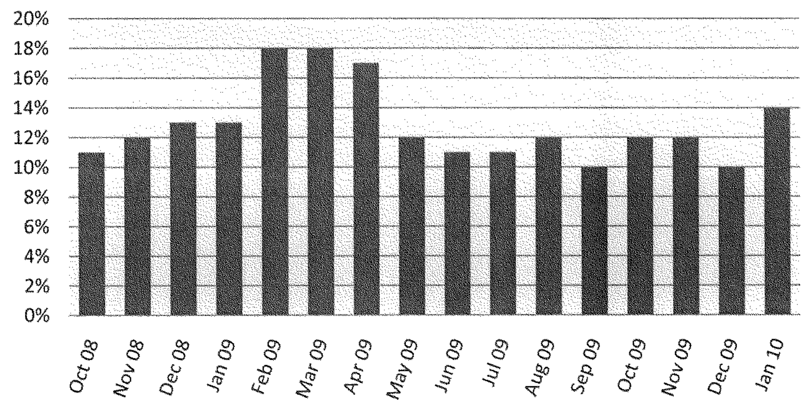
[399] Zach Fox, *With Foreclosures, Python Refuses to Digest Pig,* SNL Financial (Mar. 24, 2010).

[400] A short sale applies only to borrowers with negative equity, or near negative equity. Only when the sale proceeds (the value of the property less sale costs) are less than the loan balance (i.e., negative equity) is the sale considered "short." A borrower with significant positive equity would have sale proceeds that are greater than the loan balance; the sale would not be considered "short."

[401] Data provided by National Association of Realtors.

FIGURE 46: SHORT SALES AS A PERCENTAGE OF ALL HOME SALES [402]



Another alternative to foreclosure is a deed-in-lieu of foreclosure, in which the borrower voluntarily gives the house to the lender in exchange for elimination of the mortgage. This strategy also avoids the difficulties of foreclosure for both lender and borrower. While data on deeds-in-lieu for the entire market are not readily available, FHFA does release deed-in-lieu data for approximately 30 million GSE-serviced loans, which are a significant portion of the overall market. As of October 2009, the GSEs had completed 382,848 foreclosure prevention actions in the prior 12 months. Only 2,872, or 0.7 percent, of these actions were deed-in-lieu of foreclosure transactions.[403] It is unclear whether this minimal level of activity is indicative of the use of deeds-in-lieu in the broader housing market.

k. Strategic Defaults

Recently, there has been a surge of interest in the subject of strategic defaults, in which borrowers choose to default on their mortgages, despite the fact that they have the ability to continue making payments.[404] The term "strategic default" encompasses a number of different situations.

Some borrowers who are deep in negative equity may decide that the consequences of default—having to move, damage to their credit ratings, and, for some, feelings of guilt or embarrassment—are less than the burden of negative equity that they would remain responsible for paying. Owners of investment properties and second homes may make more detached, businesslike decisions in this regard than borrowers contemplating default on their primary residences. Other borrowers may strategically default out of what they believe to be financial necessity. For example, if they believe they

[402] Data provided by National Association of Realtors.

[403] Federal Housing Finance Agency, *Refinance Volumes and HAMP Modifications Increased in December* (Jan. 29, 2010) (online at ofheo.gov/Default.aspx/cgi/t/text/webfiles/15389/Foreclosure_Prev_release_1_29_10.pdf).

[404] *See, e.g.,* James R. Hagerty and Nick Timiraos, *Debtor's Dilemma,* Wall Street Journal (Dec. 17, 2009) (online at online.wsj.com/article/SB126100260600594531.html); Linda Lowell, *Who, in the End, Will Strategically Default?*, Housing Wire (Mar. 1, 2010) (online at www.housingwire.com/2010/03/01/who-in-the-end-will-strategically-default/).

will never be able to repay the debt, default may be the only reasonable option left. The comparatively low cost of renting as opposed to owning may also be an incentive to a strategic default for some borrowers.

A borrower may also strategically default if he or she needs to move, but does not have sufficient cash to pay off the mortgage's negative equity. If the lender does not agree to a principal write-down, short sale, or other form of debt forgiveness, borrowers remain "trapped" in their homes and have little choice but to default if they wish to move. There is a wide range of inevitable life events that necessitate moves: the birth of children, illness, death, divorce, retirement, job loss, education, and new jobs. Without a way to deal with the negative equity, many borrowers facing these events will be forced to default.

The decision for a strategic default is often influenced by the borrower's expectation of when property values will recover, erasing the negative equity. Since some predictions do not expect a full recovery in the hardest hit markets until 2030 or later,[405] many borrowers have significant incentives to default.

Because borrowers who strategically default do not usually reveal that they have done so, it is hard to determine exactly how many strategic defaults are occurring. Although estimates of strategic defaults vary considerably, it is apparent that these defaults are common and are, not surprisingly, increasingly likely as borrowers sink deeper underwater.

Researchers at Northwestern University's Kellogg School of Management have estimated that 26 percent of all defaults are strategic. They also found a strong correlation between negative equity and strategic default, and that "below 10 percent negative equity people do not walk away, as it is too costly and there is a moral consideration—a shame factor." Another interesting finding was that "social pressure not to default is weakened when homeowners live in areas with high frequency of foreclosures or know other people who defaulted strategically."[406]

A September 2009 study by credit bureau Experian and consulting firm Oliver Wyman estimated that 18 percent of delinquent borrowers strategically defaulted in 2008. That study also found that borrowers with higher credit ratings were 50 percent more likely to strategically default, and that these defaults were most common in markets with many borrowers who are deeply underwater. The principal researcher of the study, Piyush Tantia, has said that borrowers who strategically default "are clearly sophisticated" and view the default as a business decision.[407]

[405] Fiserv, FHFA, and Moody's Economy.com, *Hardest Hit Metros Will Take Longer to Recover* (2010). *See also* John Spence, *Moody's Bearish on Housing Recovery,* MarketWatch (Sept. 18, 2009) (online at www.marketwatch.com/story/home-prices-wont-regain-peak-this-decade-moodys-2009–09–18). A map based on these predictions is shown at the end of Annex I.

[406] Kellogg Insight, *Walking Away: Moral, Social, and Financial Factors Influence Mortgage Default Decisions* (Jul. 2009) (online at insight.kellogg.northwestern.edu/index.php/Kellogg/article/walking_away).

[407] Experian-Oliver Wyman, *Market Intelligence Report: Understanding Strategic Default in Mortgages, Part I* (Sept. 2009) (online at www.marketintelligencereports.com) (subscription required); Kenneth R. Harney, *Homeowners Who "Strategically Default" on Loans a Growing Problem,* Los Angeles Times (Sept. 20, 2009) (online at www.latimes.com/classified/realestate/news/la-fi-harney20-2009sep20,0,2560658.story).

1. Shadow Inventory

"Shadow inventory" in the housing market most commonly refers to REOs held by banks but not yet put up for sale, homes that are in the foreclosure process, and seriously delinquent homes that are expected to enter foreclosure.

First American CoreLogic, a subsidiary of First American Corp., has estimated a shadow inventory of 1.7 million homes as of September 2009, an increase of 55 percent in one year.[408] Bank Foreclosures Sale, an online foreclosure listing site, estimates an additional 2.4 million foreclosures will occur in 2010.[409] For comparison, as mentioned earlier, there are 3.3 million homes currently on the market.[410]

A recent study by Standard & Poor's, while not quantifying the number of homes in shadow inventory, found that at the current rate of disposal ("closing") of REOs and delinquent loans, there are currently 29 months of shadow inventory. When recently cured delinquent loans that are expected to redefault are added (using current redefault rates),[411] the total increases to 33 months of shadow inventory. Currently performing loans that default in the future would only add to this inventory.[412]

Some definitions of shadow inventory include homes that homeowners want to sell, but are waiting to put on the market until conditions improve. This is potentially a significant number of homes. A survey conducted by Zillow found that almost a third of homeowners have considered putting their homes up for sale, but are waiting for market conditions to improve.[413] There is little reason to believe that this number has shrunk substantially in the year since the survey was conducted. Since there are 75 million privately owned homes in the United States, this potential inventory could be as much as 24 million homes.[414]

It would not be appropriate to count all these homes as shadow inventory since many owners may not carry through with their intention to sell, and those that do will not sell all at once. Nevertheless, the number is so large that even a fraction of this additional supply coming to market could easily tamp down any recovery in property values. Figure 47 shows the responses to Zillow's survey.

[408] First American CoreLogic, *"Shadow Housing Inventory" Put at 1.7 Million in 3Q According to First American CoreLogic* (Dec. 17, 2009) (online at www.facorelogic.com/uploadedFiles/Newsroom/RES_in_the_News/FACL_Shadow_Inventory_121809.pdf).

[409] PR Newswire, *Shadow Inventory Properties May Contribute to Next Wave of Foreclosures in 2010,* MarketWatch (Jan. 11, 2010) (online at www.marketwatch.com/story/shadow-inventory-properties-may-contribute-to-next-wave-of-foreclosures-in-2010-2010-01-11?siteid=nbkh).

[410] Existing-Home Sales Down in January, *supra* note 345.

[411] Currently modified loans may not redefault in the future at the rate assumed here. However, some of these modified and performing loans will certainly redefault, and should be considered as shadow inventory.

[412] Standard & Poor's, *The Shadow Inventory of Troubled Mortgages Could Undo U.S. Housing Price Gains* (Feb. 16, 2010) (online at www.standardandpoors.com/ratings/articles/en/us/?assetID=1245206147429).

[413] Stan Humphries, *When the Bottom Arrives, A Flood of "Shadow Inventory"?*, Zillow (May 19, 2009) (online at www.zillow.com/blog/when-the-bottom-arrives-a-flood-of-shadow-inventory/2009/05/19/) (hereinafter "Stan Humphries, When the Bottom Arrives"). Zillow has indicated to Panel staff that many of these homeowners who responded that they were likely to sell may have wanted to sell during 2006–2010, but decided to "wait it out" because of the low level of home prices. Zillow also indicated that many of these may be homeowners "trapped" by negative equity, and therefore unable to move until prices recover (or they default, as discussed in Annex I(1)(k).

[414] U.S. Department of Commerce, Bureau of the Census, *Census Bureau Reports on Residential Vacancies and Homeownership,* at 3 (Feb. 2, 2010) (online at www.census.gov/hhes/www/housing/hvs/qtr409/files/q409press.pdf).

Figure 48 shows what homeowners who are considering selling would consider to be a "turnaround" in the housing market.

FIGURE 47: ZILLOW SURVEY SHADOW INVENTORY RESPONSES[415]

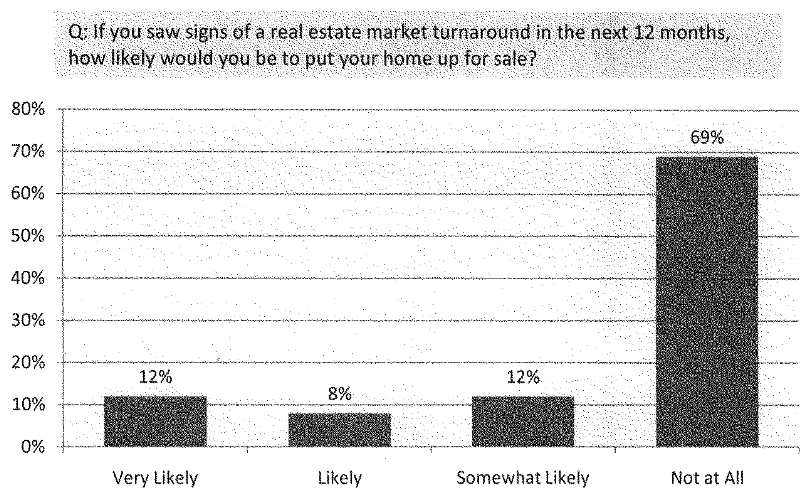
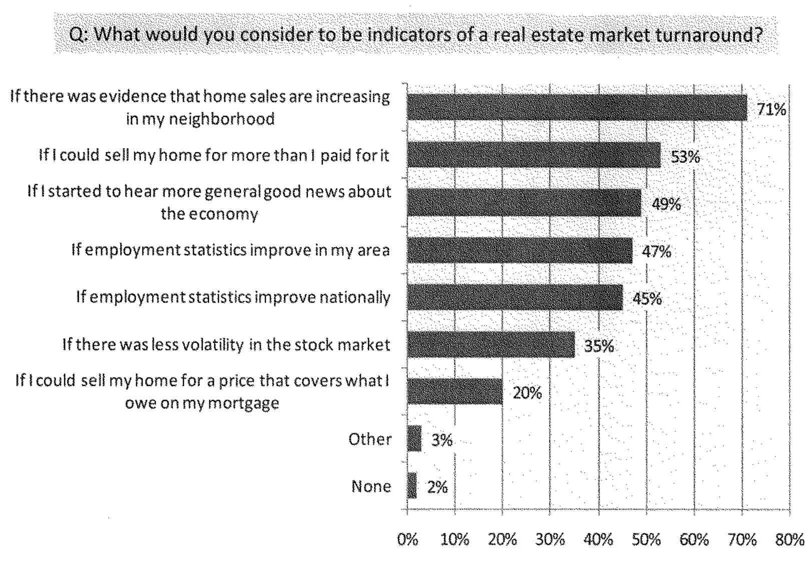


FIGURE 48: ZILLOW SURVEY MARKET TURNAROUND RESPONSES[416]



[415] Stan Humphries, When the Bottom Arrives, *supra* note 413.
[416] *Id.*

2. Economic Indicators

The state of the housing market and the state of the overall economy are closely intertwined. While the growth of the housing bubble and its subsequent collapse were key causes of the recent recession, the linkage works in the other direction as well—a weak economy can drag down the housing market. Several economic indicators, especially unemployment and interest rates, are of critical importance to housing values and consequently to foreclosure mitigation. This section explores recent trends in major economic indicators.

a. Unemployment

As mentioned at the beginning of Section I(B), unemployment is a major driver of delinquencies, foreclosures, and consequently, home values. Unemployed borrowers without significant savings are unlikely to be able to pay their debt service regardless of what loan modifications they receive.

According to the most recent data from the Bureau of Labor Statistics (BLS), the unemployment rate held steady at 9.7 percent in March 2010 for the second month in a row. This equates to 14.9 million unemployed workers. Although the unemployment rate has fallen from its late 2009 highs, which topped 10 percent, it remains considerably higher than the 8.6 percent rate a year earlier.[417] The number of long-term unemployed (jobless for 27 weeks or more) increased from 6.3 million in January to 6.5 million in March on a seasonally adjusted basis. Since the start of the recession in December 2007, the number of long-term unemployed has risen by 5 million. The average duration of unemployment was 29.3 weeks, slightly higher than in January, and almost 10 weeks higher than in February 2009.[418] The current long-term unemployment rate of nearly 4 percent (41 percent of all unemployed) is significantly higher than in other recent recessions. In June 1983, seven months after the official end of a recession, long-term unemployment peaked at 3.1 percent, which until recently was the highest long-term rate since before World War II.[419]

Figure 49, below, shows the percentage of workers unemployed for 27 weeks or longer since 1980. The shaded areas indicate recessions. As the chart shows, the current rate of long-term unemployment is higher than at any other time during this period, including the severe recession of 1981–1983.

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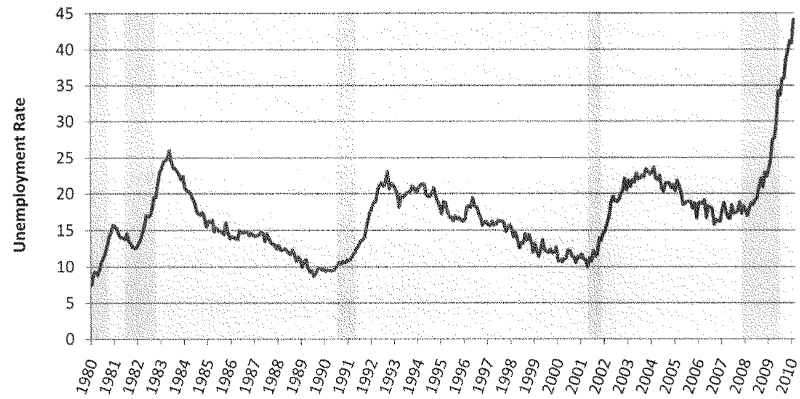
[417] U.S. Department of Labor, Bureau of Labor Statistics, *The Employment Situation—March 2010,* at 4 (Apr. 2, 2010) (online at www.bls.gov/news.release/archives/empsit_04022010.pdf) (hereinafter "The Employment Situation—March 2010") (using seasonally adjusted data).

[418] *Id.*

[419] U.S. Department of Labor, Bureau of Labor Statistics, *A Glance at Long-Term Unemployment in Recent Recessions,* Issues in Labor Statistics, Summary 06–01 (Jan. 2006) (online at www.bls.gov/opub/ils/pdf/opbils53.pdf).

FIGURE 49: LONG TERM UNEMPLOYMENT AS A PERCENTAGE OF TOTAL UNEMPLOYMENT [420]



Unemployment is highest in Michigan (14.1 percent), Nevada (13.2 percent), and Rhode Island (12.7 percent), and lowest in North Dakota (4.1 percent), Nebraska (4.8 percent), and South Dakota (4.7 percent).[421]

Unemployment increased in the past year across all occupations. The job categories with the highest rates of unemployment in March 2010 were construction and extraction (24.6 percent), and farming, fishing, and forestry (21.8 percent). The occupations with the lowest rates were professional and related (4.3 percent) and management, business, and financial operations (5.4 percent).[422]

The unemployment rate was significantly higher for men (10 percent) than for women (8.0 percent).[423] Unemployment was also higher among African Americans (16.5)[424] and Latinos (12.6 percent)[425] than among Whites (9.3 percent) and Asians (7.5 percent).[426] All of these demographic groups had higher rates of unemployment in March 2010 than a year earlier.

Workers with little education have fared the worst in this recession. The unemployment rate is 14.5 percent for workers with less than a high school diploma. High school graduates have an unem-

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[420] U.S. Department of Labor, Bureau of Labor Statistics, *Total Unemployed, Percent Unemployed 27 Weeks & Over (Instrument: Percent Distribution, 27 Weeks and Over)* (online at www.bls.gov/webapps/legacy/cpsatab12.htm) (accessed Apr. 12, 2010). The shaded areas represent periods of recession as defined by the National Bureau of Economic Research (NBER). The NBER has not yet determined whether the recession that began in December 2007 has ended nor established the date of its ending. The Panel's own estimate is that this recession ended at the end of Q2 2009, the last quarter of net decline in the U.S. Gross Domestic Product (GDP), and that is the date assumed here. Bureau of Economic Analysis, *Gross Domestic Product* (accessed Apr. 5, 2010) (online at www.bea.gov/national/txt/dpga.txt).

[421] U.S. Department of Labor, Bureau of Labor Statistics, *Regional and State Employment and Unemployment Summary,* at 3 (Mar. 26, 2010) (online at www.bls.gov/news.release/archives/laus_03262010.pdf). This data is for February 2010, the latest available.

[422] The Employment Situation—March 2010, *supra* note 417, at 24 (using data that is not seasonally adjusted).

[423] The Employment Situation—March 2010, *supra* note 417, at 4 (using seasonally adjusted data).

[424] *Id.*, at 12.

[425] *Id.,* at 14.

[426] *Id.*, at 12. Unlike the other racial categories in this paragraph, the unemployment rate for Asians is not seasonally adjusted. The BLS does not publish seasonally adjusted unemployment data for Asians.

ployment rate of 10.8 percent. Workers with some college have an 8.2 percent rate. Workers with a bachelor's degree or higher are faring best, with only a 4.9 percent unemployment rate.[427] By contrast, in 1980, high school graduates had an unemployment rate of 5.8 percent, the rate of workers with some college was 4.7 percent, and the rate for workers with a bachelor's degree was 2.1 percent, according to the Department of Education.[428]

The number of people working part-time for economic reasons grew from 8.8 million in February 2010 to 9.0 million in March 2010.[429] An additional 2.3 million people not included as "unemployed" were considered "marginally attached" to the labor force, an increase of 149,000 from a year earlier; these are people who are available to work and have looked for work sometime in the past year. Of these marginally attached workers, 994,000 were considered "discouraged," an increase of 309,000 from a year earlier.[430] Adding these people to the number of people who are officially unemployed yields a 16.9 percent rate of unemployment/underemployment, up from 16.5 percent in January 2010.[431]

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[427] *Id.*, at 15.

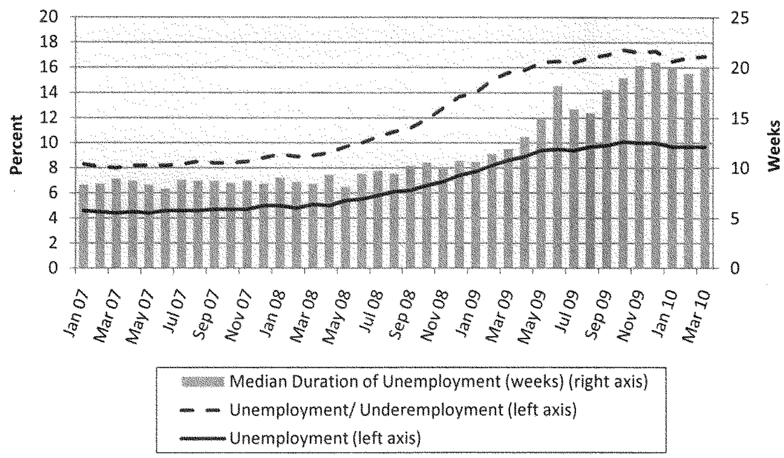
[428] In the 2001 recession the unemployment rates for workers with high school diplomas, some college, and bachelor degrees were 3.8, 2.6, and 1.7 percent, respectively. *See* U.S. Department of Education, National Center for Education Statistics, *Employment Outcomes of Young Adults by Race/Ethnicity* (online at nces.ed.gov/programs/coe/2005/section2/table.asp?tableID=264) (accessed Apr. 12, 2010). The most recent economic downturn (2008-current) highlights the fact that college-educated individuals are experiencing increasingly difficult times finding work. *See* U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2009*, at 558 (Apr. 2010) (online at nces.ed.gov/pubs2010/2010013.pdf) (noting the rise in unemployment among all individuals with a bachelor's or higher degree from 2006–2008).

[429] The Employment Situation—March 2010, *supra* note 417, at 19.

[430] *Id.*, at 27 (using data that is not seasonally adjusted).

[431] *Id.*, at 26.

FIGURE 50: UNEMPLOYMENT, UNEMPLOYMENT/UNDEREMPLOYMENT, AND DURATION OF UNEMPLOYMENT[432]



On the positive side, the informal though well-regarded report on layoffs compiled by the outplacement firm Challenger, Gray, and Christmas showed a decline in layoffs in February 2010 to the lowest level since July 2006. In total, 42,090 planned layoffs were reported in February, down 41 percent from 71,482 in January, and down 71 percent from the 186,350 layoffs announced in February 2009. The retail and automotive sectors showed the biggest drops in layoffs compared to last year, down 75 percent and 90 percent, respectively.[433] This is perhaps not surprising, given the massive job losses these industries suffered in 2009. It should be noted that the Challenger, Gray, and Christmas report tracks announced layoffs only, and does not include all job losses. Nevertheless, it indicates that the rate of job losses is slowing.

However, there is negative news regarding employment by state and local governments. This sector was traditionally thought to be "recession-proof," but more recently, extensive layoffs have been announced. According to the Bureau of Labor Statistics, the number of unemployed government workers in March 2010 (not seasonally adjusted) is projected to be as high as 881,000.[434] Because the economy has not recovered to a sufficient degree to boost tax revenues, more government employees may be laid off in 2010 and be-

[432] The Employment Situation—March 2010, *supra* note 417, at 26 (citing to data in Table A–15. Alternative measures of labor underutilization); Federal Reserve Bank of St. Louis, *Median Duration of Unemployment* (online at research.stlouisfed.org/fred2/series/UEMPMED/downloaddata) (accessed Apr. 12, 2010). The Bureau of Labor Statistics defines the underemployment measure as "[t]otal unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force." The Employment Situation—March 2010, *supra* note 417, at 26.

[433] Challenger, Gray & Christmas, Inc., *Planned Job Cuts Drop 41%* (Mar. 3, 2010). *See also* Rex Nutting, *Planned Layoffs Drop to Lowest Level Since 2006,* MarketWatch (Mar. 3, 2010) (online at www.marketwatch.com/story/planned-layoffs-drop-to-lowest-level-since-2006-2010-03-03).

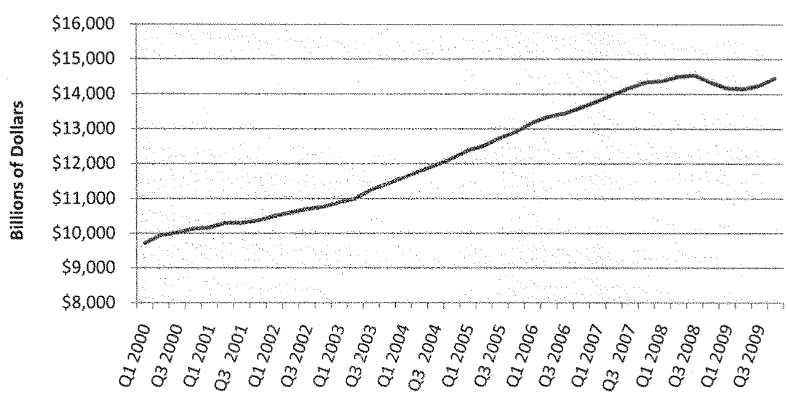
[434] The Employment Situation—March 2010, *supra* note 417, at 25 (using data that is not seasonally adjusted).

yond, absent further federal support to state and local governments.

b. Gross Domestic Product

The overall level of economic activity is most commonly measured by the Gross Domestic Product (GDP). The GDP of the United States continued to grow, and in fact accelerate, through the end of 2009. Real GDP rose at an annualized rate of 5.9 percent in the fourth quarter of 2009, a considerable increase from 2.2 percent growth in the third quarter[435] and a decrease of 0.7 percent in the second quarter.[436] The Bureau of Economic Analysis attributes the robust fourth quarter growth to increases in exports, personal consumption expenditures, nonresidential fixed investment, and private inventory investment. Unfortunately, the rise in inventory investment was likely due in large part to businesses replenishing their stocks as they anticipated economic recovery; this often happens toward the end of a recession after businesses have reduced their inventories. Therefore, the recent boost in inventory investment is unlikely to have a long duration, which means it may be hard to sustain the level of GDP growth seen in the fourth quarter. Also, while it is likely that federal government stimulus spending has had some positive effect on GDP growth, it is not clear to what degree it has helped, or what impact the end of stimulus spending will have on the economy.

FIGURE 51: GDP



c. Interest Rates

Interest rates are, for many reasons, a matter of great importance to the housing market. Lenders price mortgages at a spread over a baseline interest rate, such as a Treasury security with a comparable term. In addition to affecting affordability and home prices, the mortgage payment on an adjustable rate mortgage de-

[435] U.S. Department of Commerce, Bureau of Economic Analysis, *GDP and the Economy: Second Estimates for the Fourth Quarter of 2009,* at 1 (Mar. 2010) (online at www.bea.gov/scb/pdf/2010/03%20March/0310_gdpecon.pdf) (hereinafter "GDP and the Economy: Second Estimates for the Q4 2009").
[436] *Id.*, at 2.

pends on prevailing market interest rates. As interest rates on mortgages reset over the next three years, as discussed in Section C, prevailing interest rates could help determine whether the housing market recovers or crashes again.

The section below looks at several interest rates that affect the residential mortgage market. Although market forces play a major role in determining most interest rates, the Federal Reserve monetary policy also has a great effect on rates in normal times, and is thus central to understanding the prospects of the housing market and foreclosure mitigation efforts. Short-term rates generally reflect the current supply and demand for credit in the economy, as well as inflation, government fiscal policy, monetary policy actions, market sentiments, foreign exchange rates, and other factors. Longer-term rates are influenced by these factors as well, but more importantly, by expectations of future short-term rates. If lenders expect rates to rise in the future, they will require a higher interest rate on long-term loans. Long-term rates are more market driven and less sensitive to central bank policies than are short-term rates.

In general, interest rates remain extremely low in both nominal and real terms. Rates set or targeted by the Federal Reserve remain near the "zero bound," beyond which nominal rates cannot fall, constraining the ability of monetary policy to stimulate the economy.

i. Discount Rate Increase

The discount rate is the interest rate charged to financial institutions on the fully secured loans they receive from the Federal Reserve—the "discount window." Short-term discount rate loans from the Federal Reserve are available to depository institutions that offer eligible collateral, such as Treasury securities, or more recently, certain mortgage-backed securities. By setting the discount rate at a certain level, the Federal Reserve can influence other market-set interest rates.[437] On February 18, 2010, the Federal Reserve Board announced a 25-basis point increase in the discount rate to 0.75 percent. This was the first increase in the discount rate since June 2006, near the height of the housing bubble. Furthermore, the Federal Reserve shortened the maturity period for borrowing under the primary credit window from 28 days to overnight.[438]

ii. Fed Funds Rate

The Fed Funds rate, the interest rate at which depository institutions loan funds held at the Federal Reserve to other depository institutions, was 0.20 percent on April 6, 2010. Interbank borrowing at the Fed Funds rate is a major source of liquidity in the banking system. Although the actual rate is set by the market, it is greatly influenced by the Federal Reserve, which uses open market operations to hold the rate at a predetermined target as part

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[437] Federal Reserve Bank of New York, *The Discount Window* (Aug. 2007) (online at www.newyorkfed.org/aboutthefed/fedpoint/ fed18.html).

[438] Board of Governors of the Federal Reserve System, *Federal Reserve Approves Modifications to the Terms of Its Discount Window Lending Programs* (Feb. 18, 2010) (online at www.federalreserve.gov/newsevents/press/monetary/ 20100218a.htm).

of its monetary policy. These actions to target a particular rate affect the amount of reserves in the banking system, and consequently influence bank lending policies and behavior.[439] This rate has fluctuated from 0.05 to 0.20 percent from October 2009 through March 2010. This is down considerably from rates above 2 percent at the height of the credit crunch in late 2008.[440]

Many market observers have viewed the Federal Reserve's recent decisions, including raising the discount rate, shortening the maturity period for borrowing under the primary credit window, and the decision to allow four Federal Reserve programs established to provide liquidity at the height of the crisis to expire as indicators that the Federal Reserve may target an increase in the Fed Funds rate in the near future.[441] The current extremely low interest rates, with short-term rates near zero, concern some members of the Federal Reserve, who believe that extended periods of low rates fuel speculative asset bubbles.[442] A policy of continued monetary tightening would inevitably drive up mortgage rates. On February 24, 2010, however, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke stated:

> The FOMC [Federal Open Market Committee] continues to anticipate that economic conditions—including low rates of resource utilization, subdued inflation trends, and stable inflation expectations—are likely to warrant exceptionally low levels of the federal funds rate for an extended period.[443]

Although the meaning of "an extended period" is deliberately vague, Federal Reserve Bank of Chicago President Charles Evans (who is not an FOMC voting member) has suggested that this term means approximately six months, a considerably shorter time than many observers had assumed the term meant.[444]

iii. Treasury Yields

The yields of Treasury securities trading in the secondary market, that is, the effective rate of return from these securities at market prices, are the most common benchmark interest rates used by banks to determine the rates on loans, including many mortgages (i.e., long-term market-determined interest rates). The yield of 30-year Treasury bonds, the most widely followed Treasury yield,

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[439] Federal Reserve Bank of New York, *Federal Funds* (Aug. 2007) (online at www.newyorkfed.org/aboutthefed/ fedpoint/fed15.html).

[440] Board of Governors of the Federal Reserve System, *Selected Interest Rates, Fed Funds Rate, Daily Series* (online at www.federalreserve.gov/releases/h15/ data/Daily/H15_FF_O.txt) (accessed Apr. 8, 2010). As of March 16, 2010, the Federal Open Market Committee's target range for the federal funds rate was 0 to 1/4 percent. Board of Governors of the Federal Reserve System, *FOMC Statement* (Mar. 16, 2010) (online at www.federalreserve.gov/ newsevents/press/ monetary/ 20100316a.htm) (hereinafter "FOMC Statement").

[441] The four Federal Reserve facilities were the Primary Dealer Credit Facility (PDCF), the Term Securities Lending Facility (TSLF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), and the Commercial Paper Funding Facility (CPFF).

[442] FOMC Statement, *supra* note 440 (noting the dissent of Kansas City Fed President Thomas M. Hoenig); *see also Peter Barnes Interview with Kansas City Fed President Thomas Hoenig* (Fox Business Network television broadcast Mar. 24, 2010).

[443] House Committee on Financial Services, Written Testimony of Ben S. Bernanke, chairman, Board of Governors of the Federal Reserve System, *Semiannual Monetary Policy Report to the Congress*, at 3 (Feb. 24, 2010) (online atwww.house.gov/apps/list/hearing/financialsvcs_dem/ 022410_mpr_house-financial-services.pdf).

[444] Robert Flint, *Defining Fed's Extended Period*, Wall Street Journal (Feb. 26, 2010) (online at blogs.wsj.com/marketbeat/2010/02/26/defining-feds-extended-period/).

was 4.74 percent as of April 7, 2010. Yields of all maturities are low in historical terms. The yield curve, a graphical representation of the yields of Treasury securities of all maturities, is "normal" (longer maturities bear higher yields) and relatively steep. For example, the difference between 2-year and 10-year Treasury yields was 2.83 percent on April 7, 2010.[445] Long-term and short-term interest rates tend to move together but may react differently to market or economic changes. Two-year notes and other shorter term rates are impacted primarily by monetary policy, responding quickly and precisely to actions taken by the Federal Reserve such as changes to the discount rate. Long-term interest rates, on the other hand, behave in a more complicated manner, incorporating expectations for inflation and future interest rates as well as supply and demand conditions in the mortgage-backed securities market. Absent Federal Reserve activity in Treasury markets or mortgage-backed securities markets, long-term interest rates move somewhat independently from Federal Reserve action. A steep yield curve is considered a sign of economic optimism among bond investors, and often precedes an economic recovery. In April 1992, for example, the yield curve was relatively steep as the economy emerged from recession and the savings and loan debacle. A steeper yield curve indicates that investors expect higher short-term interest rates in the future. Higher rates are usually, though not always, a reaction to inflation driven by increased economic activity.[446]

d. Economic Sector Surveys

Business surveys are often useful for illuminating trends that are occurring in the economy or providing insight into the thinking of business leaders. The Institute for Supply Management's Report on Business (Non-Manufacturing), which tracks the health of the service sector of the economy, showed general improvement in its most recent report from March 2010. Business activity/production and new orders both grew at increasingly faster rates than in previous months. Inventories fell again, but at a slower rate than February. However, these positive signs were countered by the survey's results on inventory sentiment, which indicated that for the 154th straight month, service businesses believe that there is too much inventory in the system. Reported service employment also declined, albeit at a slowing rate.[447] This continued lack of hiring may indicate that service business owners lack confidence in the strength of the economy.

The Philadelphia Federal Reserve's widely followed manufacturing sector survey showed an increase in its "diffusion index" in March to a level of 18.9, up from 17.6 in February. This increase means that survey respondents reported an increase in business activity. The diffusion index has remained positive for seven consecutive months, indicating a steady revival of the manufacturing sector. Survey responses in specific business activity categories

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[445] U.S. Department of the Treasury, *Daily Treasury Yield Curve Rates* (online at www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml) (accessed Apr. 8, 2010).

[446] PIMCO, *Yield Curve Basics* (July, 2006) (online at www.pimco.com/LeftNav/Bond+Basics/2006/ Yield__Curve__Basics.htm).

[447] Institute for Supply Management, *March 2010 Non-Manufacturing ISM Report on Business* (Apr. 5, 2010) (online at www.ism.ws/ISMReport/NonMfgROB.cfm).

showed positive numbers for new orders, shipments, and employment in March. The report also concluded that manufacturers remain optimistic about future business activity.[448]

[448] Federal Reserve Bank of Philadelphia, *March 2010 Business Outlook Survey* (Mar. 2010) (online at www.phil.frb.org/research-and-data/regional-economy/business-outlook-survey/2010/bos0310.pdf).

ANNEX II: WHAT'S GOING ON IN ARIZONA, CALIFORNIA, FLORIDA, NEVADA, AND MICHIGAN?

Although the troubles in the housing market have affected all areas of the country, as shown by statistics in Annex I, certain markets have been particularly struck by the downturn in housing prices. This annex examines the dire housing market conditions in Arizona, California, Florida, Michigan, and Nevada. With the exception of Michigan, the states that boomed the most during the bubble years are now suffering the most severe bust.

a. What are their housing market and economic indicator statistics?

Figure 52 below shows some housing related indicators for the five hardest hit states.

FIGURE 52: STATE INFORMATION

	FHFA Housing Price Index % Change 2001–2006 [449]	FHFA Housing Price Index % Change Since Q4 2006 [450]	FHFA Housing Price Index % Change 2009 [451]	Percent of Borrowers in Negative Equity [452]	Delinquency Rate (90 days+) [453]	Percentage of Loans in Foreclosure [454]	Unemployment Rate (as of 12/31/09) [455]
Arizona	97%	(36)%	(12.7)%	51.3%	7.13%	6.07%	9.1%
California	106%	(38)%	(0.4)%	35.1%	6.93%	5.56%	12.4%
Florida	107%	(37)%	(8.2)%	47.8%	6.99%	13.44%	11.8%
Nevada	99%	(48)%	(17.3)%	69.9%	9.28%	9.76%	13.0%
Michigan	16%	(20)%	(2.8)%	38.5%	6.57%	4.56%	14.6%
National Average	55%	(10)%	(1.2)%	23.8%	5.09%	4.58%	9.7%

[449] HPI Historical Reports (2000–2009), *supra* note 324.
[450] U.S. and Census Division Monthly Purchase Only Index, *supra* note 330 (accessed Apr. 13, 2010); U.S. and Census Division Monthly Purchase Only Index, *supra* note 330 (accessed Apr. 13, 2010).
[451] Federal Housing Finance Agency, *Purchase Only Index: State HPI Summary* (online at www.fhfa.gov/Default.aspx?Page=215&Type=summary) (accessed Apr. 13, 2010).
[452] Underwater Mortgages On the Rise, *supra* note 369.
[453] MBA National Delinquency Survey, *supra* note 1 (subscription required); *see also* February MBA Survey Results, *supra* note 1.
[454] MBA National Delinquency Survey, *supra* note 1 (subscription required); *see also* February MBA Survey Results, *supra* note 1.
[455] U.S. Department of Labor, Bureau of Labor Statistics, *Regional and State Employment and Unemployment Summary—December 2009* (Jan. 22, 2010) (online at www.bls.gov/news.release/archives/laus_01222010.pdf).

b. Why are things so bad there?

Although all five states have been severely affected by the bursting of the housing bubble, Michigan's situation is different from the other states. The drop in Michigan property values has been largely due to the continued decline of the state's economic engine, the big three American auto companies. Although this downward trend has been going on for nearly 40 years, the acute difficulties the automakers faced in 2008 and 2009 led to massive layoffs and plant closings that crippled an already weak housing market. As mentioned earlier, Michigan has the nation's highest unemployment rate. Many homes in the state's largest city, Detroit, are nearly worthless due to a lack of employed, qualified buyers. Detroit has 33,000 vacant homes, and over 90,000 abandoned lots. To cope with this situation, the Mayor of Detroit has proposed bulldozing large portions of the city to reduce the area that the city government must serve.[456]

[456] Michael Snyder, *The Mayor of Detroit's Radical Plan to Bulldoze One Quarter of the City*, Business Insider (Mar. 10, 2010) (online at www.businessinsider.com/the-mayor-of-detroits-radical-plan-to-bulldoze-one-quarter-of-the-city-2010–3).

Arizona, California, Florida, and Nevada have the opposite problem. They are high growth "sunbelt" areas, which have attracted millions of new residents in recent decades from declining areas such as Michigan, for instance. An excessive level of optimism about the economic prospects of these states led to many poorly planned investments and severe overdevelopment of housing. These four states saw particularly extreme versions of the trends that affected the country as a whole during the housing bubble: easy credit, sloppy mortgage underwriting, subprime and stated income lending, general disregard for credit risk, the rampant use of exotic loans, overdevelopment of new homes, and manic, speculative home buying. The existence of a real estate market cycle was largely disregarded, conservative underwriting standards were derided as obsolete, and rising home prices drove a "sky's the limit" mentality.

For example, option ARMs, perhaps the most risky type of mortgage generally available to the public, were particularly common in these four states. Nearly 75 percent of all option ARMs were originated in these four states.[457] By contrast, these states account for only 17 percent of all mortgages outstanding in the United States.[458]

It is difficult to predict how long the decline will continue in the five hardest-hit states, and how far prices will ultimately fall, given the various external factors that could affect the housing market. Such predictions are outside the scope of this report. However, a research arm of the credit rating agency Moody's, Economy.com, predicts home prices in most parts of the five states will not return to their previous highs until the year 2030 or later. Figure 53, below, shows Economy.com's estimates of housing recovery dates by metropolitan statistical area.

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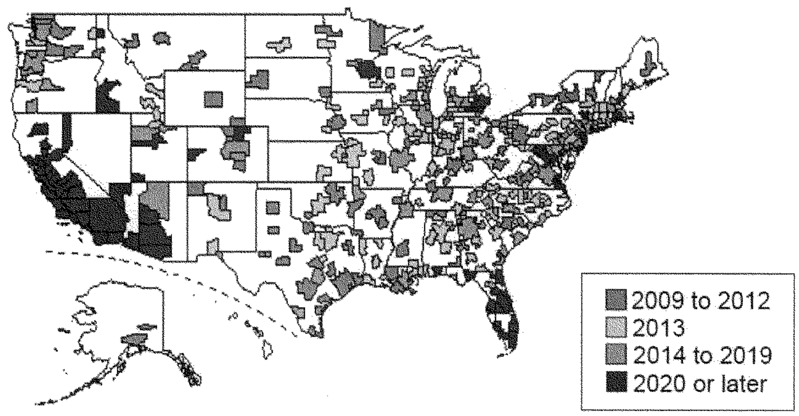
[457] Levitin & Twomey, *supra* note 78.

[458] MBA National Delinquency Survey, *supra* note 1 (subscription required); see also February MBA Survey Results, *supra* note 1.

FIGURE 53: YEAR IN WHICH METRO AREA REGAINS PREVIOUS HOUSE PRICE PEAK[459]



[459] Fiserv, FHFA, and Moody's Economy.com, *Hardest Hit Metros Will Take Longer to Recover* (2010).

ANNEX III: LEGAL AUTHORITY

EESA authorizes the Secretary of the Treasury to establish the TARP "to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution." [460] Treasury has structured HAMP to involve commitments to purchase financial instruments from mortgage servicers, but the underlying economics of the program are that Treasury is paying not for financial instruments but for the servicing of loan modifications. Members of the Panel have questioned Treasury as to whether expenditures under HAMP are in fact authorized by EESA.

A. Treasury's Position

Treasury's General Counsel, George Madison, has shared with the Panel a summary of his legal views on the authority for HAMP, but Treasury has asserted that the letter containing that summary would be subject to the attorney-client privilege as applied to third parties, and is subject to the Panel's confidentiality arrangements with Treasury.[461] The General Counsel's letter is addressed to Panel member Paul Atkins and copied to Panel Chair Elizabeth Warren. Treasury has stated that the Panel may summarize or quote from the letter but may not reprint it in its original form.

The letter states that HAMP is authorized by sections 101 and 109 of EESA. It argues that a HAMP Servicer Participation Agreement involves Treasury's commitment to purchase a "financial instrument" that is a "troubled asset," from a financial institution and thus the commitment and purchase are authorized by section 101. It adds that the payments Treasury makes are "credit enhancements" authorized by section 109. Treasury's primary assertion is that it is purchasing "financial instruments" from servicers. The HAMP Servicer Participation Agreement is titled "Commitment to Purchase Financial Instrument and Servicer Participation Agreement," and includes an attachment titled "Financial Instrument." [462]

The General Counsel notes that EESA authorizes the Secretary of the Treasury to establish a program to purchase "troubled assets" from financial institutions. He notes that "troubled assets" are defined under EESA to include "any other *financial instrument* that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress." [463] (Emphasis added.)

EESA does not define "financial instrument," but the letter outlines the view that:

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[460] 12 U.S.C. § 5211(a)(1).

[461] The letter explains that "[w]hile it is not our custom to release internal legal analyses, [this letter] share[s] a summary of my legal views with you." Letter from George Madison, general counsel, U.S. Department of the Treasury, to Paul Atkins, member, Congressional Oversight Panel (Jan. 12, 2010).

[462] U.S. Department of the Treasury, *Commitment to Purchase Financial Instrument and Servicer Participation Agreement* (online at www.hmpadmin.com/ portal/docs/hamp_servicer/ servicerparticipationagreement.pdf) (hereinafter "Commitment to Purchase Financial Instrument and Servicer Participation Agreement") (accessed on Apr. 5, 2010).

[463] Letter from George Madison, general counsel, U.S. Department of the Treasury, to Paul Atkins, member, Congressional Oversight Panel (Jan. 12, 2010) (citing 12 U.S.C. § 5202(9)).

> In the absence of such a definition, the Supreme Court has directed that a statutory term be construed in accordance with its ordinary or natural meaning. The ordinary and natural meaning of 'financial instrument' includes a written legal document that defines duties and grants rights and is financial in nature. This meaning is supported by dictionary definitions, federal case law and published financial accounting standards.[464]

The letter continues:

> The instruments executed by the servicers easily fall within the ordinary and natural meaning of the term 'financial instrument' in that each one is a written legal document that defines duties and grants rights and pertains to the receipt and use of money. The instruments recite the servicers' respective promises (i.e., duties) to Treasury to modify mortgages meeting criteria set out in the instrument and to distribute the funds paid by Treasury consistent with the directions set out in the instruments.

The General Counsel explains that, while Treasury has "generally used its authority under EESA to purchase financial instruments in the form of shares of preferred stock or promissory notes, the ordinary or natural meaning of the term 'financial instrument' is not limited to stock certificates and promissory notes," given Treasury's authority, noted above, to purchase "any financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability." The letter states that EESA section 2(1), which says that the purpose of EESA is "to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States," gives the Secretary "broad authority" to determine which type of financial instrument can be purchased.

The General Counsel points to the legislative history to support the interpretation that the Secretary has broad authority to determine which type of financial instrument to purchase[465] and to use some of this authority to purchase assets "directly for foreclosure mitigation."[466] His letter explains that "[t]he contract that the Sec-

[464] The letter does not contain citations to dictionary definitions, federal case law, or published financial accounting standards.

[465] The letter cites to Senator Dodd's statement:

> Section 101 of the legislation gives broad authority for the Treasury Secretary, in consultation with other agencies, to purchase and make and fund commitments to purchase troubled assets from financial institutions on terms and conditions that he determines. This legislation does not limit the Secretary to specific actions, such as direct purchases or reverse auctions but could include other actions, such as a more direct recapitalization of the financial system or other alternatives that the Secretary deems are in the taxpayers' best interest and that of the Nation's economy.

154 Cong. Rec. 10283 (daily ed. Oct 1, 2008) (statement of Sen. Dodd).

[466] To support this, the letter points to a colloquy between Representatives Edwards and Frank "in which Representative Frank clarified this important legislative intent that Treasury use a portion of the spending authority in EESA to mitigate mortgage foreclosures:"

> Ms. EDWARDS of Maryland. Madam Speaker, if I might make an inquiry of the gentleman from Massachusetts.

Continued

retary enters into with each servicer is a 'commitment' to purchase the financial instrument executed by the servicer, and the Secretary 'purchases' the financial instrument by making the payments to the servicer set out in the contract." It continues that:

> [T]he purchase contracts . . . are enforceable contracts that contain the servicers' agreement to issue their financial instruments to the Secretary, and the Secretary's agreement to purchase those financial instruments. Treasury pays the purchase price for those financial instruments, as valuable consideration, by making the payments of money to the servicers set out in the contracts. The contracts entered into by the Secretary . . . with the servicers are plainly 'commitments to purchase troubled assets' authorized by section 101(a)(1) of EESA and the Secretary is 'purchasing' financial instruments by making those payments.

The letter also describes the purchase price of each contract as the series of payments that Treasury makes to a servicer as incentive payments for the servicer and for the servicer to pass along to the lender/investor or borrower.

Finally, the General Counsel explains that the servicers are "financial institutions" under section 3(5) of EESA. He notes that the statutory definition of "institution" does not contain an exclusive list, so long as the organization is created and regulated under U.S. federal, state, possession or territorial law, has substantial U.S. operations, and is not operating as or owned by foreign central banks.

In addition, the General Counsel characterizes the payments made to servicers as "credit enhancements" under EESA section 109(a). The letter states that EESA section 109(a) says that "the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." The letter notes that neither EESA nor Black's Law Dictionary defines "credit enhancement." The analysis in this instance cites to the Encyclopedia of Banking and Finance (10th ed. 1994), which "defines 'credit enhancement' as being '[a] generic term for collateral, letters of credit, guarantees, and other contractual mechanisms aimed at reducing credit risk.'" The letter explains how each payment is a credit enhancement:

> The Treasury commitment in the proposed contacts [sic] to make interest-subsidy and principal-reduction payments to lenders and investors plainly enhances the creditworthiness of the homeowners; it therefore constitutes a credit

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> In my reading of the bill, I am trying to understand whether it is your belief that the Treasury has the authority under this legislation to use some portion of that $700 billion to deal directly with homeowners, specifically with homeowners facing foreclosure. And could you clarify for me the circumstances under which the Treasury has that authority when it wholly owns the mortgage, and when that mortgage is being serviced by loan servicing centers?
>
> Mr. FRANK of Massachusetts. If the gentlewoman will yield, the answer is absolutely. And I can tell you that I have spoken to the Treasury, to the Secretary, to tell him it is very important; that many Members will be voting for this bill only with the understanding that he will use that authority. And I believe he accepts that fact and will act on it.

154 Cong. Rec. H10770–10771 (daily ed. Oct 3, 2008) (statements of Rep. Edwards and Rep. Frank).

> enhancement that facilitates loan modifications by the servicers. The Treasury commitment to make the 'home price depreciation reserve' payments is a contractual mechanism that operates to guarantee, or at least mitigate loss to, the value of the collateral for the credit transaction as a whole; it therefore also constitutes a credit enhancement that facilitates loan modifications. The Treasury commitment to make the proposed payments to servicers to extinguish junior liens reduces the homeowners' overall indebtedness; it therefore plainly constitutes a credit enhancement that facilitates loan modifications. The Treasury commitment to make the proposed payments for foreclosure alternatives minimizes the negative impact that a foreclosure would have on the credit rating of a borrower; it therefore constitutes a credit enhancement, vis-a-vis foreclosure, that prevents avoidable foreclosure. Lastly, it is highly questionable that servicers would enter into thousands of loan modifications under the HAMP, and therefore doubtful that the HAMP could be successfully implemented, if the HAMP did not include incentive and 'success' payments to servicers. Moreover, the 'success' payments increase the likelihood that servicers will modify loans that are more likely than other troubled loans to continue to be repaid.[467]

Finally, the letter points out that section 109(a) of EESA instructs the Treasury that, "to the extent that the Secretary acquires mortgages and mortgage-backed securities," it shall encourage the servicers of the underlying mortgages to take advantage of existing programs to minimize foreclosures. The letter explains that "while Treasury has not acquired whole mortgages or mortgage-backed securities under EESA, Treasury has, in furtherance of the spirit of that provision, developed and implemented the voluntary HAMP to encourage servicers to minimize foreclosures on mortgages . . . that the Treasury does not even own."

B. Outside Legal Experts' Opinions

The Panel requested outside legal opinions from independent, nationally recognized legal scholars. Professor Eric Posner of the University of Chicago Law School and Professors John A.E. Pottow and Stephen P. Croley from the University of Michigan Law School provided the Panel with opinions. The full text of the two opinions is included in this Annex.

Professor Posner concluded that under clear administrative law precedent, Treasury would be accorded deference in its determination of what constitutes a financial instrument and therefore a troubled asset under section 3(9)(B) of the EESA, so long as its determination was "reasonable." Professor Posner noted, however, that even with such deference, Treasury's determination that HAMP payments to servicers were pursuant to the commitment to purchase a financial instrument was in fact not reasonable, as the

[467] The letter is dated the day before the announcement of the Hardest Hit Fund program, therefore it does not describe how the payments to local housing finance agencies are financial instruments or credit enhancements.

contracts with servicers were not commitments to purchase financial instruments in any sense that the term "financial instrument" is used elsewhere in federal law or the Uniform Commercial Code. Professor Posner noted, however, that it is unlikely that any party would have legal standing to challenge HAMP's legality.

Professors Pottow and Croley concluded that HAMP is implicitly authorized by EESA's purposes and design. They state that section 109 of EESA applies expressly to loans in which Treasury has an ownership interest, but does not preclude Treasury from establishing a program for loans which it does not own. They note that, despite Treasury's titling of the "Servicer Participation Agreement" as also being a "Commitment to Purchase Financial Instrument," even under "the most generous legal interpretation," the document is a service contract and not a financial instrument. In doing so, Professors Pottow and Croley examined a number of definitions of "financial instrument" from the Uniform Commercial Code, case law, the tax code, and the Office of Thrift Supervision. Turning to EESA's statutory purpose, they explain that Congress gave Treasury broad powers to stabilize the financial markets, including the mortgage arena. They point to the purposes of EESA as set out in section 2, as well as the Secretary's "necessary and appropriate" implementing power. Professors Pottow and Croley conclude that Treasury's actions with regard to HAMP would "likely pass the 'arbitrary and capricious' bar of EESA section 119(a)(1)" and would not constitute an "abuse of discretion" under 119(a)(1).

The Panel takes no position on the ultimate legality of HAMP and suggests that HAMP's legality is an issue best suited for Congress to take up if it is in fact concerned by Treasury's actions.[468]

[468] The Panel recognizes the possibility that even if Treasury's actions are extra-legal, Congressional inaction could be interpreted as ratification.

To: Professor Elizabeth Warren, Chair, Congressional Oversight Panel
From: Eric A. Posner, University of Chicago Law School
Date: April 1, 2010
Re: Treasury's Authority Under the Emergency Economic Stabilization Act to Implement the Home Affordable Modification Program

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You have asked me for my opinion as to whether Treasury has the authority under the Emergency Economic Stabilization Act (EESA) to use TARP funds to finance the Home Affordable Modification Program (HAMP). I conclude that Treasury has no such authority. However, because no one may have standing to challenge HAMP, it seems unlikely that it will be struck down by a court. I do not represent anyone, and have not received compensation for this opinion from the Congressional Oversight Panel or anyone else.

I. The Home Affordable Modification Program

HAMP is available to certain homeowners at risk of foreclosure. The central feature of this program is a model contract entitled the Commitment to Purchase Financial Instrument and Servicer Participation Agreement (the "Commitment"). Fannie Mae, as financial agent of the United States, may enter this contract with any loan servicer eligible to participate in the program. Under the contract, Fannie Mae pays loan servicers to modify mortgage contracts in favor of homeowners, using funds made available to Treasury under EESA. In addition, Fannie Mae channels money through the loan servicer to homeowners who stay current with HAMP modified loans and investors whose contractual rights are modified. The overall goal is to reduce mortgage payments without compromising the rights of investors. This should both reduce the incidence of foreclosure and strengthen the financial condition of banks and other institutions that hold mortgages and mortgage-related securities.

II. Treasury's Authority Under EESA

EESA grants Treasury the authority:

> to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.

EESA, § 101(a)(1). Under the Commitment, Treasury pays the loan servicers to modify mortgage contracts and to transfer funds to investors and homeowners. Accordingly, the issue is whether Treasury's authority to "purchase" a "troubled asset" entitles it to pay for a loan modification—or, in short, whether a loan modification is a troubled asset.[469]

"Troubled assets" are defined as:

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[469] A question could also be raised whether Treasury has the authority to make payments to homeowners and investors, using loan servicers as agents.

(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and

(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

EESA, § 3(9). Accordingly, a troubled asset is a mortgage, a mortgage-related security, a mortgage-related obligation, a mortgage-related instrument, or "any other financial instrument" that satisfies the criteria in subsection (B).

This definition spells trouble for HAMP. Under HAMP, Fannie does not purchase an "asset," troubled or otherwise, from the loan servicer. It purchases, in effect, a right to have loans modified. Loan modification is a service: it is the performance of a series of actions rather than a tangible or intangible thing. Subsection A defines a troubled asset as, among other things, a mortgage. A loan modification is not a mortgage—the loan servicer is modifying other people's mortgages; it is not selling mortgages that it owns or they own. Subsection A also defines a troubled asset as a mortgage-related security or obligation. A loan modification is a service, not a security or other obligation.

Subsection A also defines a troubled asset as a mortgage-related instrument and Subsection B broadens this definition to include "any other financial instrument." The Commitment is clearly written with these definitions in mind. The Commitment refers to the loan servicer's obligation to modify loans as a "financial instrument" in numerous places. Its title mentions a "commitment to purchase *financial instrument*" (emphasis added). Section 1(B) of the Commitment provides that "Servicer shall perform the Services described in (i) the Financial Instrument attached hereto as Exhibit B (the 'Financial Instrument')." Section 4(A) provides that "Fannie Mae, in its capacity as a financial agent of the United States, agrees to purchase, and Servicer agrees to sell to Fannie Mae, in such capacity, the Financial Instrument that is executed and delivered by Servicer to Fannie Mae in the form attached hereto as Exhibit B, in consideration for the payment by Fannie Mae, as agent, of the Purchase Price." Exhibit B supplies the form of the Financial Instrument. The Financial Instrument, as it appears in Exhibit B, restates Fannie Mae's obligation to pay for the Servicer's services; makes that obligation conditional on prior performance of those services and other actions; imposes various reporting requirements on the Servicer; requires the Servicer to implement an internal control program; states that the Servicer promises to comply with various laws, regulations, business norms, and the like; and much else in this vein.

Is the Financial Instrument a mortgage-related "instrument" or a "financial instrument" within the meaning of § 3(9) of EESA? If so, Treasury has the authority to fund HAMP. If not, it does not have the authority under EESA.

EESA does not define "financial instrument." Accordingly, one must look outside the statute for definitions. The legislative history is uninformative.[470] One lay definition of "financial instrument" is "cash; evidence of an ownership interest in an entity; or a contractual right to receive, or deliver, cash or another financial instrument."[471] On this definition, the Financial Instrument is not a financial instrument because it is not cash; it is not evidence of an ownership interest but instead a contractual right to services; and it is not a contractual right to receive cash but a contractual right to receive services. Nor is it a contractual right to receive or deliver another financial instrument.

A legal definition of "instrument" can be found in the Uniform Commercial Code:

> "Instrument" means a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary endorsement or assignment. The term does not include (i) investment property, (ii) letters of credit, or (iii) writings that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card.

U.C.C., § 9–102(1)(47). Courts distill this definition into two elements: (1) a writing that evidences a right to the payment of a monetary obligation, (2) of a type that in ordinary course of business is transferred by delivery with any necessary endorsement or assignment. See, e.g., *In re Omega Environmental Inc.*, 219 F.3d 984, 986 (9th Cir., 2000) (holding that a certificate of deposit is an instrument). See also *In re Commercial Money Center, Inc.*, 392 B.R. 814, 833–34 (Bankr. App. 9, 2008) (holding that surety bonds are not instruments because they are not transferrable by delivery in the ordinary course of business and do not provide for the payment of any sum certain); *In re Matter of Newman*, 993 F.2d 90 (5th Cir., 1993) (holding that an annuity contract is not an instrument because it is not transferred in the regular course of business).

None of these courts would regard the Financial Instrument as an "instrument" under the Uniform Commercial Code. The Financial Instrument is a writing but it does not evidence a right to the payment of a monetary obligation. Instead, it evidences a right to the modification of mortgages held by others. Someone who possess the Financial Instrument, whether Fannie Mae or a transferee, would have no right to obtain money from anyone. In addition, as far as I know, writings evidencing rights to loan modifications are not transferred by delivery in the ordinary course of business. Such rights may be assigned as part of a contract, but their value is not

[470] For the legislative history, see www.dechert.com/emailings/fre-fmrpu/fre-fmrpu-1.html. One senator, in passing, gives the following examples of "financial instrument": mortgage-related assets, securities based on credit card payments or auto loans, and common stock. See www.dechert.com/emailings/fre-fmrpu/docs/Senate-Debate-1.pdf, p. S10240.

[471] Wikipedia, en.wikipedia.org/wiki/Financial__instrument.

embodied in a piece of paper which is routinely transferred as a way of conveying value, as is the case for checks, securities, and other conventional financial instruments.

The U.S. Code contains a number of references to financial instruments.

> The term "financial instrument" includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.

26 U.S.C. 731(c)(2)(C). This section does not define financial instrument but lists a series of examples that are consistent with the definition of instrument in the Uniform Commercial Code. The term "financial instrument" also appears in 18 U.S.C. 514(a)(2), which criminalizes fraudulent use of phony financial instruments, but does not define the term. Judicial interpretations of the latter statute are consistent with the U.C.C. definition and do not provide any support for a broader interpretation that would encompass transactions like the Financial Instrument in the Commitment. See, e.g., *United States* v. *Howick*, 263 F.3d 1056 (9th Cir. 2001) (phony Federal Reserve notes are fictitious instruments). See also *United States* v. *Sargent*, 504 F.3d 767 (9th Cir. 2007) (postage statements are not financial instruments).

HAMP is consistent with the purposes of EESA, which include "protect[ing] home values" and "preserv[ing] homeownership." EESA, § 2(2)(A) and (B). However, EESA does not authorize all kinds of transactions that might advance these goals. Treasury can advance these goals only by purchasing mortgages, mortgage-related obligations, and financial instruments. Congress may well have limited Treasury in this way for reasons expressed in § 2(2)(C): to maximize overall returns to the taxpayers of the United States. Purchasing mortgages, securities, and other financial instruments is plausibly a safer way to protect the public fisc than paying for services and giving away money to homeowners, since financial instruments are generally liquid and can be resold or held to maturity in return for cash.[472]

Treasury also argues that it has authority under § 109(a) of EESA, which provides:

> To the extent that the Secretary acquires mortgages, mortgage backed securities, and other assets secured by residential real estate, including multifamily housing, the Secretary shall implement a plan that seeks to maximize assistance for homeowners and use the authority of the Secretary to encourage the servicers of the underlying mortgages, considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program under section 257 of the National Housing Act or other available programs to minimize foreclosures. In addition, the Secretary may use loan guarantees and credit en-

[472] The U.S. Department of Treasury's definition of "financial instrument"—"a written legal document that defines duties and grants rights and is financial in nature"—would encompass virtually any financial transaction. The U.S. Department of Treasury's definition ignores the conventional meaning of "instrument," which is narrower than that of "transaction."

hancements to facilitate loan modifications to prevent avoidable foreclosures.

Treasury argues that the authority to use "credit enhancements to facilitate loan modification" enables it to pay loan servicers to modify mortgages and to make payments to investors and homeowners.

However, § 109(a) gives the Secretary this authority only over mortgages it has acquired, and the HAMP program involves privately owned mortgages, not mortgages owned by the government or its agencies. Accordingly, § 109(a) cannot provide authority for HAMP. In addition, although "credit enhancement" is not defined in EESA, it is a term of art in the financial world. It refers to a number of conventional transactions that are used to provide assurances to a creditor that it will be repaid even if the debtor defaults.[473] These transactions include third-party guarantees, where a third party promises to repay the creditor if the debtor defaults, and the provision by the debtor of excess collateral, which protects the creditor against default in case the market value of the collateral declines. The placement of the term "credit enhancement" next to "loan guarantees" in § 109(a) reinforces this conventional interpretation. Given limits on my time, I have not been able to track down a definition of "credit enhancement" in U.S. statutes or judicial opinions, but the term does appear (undefined) in a number of statutes and a survey of the judicial opinions that involve consideration of those statutes address standard examples of credit enhancements such as loan guarantees.

Treasury's argument boils down to a claim that, in effect, a third party "uses a credit enhancement" when it pays a creditor to give better terms to the debtor because the risk that the creditor will not be repaid will decline, just as it does in the case of loan guarantees and excess collateralization. I am not persuaded but I believe that reasonable people could disagree on this issue, and that therefore a court might be willing to defer to Treasury's interpretation. However, as I noted above, this issue is moot because Treasury does not have authority under EESA to use credit enhancements on mortgages that the U.S. government does not own.

III. Judicial Review

You have asked me whether parties may seek judicial review of HAMP. This is a closer question.

Section 119 provides for judicial review of actions by the Secretary pursuant to the authority of EESA under the "arbitrary and capricious" standard, but limits the availability of injunctions. Conceivably, individuals could also challenge HAMP under the general judicial review provisions of the Administrative Procedure Act, 5 U.S.C. §§ 702–06, on the ground that the Secretary is acting outside of EESA, with no authority at all.

However, anyone who seeks to challenge HAMP would need to have standing, which requires, among other things, an injury. Taxpayers might argue that HAMP injures them but courts tend to deny standing where the injury is generalized or undifferentiated. With the exception of establishment clause challenges, taxpayers

[473] See Wikipedia, en.wikipedia.org/wiki/Credit__enhancement.

rarely if ever have standing to challenge spending programs. Investors who are not adequately compensated under HAMP for losses resulting from mortgage modifications would have standing. But it is not clear whether such investors exist.

If a challenge to HAMP reached the merits, Treasury's interpretation of EESA would be subject to *Chevron* deference under *Chevron U.S.A. Inc.* v. *National Resources Defense Council,* 467 U.S. 837 (1984).[474] However, this deference is limited. Courts apply a two-step procedure. First, they determine whether the statute addresses the question at issue. Second, if not, they determine whether the agency's interpretation of the statute is "reasonable." For reasons given in Part II, I do not believe that Treasury's interpretation of "financial instrument" in § 3(9) of EESA is reasonable. A contractual right to loan modification is not a financial instrument. Accordingly, if a court were to review HAMP, it would hold that Treasury does not have the authority to fund it.

The most serious obstacle to judicial review is standing. If this obstacle cannot be overcome, then judicial review will not take place.

[474] There is disagreement about whether *Chevron* deference applies to an agency's interpretation of the statute that confers jurisdiction on it; for present purposes, I assume that it does.

To: Elizabeth Warren, Chair, TARP Congressional Oversight Panel
From: Steven Croley, John Pottow
Re: Requested Analysis of HAMP Authority
Date: April 5, 2010

We are two law professors at the University of Michigan (one specializing in commercial law and the other in administrative law), who have been asked to analyze the statutory authority under which the Secretary of the Treasury ("Secretary") has promulgated the Home Affordable Modification Program ("HAMP") under the Emergency Economic Stabilization Act of 2008, ("EESA" or "Act"), and the Troubled Asset Relief Program ("TARP") created by the Act.[475] We have been asked to address especially payments to mortgage servicers.

1. Short Answer

(1) Encouraging mortgage servicers to participate in mortgage modifications through financial incentives, where the Secretary has taken a direct interest in the mortgages in question (either through acquisition in whole or in part of the loan or through investment in securities related to the loan), is unquestionably authorized by the EESA.

(2) Encouraging servicers to modify mortgages in which the Secretary has taken no direct interest is not *explicitly* authorized by the EESA. Yet incentive payments to mortgage servicers here seem *implicitly* consonant with the EESA's design and purposes. Given the Secretary's considerable discretion created by the EESA, such payments would most likely survive any judicial challenge.

2. Scope of HAMP

HAMP is designed to facilitate the modification of residential mortgage loans as a loss mitigation effort, with the goal of preventing foreclosure and thus keeping financially struggling Americans in their homes. We have reviewed the summary of the HAMP guidelines from online sources, as none have yet been promulgated in the Code of Federal Regulations.[476]

In relevant part, HAMP sets forth a series of incentives to encourage mortgage modifications. These include the following, which we put in quotations for mnemonic ease: "incentive" payments of $1,000 for mortgage servicers who successfully implement a mortgage modification (as well as follow-up "success fees" up to $1,000 for modifications that avoid default for subsequent years); "reward" payments for homeowners who stick to modified repayment schedules; "insurance" coverage for depreciating home prices (to overcome the anxiety mortgagees have to modification in the face of falling collateral values); "surrender fees" for second-lien holders to give up their largely out-of-the-money liens; and "loss sharing" payments for investors and lenders who take principal and other reductions on modified loans.

Importantly, the scope of HAMP is broad. Loans eligible for application seem to cover almost the entire universe of primary resi-

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[475] Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110–343 § 122.
[476] MHA Detailed Program Description, *supra* note 47; HAMP Guidelines, *supra* note 106.

dential mortgages: that is, both mortgages in which the Secretary (1) has taken a direct interest, either through (a) acquisition (partial or complete) of the underlying mortgage or (b) investment in a mortgage-backed security related to the underlying mortgage, and (2) has no direct financial stake whatsoever. (Throughout this memo, we call the latter "stranger" loans and both of the former "non-stranger" loans vis. the Secretary.)

In addition to the summarized HAMP guidelines, we reviewed what appears to be the implementing document for a HAMP-participating mortgage servicer—the "Commitment to Purchase Financial Instrument and Servicer Participation Agreement" ("SPA").[477] The SPA spells out the terms and conditions by which a servicer must abide in order to receive its incentive and other payments under HAMP (and related programs).

The SPA, by its own express terms (in its introductory recitals) does not apply to so-called Government-sponsored entity ("GSE") loans, that is, loans "owned, securitized, or guaranteed by Fannie Mae or Freddie Mac."[478] This is so, according to the same recitals, because the guidelines for those participating servicers are being promulgated by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac").[479] Thus, the scope of the SPA we consider covers only mortgages that have no connection to Fannie Mae or Freddie Mac.

Similarly, the guidelines instruct that "FHA, VA and rural housing loans will be addressed through standalone modification programs run by those agencies."[480] As such, HAMP appears to be a residuum program that applies to (1) loans not covered by, e.g., FHA, VA, USDA, Fannie Mae and Freddie Mac programs, but nevertheless find themselves under the purview of the federal government (through acquisition by TARP), as well as (2) loans with a more tangential (if any) connection to the federal government, i.e., purely private loans uninsured by Fannie Mae or Freddie Mac. In sum, it appears that the SPA (and hence HAMP) seems to cover both stranger and non-stranger loans.

3. Statutory Authority under the EESA

a. General Authority

The EESA contains at least three potential bases of textual authority for HAMP. The first is found in the explicit mortgage foreclosure prevention and homeowner assistance directives of Title I, sections 109 and 110. The second relates to the general authority to acquire (and insure) troubled assets under Title I, sections 101 and 102. The third flows from the broader structural objectives of the Act, expressed in its statement of purposes in section 2.

These specific provisions of the Act are best interpreted, however, not in a vacuum but rather mindful of what we perceive to be distinctive characteristics of the EESA relevant to the question of HAMP's authority. In the first place, the statute delegates very

[477] Commitment to Purchase Financial Instrument and Servicer Participation Agreement, *supra* note 462 (accessed Apr. 5, 2010).
[478] *Id.*
[479] *Id.*
[480] HAMP Guidelines, *supra* note 106, at 15.

broad authority to the Secretary, expressly using statutory language generally understood to convey that the Secretary will exercise discretion to achieve the purposes of the Act and that the Secretary will enjoy deference in the exercise of that discretion. Thus, section 101(c) states: "Necessary Actions.—The Secretary is authorized to take *such actions as the Secretary deems necessary* to carry out the authorities in this Act, including, *without limitation*, the following: . . . ." (emphasis added).[481]

Second, related to this wide discretion, the Act is sparse in terms of just what the Secretary is supposed to do in discharging his mandate under section 2 to "restore liquidity and stability to the financial system of the United States." This wide latitude may indeed be why Congress concomitantly created this Oversight Panel—to keep a watch over this huge grant of power (and money).

Third, the EESA repeatedly instructs the Secretary to focus on the interests of homeowners, wholly apart from the duty to help stabilize the financial markets. For example, section 2(B) says that the purposes of the Act are to "preserve homeownership." Similarly, section 103(3) ("Considerations") says that the Secretary "shall" take into consideration "the need to help families keep their homes and to stabilize communities." This focus on homeowners is consistent with the legislative history. More than a few legislators were expressly focused on how the bill would help American homeowners struggling to stay in their homes.[482]

b. Specific Provisions

i. Section 109's Requirements

Captioned "Foreclosure Mitigation Efforts," section 109 requires ("shall") the Secretary to implement "a plan that seeks to maximize assistance for homeowners," and use the authority of the Secretary to "encourage" the servicers of those underlying mortgages to avail themselves to the "HOPE for Homeowners Program . . . or other available programs [presumably such as HAMP] to minimize foreclosures." In addition, the Secretary also "may" use loan guarantees and credit enhancements to "facilitate" loan modifications "to prevent avoidable foreclosures."

Section 109's operative term "encourage" of course does not confine the Secretary to rhetorical encouragement. Economic incentives, such as use of the Tax Code, are a common way the federal government "encourages" desirable actions. And again, the Secretary enjoys considerable discretion concerning how best to implement those plans and provide that encouragement. Nor does the Act restrict the *tools* the Secretary chooses to deploy in the exercise of his statutory authority, assuming of course that he is acting within the *scope* of that authority. Therefore, the Secretary's deci-

[481] EESA § 101(c); *see also* EESA § 101(c)(5) ("Issuing such regulations and other guidance as may be necessary or appropriate to define terms or carry out the authorities or purposes of this Act").

[482] *See, e.g.*, House Committee on Financial Services, *Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on the Economy and Credit Availability*, 110th Cong. (Nov. 18, 2008) (statement of Rep. Waters) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/hr111808.shtml) (reminding "we gave [the Secretary] the authority . . . to deal with foreclosure mitigation efforts" and that "I sold [members of my caucus and the Congressional Black Caucus] this program and told them about my faith in your ability to carry out this program").

sion to "encourage" servicers through, for example, the $1,000 incentive payments under HAMP seems easily authorized by section 109 of the Act.

The sticking point with reliance on section 109 to ground all of HAMP is the section's introductory clause, "To the extent the Secretary acquires mortgages, mortgage backed securities, and other assets secured by residential real estate . . . the Secretary shall implement a plan [etc.]." This means that the section 109 powers are intended to apply only to "non-stranger" loans, *i.e.*, mortgages where the Secretary has purchased or otherwise come into possession of the loans themselves (or securities based on the loans). There is no basis, given this textual qualifier, for applying section 109 to "stranger" loans to which the Secretary has no connection.

That said, Congress's decision to use "shall" in commanding the Secretary to undertake foreclosure mitigation efforts regarding non-stranger loans should not be overlooked. That is, by using mandatory language here, it is possible that while foreclosure mitigation would be demanded for *non-stranger* loans, the Secretary has discretion whether to extend his foreclosure mitigation efforts to *stranger* loans (if he decided it was a desirable use of his authority to deal with those loans). In other words, requiring servicer encouragement for non-stranger loans does not preclude servicer encouragement for stranger loans, should the Secretary determine that the latter would also further congressional purposes.

By contrast, if section 109 had, instead, said that to the extent the Secretary acquires non-stranger loans, he "may" implement a plan to help the underlying homeowners, it would be textually awkward to contend that he would also be authorized to establish such a program for stranger loans, as the creation of a servicer encouragement initiative would depend upon acquisition of mortgages. But since Congress chose to give the Secretary a specific mandate regarding non-stranger loans, we find its silence on stranger loans more consistent with ambivalence than with an implied restriction of authority.

To be clear, section 109 plainly does not authorize servicer encouragement for stranger loans. The question is whether it precludes it. In candor, the point could be argued either way. But in light of section 109's hierarchically inferior placement to section 101 and the significance of its mandatory language, this provision certainly can be read not to foreclose the inclusion of stranger loans under HAMP.

ii. Section 101(a)'s Authority to Purchase "Troubled Assets"

Apart from what the Secretary is obligated to do under section 109, the Secretary has very broad powers under section 101 to establish TARP and to use TARP "to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution. . . "[483] "Troubled assets" are defined as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages. . . ."[484]

[483] EESA § 101(a)(1).
[484] EESA § 3(9)(a).

Thus, any non-stranger loans in which the Secretary has made some sort of purchase connection would clearly be troubled assets and have explicit statutory authority.

But the definition of troubled asset also includes "any other financial instrument that the Secretary . . . determines the purchase of which is necessary to promote financial market stability."[485] This definition raises the question whether categorizing stranger loans as "troubled assets" might provide an explicit statutory basis for HAMP's servicer incentives for those loans. That is, if the stranger loans could somehow be found to come under the purview of section 101 as troubled assets, then the Secretary would be given wide latitude under section 101(c)(5) to "issue such regulations and other guidance as may be necessary or appropriate to carry out the authorities *or purposes* of this Act" (emphasis added).

The extension of HAMP to stranger loans is through the SPA. The SPA, in turn, purports to be not just a "Servicer Participation Agreement" (which it most clearly is) but also a "Commitment to Purchase [a] Financial Instrument." Thus, the financial instrument supposedly being purchased presumably falls under the section 9(B) definition of "troubled asset," thereby providing a basis under the EESA for incentivizing servicer modification of stranger loans. The problem here is that notwithstanding its caption, the SPA is not a "financial instrument," at least under traditional conceptions of commercial law. It looks more like a services contract, or perhaps an offer for a unilateral contract to be accepted by performance, or maybe even just a term sheet of rules that a servicer hoping to enjoy the fruits of a HAMP incentive must follow. Even if it rises to the level of being a contract, however, it is still not a conventional instrument (financial or otherwise). True, an "instrument" can be and often is a "contract," but that does not mean that a "contract" is an "instrument."

Commercial lawyers usually talk about "instruments" as being "negotiable instruments," such as drafts and notes.[486] And "negotiable instrument" is defined as "an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order . . . [listing requirements]." (A draft is typified by a check and a note by a promissory note.)[487] This of course implies a residuum of non-negotiable instruments, and that is true: an otherwise negotiable promissory note can be rendered non-negotiable by the simple inscription "non-negotiable" at the top, which presumably would relegate it to being a mere instrument.[488]

[485] EESA § 3(9)(b).

[486] See U.C.C. § 3–104(b) ("'Instrument' means a negotiable instrument").

[487] U.C.C. § 3–104(a).

[488] Article 9 of the Uniform Commercial Code defines "instrument" more broadly: "'Instrument' means a negotiable instrument (defined in Section 3–104), or a certificated security (defined in Section 8–102) or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease *and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment.*" *See* U.C.C. § 9–105(1)(i) (emphasis added). Thus, even this broader definition requires some element of negotiability.

A "financial instrument" is typically understood to have some bearing to a security or similar financial obligation.[489] For example, equity shares of a corporation would be financial instruments, as would be debt issued by that corporation. And of course, contracts of financial exotica synthetically derived from those instruments are themselves financial instruments (puts, swaps, repos, etc.). But the underlying thread is that they are all related to financing. To illustrate, here are three definitions (taken from a court required to define "financial instrument" for terms of a patent dispute):[490]

> A contractual claim held by one party on another, such as a security, currency, or derivatives contract. A financial instrument entitles the other to be paid in cash or with another financial instrument.[491]
>
> Generic term for those securities or contracts which provide the holder with a claim on an obligor. Such instruments include common stock, preferred stock, bonds, loans, money market instruments, and other contractually binding obligations. The common feature which differentiates a financial instrument from a commercial or trade credit is the right to receive cash or another financial instrument from the obligor and/or the ability to exchange for cash the instrument with another entity. The definition can also include instruments where the claim is contingent, as with derivatives.[492]
>
> [A]n enforceable contract obligating one party to pay money or transfer property to another. Credit documents, (e.g., drafts, bonds, etc.) are instruments, as are documents of title, such as deeds or stock certificates.[493]

Indeed, even the Tax Code defines financial instrument as including "stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives." [494] And Treasury's Office of Thrift Supervision shared a report at a congressional hearing that defined financial instrument (using the Financial Accounting Standards Board's definition, although cautioning that that definition was "general" and more broad than a regulatory definition), ultimately summarizing: "A fundamental characteristic of all financial instruments is that they give rise to cash flows. The value of any financial instrument can be estimated by projecting the amount and timing of future net cash flows associated with the instrument, and discounting those cash flows with appropriate discount rates." [495]

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[489] Under Article 8 of the Uniform Commercial Code, a "certificated security" is represented by an instrument. *See id.* § 8–102(1)(a). Securities can also be uncertificated. *See* U.C.C. § 8–102(1)(b).

[490] *See EBS Dealing Res., Inc. v. Intercontinental Exch., Inc.,* 379 F. Supp. 2d 521, 526 (S.D.N.Y. 2005).

[491] *Dictionary of Banking and Finance,* at 159 (Standard Chartered Bank, 1st ed., 1998).

[492] *The Handbook of International Financial Terms,* at 220 (Oxford Univ. Press, 1st ed., 1997).

[493] *The McGraw-Hill Dictionary of International Trade and Finance,* at 202 (McGraw-Hill, 1st ed., 1994).

[494] I.R.C. § 731(c)(2)(C).

[495] House Committee on Banking, Finance and Urban Affairs, *Safety and Soundness Issues Related to Bank Derivatives Activities, Part I,* at 217, 103rd Cong. (Oct. 28, 1993) (quoting Office of Thrift Supervision, Risk Management Division, *Methodologies for Estimating Economic Values in the OTS Net Portfolio Value Model* (May 1993)).

The SPA, by contrast, is not the issuance of debt or other financing mechanism.[496] Nor is it in any sense intended to be a demand for payment. To break it down into its component parts, the SPA purports to be a commitment by Fannie Mae to "purchase" a "financial instrument" from the servicer (thus the servicer is apparently "selling" something to Fannie Mae). What is being "sold," in turn, is the self-styled "financial instrument" that appears as Exhibit B to the SPA. And that Exhibit B—while most assuredly captioned "Financial Instrument"—at no place summarizes just exactly what the servicer is "selling" (or, more precisely, "issuing") to Fannie Mae. Surreally, the document merely recites that for "good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, [the] Servicer agrees as follows . . ."[497] and then proceeds to list a catalogue of undertakings the servicer agrees to abide by, involving auditing, data retention, and so forth.[498]

As mentioned, the most generous legal interpretation of this document would be a service contract, whereby the participating servicer agrees to undertake specific services for Fannie Mae, although even that is unclear because it is uncertain whether a servicer who wanted to discontinue participation in HAMP would be subject to any damages for breach. This furthers the interpretation of Exhibit B as actually just a term sheet of rules that servicers must abide by in order to get paid under HAMP. Using diction that sounds related to financial instruments—for example, characterizing the servicers as "issuing" Exhibit B (much like debt is "Issued" in a real financial instrument)—and using a caption the declares a service contract (or term sheet) a "financial instrument" does not make it a financial instrument. Accordingly, it is difficult to shoehorn HAMP incentives for stranger loans into "troubled assets" under the theory that the SPAs transform them into financial instruments.

iii. Section 2's Statutory Purposes

The third possibility for finding statutory authority in the EESA for HAMP's application to stranger loans is in the intrinsic structure, design, and indeed fundamental purpose of the law, given the wide implementing discretion accorded the Secretary in section 101(c). Section 2 spells out the purposes of the Act as follows:

> (1) to immediately provide authority and facilities that the Secretary . . . can use to restore liquidity and stability to the financial system of the United States; and
>
> (2) to ensure that such authority and such facilities are used in a manner that—
>
> > (A) protects home values, college funds, retirement accounts, and life savings;
> >
> > (B) preserves homeownership and promotes jobs and economic growth;

[496] In fact, the servicer is the "issuer" of the supposed instrument, and the servicer does not obligate itself to provide any cash flows to Fannie Mae, in the way the issuer of a real financial instrument would make, say, bond coupon payments.

[497] Commitment to Purchase Financial Instrument and Servicer Participation Agreement, *supra* note 462 (accessed April 5, 2010).

[498] *See* Commitment to Purchase Financial Instrument and Servicer Participation Agreement, *supra* note 462, at Exhibit B (accessed April 5, 2010) ("Form of Financial Instrument").

(C) maximizes overall returns to the taxpayers of the United States; and

(D) provides public accountability for the exercise of such authority.

Crucially, the Secretary is admonished to fix the financial collapse the markets experienced beginning in 2007–2008 as best he can by price-stabilizing market intervention. This is a broad and necessarily vague mandate, given the complexity of the problem to which the EESA responds, but obviously an urgent one. It is unsurprising that each individual tool the Secretary might deploy (e.g., rewards for timely paying mortgagors) is not spelled out with a specific legislative provision. Such legislative brevity is far from novel. Congress routinely leaves matters of implementation, including choice of regulatory tools and devices, to the discretion of expert administrative agencies (here, Treasury).

To be sure, even broad grants of discretion have limits. Thus, the difficult question arises: if the Secretary is only explicitly authorized in section 101 to acquire mortgages (which become non-stranger loans in our taxonomy), which he in turn can certainly regulate under HAMP, can he then also regulate stranger loans under HAMP by relying upon his broader, structural powers delegated by the EESA?

Arguably yes. The mortgage market the Secretary is trying to stabilize is huge, with countless securities and underlying loans. Some of the loans the Secretary will acquire, either in whole or in part, and either directly or indirectly through mortgage-backed securities based on those loans. These are the non-stranger loans to which the Secretary has some direct financial connection. One purpose of buying these loans and securities is to help prop up their prices and hence try to avoid a downward price spiral. But in trying to stabilize the housing market, government-backed loans are unquestionably affected by stranger loans too. The fate of housing prices and the value of mortgages and mortgage-based securities are not segregated according to stranger and non-stranger loans.

Accordingly, given that the success of TARP itself will depend in part upon developments in the purely private mortgage and mortgage-backed securities market—and thus upon homeowners' abilities to modify their purely private mortgages—the Secretary has a parallel need to provide an incentive for private mortgage modifications. He is presumably animated by "defensive" motivations—preventing a selloff of foreclosed homes that would decimate real estate prices and in turn make the process of price stabilizing the non-stranger loans all the more difficult: the downward vector of prices the Secretary would be trying to fight would be strengthened. Under this analysis, then, incentivizing the modification of those stranger loans to stabilize prices, as a safeguard against his own non-stranger loans' pricing, is not only reasonable but arguably necessary. Such a purpose would very likely pass the "arbitrary and capricious" bar; nor would modest servicer incentives constitute an "abuse of discretion." [499]

Thus, the most viable basis for the valid inclusion of stranger loans under the EESA stems from the broad market-rescuing man-

[499] EESA § 119(a)(1) (setting forth the standard of judicial review).

date of section 2 and the general structure and goal of the statute as a whole (coupled with the expansive "necessary or appropriate" implementing power explicitly conferred by section 101(c)).

4. Legislative History

There is little legislative history directly on point with respect to servicer incentives, but there is some clear understanding, at least by the Chairman of the House Financial Services Committee, that servicer incentive payments were anticipated. For example, at a November 18, 2008 hearing (after the EESA's enactment, so perhaps "subsequent legislative history") in discussing model foreclosure mitigation guidelines, the Chairwoman of the FDIC (Sheila Bair) explained she would provide "a financial incentive for servicers and investors" and "administrative expenses of $1,000 per modification for servicers."[500] The Chairman then responded "I would note that, in the TARP, there is explicit authorization to provide funding for servicers in appropriate context."[501]

In a hearing the next year, regarding legislation that became known as "TARP II," and shortly before HAMP's guidelines were promulgated, Chairman Frank reiterated his belief that servicer incentive priorities lay in TARP:

> One proposal that has been floating around is that there may be a requirement that if you want to make [foreclosure mitigation programs] work, you will have to pay the servicer something. Servicers were not set up originally to do this. We believe there is authority in the first TARP to do this. Some of the lawyers in the Federal Government have told people that there isn't. That is being discussed. If there were to be a definitive decision that there wouldn't be, I think if there is no such authority, then I think we should get it.[502]

To be clear, Chairman Frank's comments are silent about the distinction between stranger and non-stranger loans, and so cannot be relied upon to answer the most difficult question of HAMP's statutory authority. It could be that he was simply opining on the easier question whether incentive payments are a specific tool the Secretary can use under TARP to "encourage" foreclosure relief. If this is what some "Federal Government lawyers" were concerned about, we respectfully disagree and think the broad discretion of the EESA would clearly give the Secretary such power for government-backed loans. (Framed another way, we see nothing in the EESA that would prohibit the Secretary in the exercise of his broad

[500] House Committee on Financial Services, *Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on the Economy and Credit Availability,* 110th Cong. (Nov. 18, 2008) (statement of Sheila Bair) (online at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110__house__hearings&docid=f:46593.pdf).

[501] House Committee on Financial Services, *Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on the Economy and Credit Availability,* 110th Cong. (Nov. 18, 2008) (statement of Rep. Frank) (online at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110__house__hearings&docid=f:46593.pdf).

[502] House Committee on Financial Services, *Promoting Bank Liquidity and Lending Through Deposit Insurance, HOPE for Homeowners, and Other Enhancements,* 111th Cong., at 3 (Feb. 3, 2009) (statement of Rep. Frank) (online at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111__house__hearings&docid=f:48672.pdf).

authority from using servicer incentive payments for non-stranger loans.)

The legislative history does not otherwise shed light on the issues in question.

5. Other Statutes and Bills

a. TARP II

The "TARP Reform and Accountability Act of 2009," H.R. 384 (so-called "TARP II"), has passed the House and has been referred to the Senate. In it, section 203(3) augments the EESA by providing the Secretary with authority to establish "[a] program under which the Secretary may make payments to servicers, including servicers that are not affiliated with a depository institution, who implement modifications to mortgages. . . ." [503] Accompanying legislative history explains, "The bill also provides several alternatives for foreclosure mitigation, such as a systematic mortgage modification program, whole loan purchasing, buy-down of second mortgages, . . . and incentives and assistance to servicers to modify loans." [504]

The timing and status of TARP II make it difficult legislative authority to address. For example, the statements made by Rep. Waters were made in January 2009, before HAMP had even had its guidelines promulgated. So it is unclear whether Congress thought these explicit conferrals of power (especially the extension to servicers that were not affiliated with depository institutions) were necessary to plug lacunae left open in the EESA or whether were codifications and clarifications of existing practice. Thus, the information to be gleaned from TARP II regarding the Secretary's legislative authority under the EESA is ambiguous at best.

b. HOPE for Homeowners

The Panel might be interested to know that the "Helping Families Save Their Homes Act of 2009," [505] which amended the "HOPE for Homeowners Act of 2008," [506] specifically added a provision on mortgage servicer payments: "The Secretary may establish payment to the—(1) servicer of the existing senior mortgage or existing subordinate mortgage for every loan insured under the HOPE for Homeowners Program." [507] According to Senators Dodd and Shelby, the bill "expand[s] the access to the HOPE for Homeowners Act" and "allows for incentive payments to servicers . . . who participate in the program." [508] Similarly, Rep. Holt remarked that the bill "provide[s] greater incentives for mortgage servicers to modify mortgages under [HOPE]" and "permit[s] payments to loan services." [509]

This might at first blush imply the Secretary had no authority under HOPE for Homeowners for incentive payments. But an analysis of HOPE for Homeowners contrasting it with the EESA is striking. HOPE for Homeowners establishes an FHA mortgage

[503] H.R. 384, 111th Cong. (2009).
[504] Statement of Representative Maxine Waters, Congressional Record, H289 (Jan. 14, 2009).
[505] Pub. L. No. 111–22, Div. A., 123 Stat. 1632 (2009).
[506] 12 U.S.C. § 1715z–23.
[507] Pub. L. No. 111–22, Div. A, § 202(a)(11), 123 Stat. 1632 (2009).
[508] Statement of Senator Christopher Dodd, *Congressional Record,* S5003 (May 1, 2009).
[509] *Id.*

modification program, but does so in extensive detail, with, for example, the criteria for eligible loans and principal reduction amounts described over several pages of legislation. This is a far cry from the one-sentence blanket authorization of the Secretary to "encourage" modifications under the EESA. Under these circumstances, it is not surprising that Congress felt the need to amend specifically HOPE by statute to add another tool (servicer incentives).

c. VA Loans

A more illuminating example might be the VA loan modification procedures prescribed by regulation. Although the Secretary (of Veterans Affairs) has been paying servicer incentives for some time, there is no explicit grant of statutory authority for such payments. That is, although 38 U.S.C. 3720 spells out "Powers of the Secretary," and subsection (2) confers the power to "consent to the modification, with respect to rate of interest, time of payment of principal or interest or any portion thereof" of certain loans acquired by the VA, there is no mention of servicer payments. Nevertheless, the Secretary promulgated 38 CFR § 36.4819 ("Servicer loss-mitigation options and incentives"), which does exactly that. (The cited authority for this regulation is the general necessary-and-appropriate power of 38 U.S.C. § 501.) This program has apparently proceeded without objection. Thus, the VA example shows how Secretaries use a wide arsenal of tools even beyond those that are expressly prescribed by statute. (Again, it does not speak to whether the VA Secretary could address non-VA loans, but that is where the analogy to a limited domain like VA loans dissolves; the market-wide sweep of the EESA is a marked contrast.)

There is not too much directly apposite to glean from similar bills and laws. The closest is the VA servicer incentives regulations promulgated by the Secretary of the VA, which are noteworthy because they seem to emanate from the general structure and power of the Secretary to modify loans, not from any textually explicit grant of legislative power.

6. Other Considerations

Two additional points require brief comment. First, we assume that the servicers are "financial institutions." Second, we considered, and rejected, the idea that the SPAs might be "credit enhancements," which would bring them under the scope of the last sentence of section 109(a). Standard financial usage defines credit enhancements as, for example, "techniques used by debt issuers to raise credit rating of their offering, and thereby lower their interest costs." [510] Similarly, the IRS uses the following: "the term 'credit enhancement' refers to any device, including a contract, letter of credit, or guaranty, that expands the creditor's rights, directly or indirectly, beyond the identified property purchased, constructed, or improved with the funds advanced and, thus effectively provides as security for a loan the assets of any person *other than the bor-*

[510] *Dictionary of Finance and Investment Terms,* at 127 (5th ed., 1998) (citing bond insurance or bank letters of credits as examples).

rower"[511] (emphasis added). Its regulation further expands: "The acquisition of bond insurance or any other contract of suretyship by an initial or subsequent holder of an obligation shall constitute credit enhancement."[512] The home depreciation insurance payments under HAMP would most likely be credit enhancements, as they provide a risk-reduction function similar to the guarantee. The loss-sharing payments might also be similarly classified, as too might the interest and principal reduction payment subsidies. But such reliance for servicer incentives would be too much of a stretch—and unnecessary, we believe, in light of our ultimate conclusions regarding the Secretary's broad powers already conferred by section 101(c).

7. Conclusion

While the exercise of authority under HAMP for stranger mortgages cannot fairly be shoehorned into the definition of "financial instrument" from section 9(B), it can be justified as an exercise of the Secretary's wide discretion under section 2 in light of the structure, design, and purposes of the statute as a whole. Moreover, the subset of HAMP incentives properly classified as "credit enhancements" can plausibly be justified by explicit textual reliance—not just implicit textual support—based on the last sentence of section 109. As for non-stranger loans to which the Secretary has some financial connection, there is no problem with the wide array of tools he has chosen to use to encourage mortgage modifications, including servicer incentive payments. That these powers are proposed to be spelled out with greater specificity in TARP II does not alter our opinion, and we are indirectly encouraged by the VA regulations as consistent with our views. Finally, we note that the legislative debates after the EESA and leading up to TARP II evince a clear congressional desire to "do more" regarding foreclosure mitigation. As such, an expansive reading of the Secretary's authority in this area to cover servicer incentives for non-government loans is consonant with the intended spirit of the statute.

[511] 26 C.F.R. § 1.861–10T(b)(7) (2009).
[512] 26 C.F.R. § 1.861–10T(b)(7) (2009).

ANNEX IV: UPDATE ON PHILADELPHIA RESIDENTIAL MORTGAGE FORECLOSURE DIVERSION PILOT PROGRAM

The Panel's October report detailed an innovative mediation program created by the Philadelphia courts. The Residential Mortgage Foreclosure Diversion Pilot Program requires "'conciliation conferences' in all foreclosure cases involving residential properties with up to four units that were used as the owner's primary residence."[513] The program is effectively a requirement that the parties talk to one another, face to face, and attempt to come to a solution.

Philadelphia's Office of Housing and Community Development reports that, between June and December 2009, approximately 9,079 homeowners had conciliation conferences scheduled. Of these, 5,707 homeowners participated in the conferences. Approximately 3,074, or 35 percent of the 9,079 homeowners, did not participate. This 35 percent breaks down into 28 percent who failed to appear, 2 percent who did not participate because the homes were vacant, and 4 percent because the homes were not owner-occupied.[514]

Of the 5,707 homeowners who did participate, approximately 1,900 homes, or one third of participating homeowners, were able to modify or refinance their mortgages through the diversion program. Data are not available regarding the modifications, including the type of modification, affordability changes, and redefault rates. Over 3,600 cases, or 63 percent, remain in active negotiation. Through August 2009, approximately 947 homes, or 16 percent were sold through sheriff sales.[515]

Although they have the same final goal, it is difficult to compare HAMP's results to those of the Philadelphia program. Other than the administrative costs of running the program, the Philadelphia program does not use any taxpayer dollars.

In addition, the two programs feature very different participation models; lenders and servicers volunteer to participate in HAMP, choosing to subject themselves to a regime requiring them to modify loans in certain circumstances. By contrast, the lenders involved in the Philadelphia program participate by court order, but a modification under the Philadelphia program is entirely voluntary—the only requirement is that the servicer participate in the conciliation conference. Because the taxpayer costs of HAMP are higher, and lenders and servicers affirm their desire to participate, it should implicitly be held to more stringent standards.

[513] October Oversight Report, *supra* note 17, at 87.
[514] Not counted in the 35 percent are the five percent of homeowners with scheduled conferences who filed bankruptcy.
[515] Data collected by the Philadelphia Office of Housing and Community Development.

ANNEX V: PRIVATE FORECLOSURE MITIGATION EFFORTS

In its October 2009 foreclosure mitigation report, the Panel included information from its survey of major servicers that had not yet signed HAMP participation agreements. Several servicers responded that they did not intend to sign up for HAMP because they believed that their own foreclosure mitigation programs were superior. More than one year later, how do the results of these private sector programs compare to the results of the taxpayer financed HAMP program?[516] Fifth Third, Sovereign Bank, and HSBC shared with the Panel data on their own foreclosure mitigation programs.

During calendar year 2009, Fifth Third evaluated over 5,300 borrowers for modifications; of these, over 3,600 received modifications, which included both term extensions and interest rate reductions. Their borrowers' median front end debt-to-income ratios went from 38 percent to 17 percent. Borrowers' median interest rate declined from 6.72 percent to 3.54 percent. Although over 1,700 borrower's principal amount increased, only 3.85 percent include a balloon payment. The redefault rate is approximately 30 percent.

The Sovereign Home Loan Modification Program (SHLMP) is newer, having only started in July 2009. As of February 2010, SHLMP has evaluated almost 1,300 borrowers, and provided modifications to 50, with over 300 more offered or in trial plans. Of the final modifications, most received interest rate reductions and term extensions, and most had an increase in principal. Borrowers' median interest rate fell from 6.4 percent to 3.9 percent. Its redfault rate in its first eight months is less than one percent. Although it does not currently offer principal forgiveness or forbearance, it will roll out changes in April that will include the availability of forbearance.

Through its Foreclosure Avoidance Program, HSBC modified the terms of 105,000 mortgages during calendar year 2009. Of the mortgages that HSBC had modified since 2007 through this program, 48 percent were delinquent or in default. HSBC modified the mortgages of 36 percent of the borrowers who applied for the program in 2009. HSBC's modified mortgages carry an average 30 percent payment reduction. Since its inception in 2003, the HSBC program provides a minimum $100 monthly payment reduction, and over a 10 percent reduction in over 90 percent of modifications. HSBC did not provide data on interest rate reductions, term extensions, principal forgiveness or forbearance, or balloon payments.

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[516] It is difficult to directly compare the programs with the data available to the Panel, as the programs might differ significantly, and there are also constraints as to the data collected by the servicers. The Panel would like to thank Fifth Third, Sovereign, and HSBC for sharing this information.

SECTION TWO: ADDITIONAL VIEWS

A. Richard H. Neiman

Foreclosure prevention is not just the right thing to do for suffering Americans, but it is the lynchpin around which all other efforts to achieve financial stability revolve.

As the Panel notes, substantial challenges remain in terms of the timeliness, accountability, and sustainability of Treasury's foreclosure mitigation programs. Even so, considerable progress has been made in crafting a responsible and effective public response.

Treasury should be commended for its recent efforts to address unemployment and negative equity as drivers of default. The housing crisis began with subprime foreclosures, as many borrowers had been given inappropriate products. However, as the recession progressed, the crisis evolved to impact prime borrowers whose loans were originally affordable. Loss mitigation initiatives need to keep pace with the changing nature of the problem, and Treasury has the difficult task of casting a wider net while maintaining the integrity of their programs.

Tension exists between expanding the scope of program eligibility and issues of fairness and preventing future defaults. **In three key areas, I believe more can be done to prevent foreclosures while balancing these competing concerns:**

1. Assisting homeowners who are experiencing temporary unemployment or other hardship;
2. Applying lessons learned from HAMP's low conversion rates to permanent modifications to the program changes that begin June 1st; and
3. Creating a national mortgage performance database.

1. The Country Needs a National Emergency Mortgage Support Program (EMS)

Even prime borrowers with loans made on prudent terms are facing increasing pressure as the crisis has continued. The number one reason for prime defaults is unemployment and reduced earnings according to Freddie Mac.

The State Foreclosure Prevention Working Group, a multi-state effort of state attorneys general and state banking supervisors, has conducted additional research that brings the impact on prime loans into sharp focus. The number of prime loans in foreclosure has doubled in each of the past two years and now account for 71 percent of the increase in the total number of loans in foreclosure.

The Administration's Help for the Hardest-Hit Housing Markets is a step in the right direction, both in terms of assisting those most in need and in leveraging states as partners. The recent enhancements to HAMP will also help unemployed borrowers through temporary payment reductions and expanded eligibility for permanent modifications.

As positive as these steps are, these measures do not replace the need for a nationwide Emergency Mortgage Support system (EMS). The Help for the Hardest-Hit Housing Markets program by design is limited to target geographies. And, the recently announced three- to six-month reprieve for the unemployed under HAMP, although very helpful, is an insufficient time frame to stabilize household budgets that have been ravaged by sharply reduced income. The scope of impacted borrowers is simply too great for anything short of a national program, which should be administered by the states with the support of the nonprofit housing community.

The five states of Pennsylvania, Delaware, North Carolina, New Jersey, and Connecticut currently have state programs to assist the unemployed facing foreclosure that can help inform a national model. They take different approaches to making short-term loans accessible for those who need temporary help while seeking to ensure that borrowers will repay their loans once their hardship has passed.

An evaluation of these differing states' approaches suggests that underwriting criteria should be based on bright lines for easy administration and program sustainability, but within a sufficiently flexible framework so that the program can truly help those it is intended to. For example, the number of past missed payments by a borrower should be evaluated on a bright line basis as most of the states do. However, the states differ on the number of missed payments that should be permitted, thus demonstrating the need for a guiding principle. The principal should perhaps be based on the age of the mortgage loan, whereby newer loans allow for fewer missed payments. This flexible framework, by incorporating a bright line, better protects the program from early payment default or fraud on newly originated mortgages while allowing appropriate discretion for aged loans to take account of servicer delays in payment processing or occasional borrower oversight.

A full set of underwriting criteria is beyond the scope of this supplemental view, but I mention this one example of how expanded assistance could be achieved within a prudent program framework. Emergency mortgage support should also involve lender and investor concessions, including eventual HAMP modification and perhaps waiving arrearages for unemployed borrowers.

2. HAMP Implementation Must Learn from HAMP's Low Conversion Rates to Permanent Modifications

I strongly support the Panel's recommendations concerning greater data collection on the HAMP process. We need improved data access to identify the choke points in the process, and then adapt to ensure that the new standards taking effect on June 1st meet their objective.

Using this data, Treasury must fully consider whether there are duplicative or burdensome document requests that could be waived, for example, in requiring profit and loss statements. More importantly, the data must address the most frequent concern I have heard from borrowers and housing counselors as Chair of New York State's foreclosure mitigation task force: borrowers do not know the status of their submissions and are not receiving timely updates as to whether submitted documents have been received or are deemed adequate. These problems do not go away on June 1st, but the number of people who will be denied access to the program will go up if they are not addressed.

I am troubled that Treasury's expanded web portal, where borrowers could check their application status and see if servicers have received necessary documentation, has so far failed to launch.

Although Treasury is seeking to improve the servicers' notification process, borrowers should be encouraged and enabled to be proactive in monitoring the processing of their modification request. I urge Treasury to swiftly implement this database.

3. A National Mortgage Performance Database Is Needed

The gaps in data access for borrowers seeking modifications highlight the general lack of data about the mortgage market. Access to complete information on existing mortgages does not exist, and the reason is simple: there is no mortgage loan performance data reporting requirement for the industry.

Once a new loan has been initially reported under the Home Mortgage Disclosure Act (HMDA), it is no longer tracked in any public database. HMDA has been a powerful tool for combating housing discrimination and predatory lending in mortgage origination, but a performance data reporting requirement would provide a similar window on servicing practices. Because lenders and servicers already report the payment status of open loans to credit bureaus, a performance data standard could be put into operation quickly.

Currently, Congress, banking regulators, consumer advocates, and other policymakers are left with incomplete or unreliable data purchased from third-party vendors or with limited data provided voluntarily by the industry. This lack of a public database has hindered the response to the housing sector. Improved intelligence on the mortgage market is critical to preventing future crises.

B. J. Mark McWatters

Although I concur with much of the analysis provided in the April report and respect the sincere and principled views of the majority, I dissent from the issuance of the report and offer the observations noted below. I appreciate, however, the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions offered during the drafting process.

Executive Summary

I offer the following summary of my analysis:

- The Administration's foreclosure mitigation programs—including the HAMP and the HARP—have failed to provide meaningful relief to distressed homeowners and, disappointingly, the Administration has created a sense of false expectation among millions of homeowners who reasonably anticipated that they would have the opportunity to modify or refinance their troubled mortgage loans under the HAMP and HARP programs. It is exceedingly difficult not to conclude that these programs have served as little more than window dressing carefully structured so as to placate distressed homeowners.
- In fairness to the tepid efforts of the Administration, I remain unconvinced that government sponsored foreclosure mitigation programs are necessarily capable of lifting millions of American families out of their underwater home mortgage loans. In my view, the best foreclosure mitigation tool is a steady job at a fair wage and not a hodgepodge of government-subsidized programs that create and perpetuate moral hazard risks and all but establish the U.S. government as the implicit guarantor of distressed homeowners.
- If the economy is indeed improving, it would be preferable to let the housing market recover on its own without the expenditure of additional taxpayer funds and without investors being forced unnecessarily to recognize huge losses that will reduce or even deplete their capital base and increase mortgage loan interest rates.
- Insufficient taxpayer funds are available under HAMP for the government to bail out millions of homeowners in an equitable and transparent manner. The Administration should not commit the taxpayers to subsidize any such bailouts where there is no reasonable expectation for the timely repayment of such funds.
- If the taxpayers do not subsidize reductions in first and second lien mortgage loan principal to the extent required under HAMP and the Administration's other foreclosure mitigation programs, the investors who own the distressed mortgage loans and securitized debt instruments will bear the financial burden of such modifications, and the regulatory capital of many financial institutions will no doubt suffer from the realization of losses triggered by the write-downs of mortgage principal. As a result, such institutions may have little choice but to seek to raise mortgage loan interest rates and curtail their lending and other financial services activities to the detriment of qualified individuals and businesses in search of capital. It is also possible that the taxpayers will be required to fund additional capital infusions to those weakened institutions through TARP, a Resolution Trust Corporation-type structure or otherwise.

• In private sector foreclosure mitigation efforts, however, the participating investors may readily determine the extent to which voluntary reductions in mortgage principal will reduce or impair their regulatory capital. As such, each private sector investor will have the opportunity to develop its own customized foreclosure mitigation program that carefully balances the costs and benefits to the institution that may arise from the write-down of outstanding mortgage principal. Prudent investors and servicers recognize the purpose and necessity of offering their borrowers voluntary mortgage principal reductions in certain well-defined circumstances, and the government should welcome and encourage their active participation in and contribution to the foreclosure mitigation process without the imposition of an overarching one-size-fits-all mandate.

• In the Panel's October report on foreclosure mitigation, Professor Alan M. White reported to the Panel that, subject to certain reasonable assumptions, the mortgage loan investor's net gain from a non-subsidized mortgage modification could average $80,000 or more per loan over the foreclosure of the property securing the mortgage loan. If Professor White is correct in his assessment, why should Treasury mandate that the taxpayers fund payments so as to motivate investors in mortgage loans and securitized debt instruments to take actions that are in their own best interests absent the subsidies?

• While many homeowners have recently lost equity value in their residences, others have suffered substantial losses in their investment portfolios including their 401(k) and IRA plans. Why should the taxpayers bail out a homeowner who has lost $100,000 of home equity value and neglect another taxpayer who has suffered a $100,000 loss of 401(k) and IRA retirement savings? This is particularly true if the homeowner was able to cash out of some or all of the homeowner's equity appreciation. That is, what public policy goal is served by bailing out the homeowner who received a ski boat, trailer, and all wheel drive SUV as proceeds from a $100,000 home equity loan while neglecting the taxpayer who suffered a $100,000 investment loss in her 401(k) and IRA accounts?

• Suppose, instead, two taxpayers purchased condominiums in the same building for $200,000 each with 100 percent financing. After the condominiums appreciated to $300,000 each, the first homeowner secured a $100,000 home equity loan to pay the college tuition of the first homeowner's son; the second homeowner declined to accept a home equity loan (expressing a "this is too good to believe" skepticism) and the second homeowner's daughter financed her college tuition with a $100,000 student loan. If the condominiums subsequently drop in value to $200,000 each, why should the taxpayers subsidize the write-off of the first homeowner's home equity loan and in effect finance the college tuition of the first homeowner's son while the second homeowner's daughter remains committed on her $100,000 student loan? I do not concur with any public policy that would yield such an inequitable treatment, particularly since the second homeowner acted in a prudent and fiscally responsible manner by electing not to over leverage the residence.

• What about (i) the retired homeowner whose residence drops in value by $100,000 after she has diligently paid each installment on her $300,000 mortgage over 30 years, (ii) the taxpayer who rents her primary residence and with a $300,000 mortgage loan purchases real property for investment purposes that subsequently drops in value by $100,000, and (iii) the homeowner suffering from a protracted illness or disability who loses $100,000 of equity value upon the foreclosure of her residence for failure to pay property taxes? HAMP and the other programs offered by the Administration offer no assistance to these taxpayers.

• Since it is neither possible nor prudent for the government to subsidize the taxpayers for the trillions of dollars of economic losses that have arisen over the past two years, the government should not undertake to allocate its limited resources to one group of taxpayers while ignoring the equally (or more) legitimate economic losses incurred by other groups.

• Only a relatively modest (although certainly not insignificant) percentage of Americans are facing foreclosure after properly considering the number of taxpayers who are current on their mortgage obligations, who are renting their primary residence, and who own their home free of mortgage debt. Is it fair to ask the overwhelming majority of Americans who are struggling each month to meet their own financial obligations to bail out the relatively modest group of homeowners who are actually facing foreclosure?

• What message does the government send to the taxpayers by treating a discrete group of homeowners as per se "victims" of predatory lending activity and undertaking to substantially subsidize their mortgage indebtedness at the direct expense of the vast majority of taxpayers who meet their financial obligations each month? Will the former group of homeowners modify their behavior and become more fiscally prudent, or will they continue to over-leverage their households with the expectation that the government will offer yet another taxpayer-funded bailout as needed?

• I remain troubled that HAMP *itself* may have exacerbated the mortgage loan delinquency and foreclosure problem by encouraging homeowners to refrain from remitting their monthly mortgage installments based upon the expectation that they would ultimately receive a favorable restructure or principal reduction subsidized by the taxpayers. The curious incentives offered by HAMP arguably convert the concept of home ownership into the economic reality of a "put option"—as long as a homeowner's residence continues to appreciate in value the homeowner will not exercise the put option, but as soon as the residence falls in value the homeowner will elect to exercise the put option and walk away or threaten to walk away if a favorable bailout is not offered.

• The TARP-funded HAMP program carries a 100 percent subsidy rate according to the GAO. This means that the U.S. government expects to recover *none* of the $50 billion of taxpayer-sourced TARP funds invested in the HAMP foreclosure mitigation program. Since Treasury is charged with protecting the interests of the taxpayers who funded HAMP and the other TARP programs, I recommend that Treasury's foreclosure mitigation efforts be structured so as to incorporate an effective exit strategy by allowing Treasury to participate in any subsequent appreciation in the home equity of any mortgagor whose loan is modified under HAMP or any other taxpayer subsidized program. An equity appreciation right—the functional equivalent of a warrant in a non-commercial transaction—will also mitigate the moral hazard risk of homeowners who may undertake risky loans in the future based on the assumption that the government will act as a backstop with no strings attached.

- In many instances it is unlikely that holders of second lien mortgage loans are truly out-of-the-money since today's fire-sale valuations are not representative of the actual intermediate to long-term fair market value of the residential collateral securing the underlying loans. I am not unsympathetic to the argument that an 80-year historic low in the housing market does not reflect a true representation of fair market value, particularly given the tepid mortgage loan and refinancing markets. If holders of second lien mortgage loans previously advanced cash to their borrowers under home equity loans, they may also be reluctant to write off such loans since the homeowners received *actual cash value* from the home equity loans and not just additional over-inflated house value. It is also entirely possible that holders of second lien mortgages are reluctant to write down their loans past a certain level for fear of impairing their regulatory capital, which could trigger another round of TARP funded bailouts or worse.
- Since the actions of Fannie Mae and Freddie Mac—the GSEs—may directly influence Treasury's foreclosure mitigation programs under the TARP, I recommend that the GSEs conduct their own foreclosure mitigation efforts in an equitable, fully transparent and accountable manner. The Federal Reserve, Treasury and the GSEs should disclose on a regular and periodic basis a detailed analysis of the amount and specific use of all taxpayer-sourced funds they have spent and expect to spend on their foreclosure mitigation efforts.
- This analysis is in no way intended to diminish the financial hardship that many Americans are suffering as they attempt to modify or refinance their underwater home mortgage loans, and I fully acknowledge and empathize with the stress and economic uncertainty created from the bursting of the housing bubble. It is particularly frustrating—although not surprising—that many of the hardest hit housing markets are also suffering from seemingly intractable rates of unemployment and underemployment. As such, I *strongly encourage* each mortgage loan and securitized debt investor and servicer to work with each of their borrowers in *good faith, in a transparent and accountable manner*, to reach an economically reasonable resolution prior to pursuing foreclosure. If Professor White is correct in his analysis, it is clearly in the best economic interest of the investors and servicers to modify the distressed mortgage loans in their portfolios rather than to seek foreclosure of the underlying residential collateral. It is regrettable that HAMP and the Administration's other foreclosure mitigation programs create disincentives for investors and servicers as well as homeowners by rewarding their dilatory behavior with the expectation of enhanced taxpayer-funded subsidies.
- EESA authorizes Treasury "to purchase, and to make and fund commitments to purchase, troubled assets from any financial insti-

tution."[517] In response to a request from Panelist Paul Atkins as to whether Treasury was authorized to fund HAMP under EESA, Treasury's General Counsel delivered a legal opinion to the Panel concluding that Treasury was so authorized. Interestingly, Treasury has requested that the Panel not publish the opinion in the Panel's report even though Treasury has permitted the Panel to quote extensively from the opinion in the report and deliver a copy of the opinion to outside experts. It is my understanding that Treasury has not asserted an attorney-client privilege regarding the opinion, but, instead, has suggested that disclosure of the opinion may impact its ability to assert attorney-client privilege over related material in other contexts. After reviewing the opinion and the basis upon which the opinion was rendered, I can think of no legal theory in support of Treasury's assertion that an attorney-client privilege could be waived by disclosure of the opinion now that Treasury has agreed that the Panel may quote extensively from the opinion in the Panel's report and deliver a copy of the opinion to outside experts. Treasury's legal analysis regarding the subject matter of the opinion is fully disclosed and discussed by the Panel and the outside experts in the Panel's report. I request that Treasury promptly abandon any position—including the assertion of an attorney-client privilege—that would keep the opinion confidential.

HAMP and HARP Have Failed

The Administration's foreclosure mitigation programs—HAMP and HARP—have failed to provide meaningful relief to distressed homeowners. Disappointingly, the Administration has only structured approximately 169,000 "permanent modifications" out of its stated goal of three to four million modifications and, remarkably, 40 percent or more of such homeowners will most likely redefault on their permanent modifications. Worse yet, the Administration has created a sense of false expectation among millions of homeowners who reasonably anticipated that they would have the opportunity to modify or refinance their troubled mortgage loans under the HAMP and HARP programs. It is exceedingly difficult not to conclude that these programs have served as little more than window dressing carefully structured so as to placate distressed homeowners.

In fairness to the tepid efforts of the Administration, I remain unconvinced that government sponsored foreclosure mitigation programs are necessarily capable of lifting millions of American families out of their underwater home mortgage loans. In my view, the best foreclosure mitigation tool is a steady job at a fair wage and not a hodgepodge of government-subsidized programs that create and perpetuate moral hazard risks and all but establish the U.S. government as the implicit guarantor of distressed homeowners. The tax and regulatory policies of the Administration have injected a substantial and relentless element of uncertainty into the private sector. Significant job growth will arguably not return in earnest until the business and investment communities have been afforded sufficient opportunity to assess and assimilate the daunting array of tax increases and enhanced regulatory burdens that have arisen

[517] 12 U.S.C. § 5211.

over the past 15 months. If the Administration continues to introduce and actively promote new taxes and regulatory changes, it is not unreasonable to suggest that the recovery of the employment and housing markets will proceed at a less than optimal pace.[518]

Recovery of the Housing Market without Taxpayer-Funded Subsidies

The Administration suggests the economy is improving, and there have been positive signs in the housing market. There is still uncertainty, however, on whether the country is "out of the woods" and can reach sustainable levels of economic growth and job recovery. If the economy is indeed improving, it would be preferable to let the housing market recover on its own without the expenditure of additional taxpayer funds and without investors being forced unnecessarily to recognize huge losses that will reduce or even deplete their capital base and increase mortgage interest rates.[519] It is worth noting that the S&P/Case-Shiller Index rose 0.3 percent, seasonally adjusted, in January from December, its eighth consecutive monthly increase, and that Los Angeles, San Francisco, San Diego, Dallas, Washington, D.C., Boston, Denver and Minneapolis have experienced year-over-year increases in housing prices from January 2009 to January 2010.[520] This trend indicates that the housing market is beginning to recover in many significant regions of the country on its own without government assistance and the attendant expenditure of taxpayer-sourced funds.[521] The Administration should refrain from developing its foreclosure mitigation policies by fixating on the rear-view mirror when the road ahead shows signs of clearing.

The Unaffordable Cost of the Administration's Foreclosure Mitigation Programs

In my view, insufficient taxpayer funds are available under HAMP for the government to bail out millions of homeowners in an equitable and transparent manner. By suggesting otherwise the Administration continues to propagate misguided expectations and fuzzy accounting. For example, if the taxpayers are required to fund $25,000 in payments to servicers, investors and homeowners per mortgage modification, the total cost of modifying four million mortgages will equal $100 billion—exactly twice the amount of TARP funds presently allocated to HAMP—with a projected 100

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[518] *See* Burton Folsom Jr. and Anita Folsom, *Did FDR End the Depression?, The Wall Street Journal* (Apr. 12, 2010) (online at online.wsj.com/article/SB10001424052702304024604575173632046893848.html?KEYWORDS=burt).

[519] Under such an approach, investors and servicers would be free to exercise their independent business judgments regarding which mortgage loans to modify or refinance, which to leave unchanged, and which to foreclose without the influence of government-subsidized programs and their ability to skew rational market-based economic decisions. In addition, it is unlikely that the regulatory capital of the investors will be impaired from the voluntary write-down of mortgage loan principal.

[520] *See* David Streitfeld, *U.S. Home Prices Inch Up, But Worries Remain,* New York Times (Mar. 30, 2010) (online at www.nytimes.com/2010/03/31/business/economy/31econ.html?hp); Javier C. Hernandez, *Sharp Rise in Home Sales in February,* New York Times (Apr. 5, 2010) (online at www.nytimes.com/2010/04/06/business/economy/06econ.html?hp); Lynn Adler, *US Subprime Delinquencies Drop 1st Time in 4 Years, Reuters* (Apr. 8, 2010) (online at www.reuters.com/article/idUSN0715337220100407); Deborah Solomon, *Light at the End of the Bailout Tunnel,* Wall Street Journal (Apr. 12, 2010) (online at online.wsj.com/article/SB10001424052702304846504575177950029886696.html?mod=googlenews_wsj).

[521] It seems unlikely that the 169,000 permanent modifications out of a projected three to four million HAMP modifications has affected the housing market for the better.

percent subsidy or loss rate to the taxpayers.[522] If the taxpayers *also* subsidize first and second lien mortgage loan principal reductions of another $50,000 per modification (which may understate the issue), the total cost to the taxpayers will equal $300 billion[523]—six times the amount of TARP funds presently allocated to HAMP—with a projected 100 percent subsidy or loss rate to the taxpayers.[524] The Administration should not commit the taxpayers to subsidize any such bailouts where there is no reasonable expectation for the timely repayment of such funds.

If the taxpayers do not ultimately subsidize reductions in first and second lien mortgage loan principal to the extent required under HAMP and the Administration's other foreclosure mitigation programs, the investors who own the distressed mortgage loans and securitized debt instruments will bear the financial burden of such modifications, and the regulatory capital of many financial institutions will no doubt suffer from the realization of losses triggered by the write-downs of mortgage principal. As a result, such institutions may have little choice but to seek to raise mortgage loan interest rates and curtail their lending and other financial services activities to the detriment of qualified individuals and businesses in search of capital. It is also possible that the taxpayers will be required to fund additional capital infusions to those weakened institutions through the TARP, a Resolution Trust Corporation-type structure, or otherwise.

If the policies of the Administration result in the near-term recognition of substantial losses by the holders of mortgage loans and securitized debt instruments, and if the housing market rebounds over the near to intermediate term, the Administration will have accomplished little more than orchestrating a huge transfer of wealth from the investment community to that select group of homeowners who were able to qualify for inclusion in HAMP or one of the Administration's other foreclosure mitigation programs. The taxpayers will share the burden of this wealth transfer to the extent that the Administration subsidizes the write-off of mortgage principal by investors and, if investors who help finance these home loans anticipate a large risk that they will not be repaid, homeowners will ultimately suffer through increased mortgage interest rates.[525] For example, a mortgage loan or securitized debt investor will suffer a $50,000 economic loss[526] upon forgiving a homeowner's like amount of mortgage principal, but the homeowner will realize a $50,000 economic gain if the mortgaged resi-

[522] Congressional Budget Office, *The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009* (June 2009) (online at www.cbo.gov/ftpdocs/100xx/doc10056/06-29-TARP.pdf).

[523] The $300 billion total cost figure is derived by multiplying four million mortgage modifications by $75,000 total cost per mortgage modification ($25,000 plus $50,000).

[524] If the *actual* goal of the Administration is to modify, for example, *only* one-million mortgage loans, the cost of the program will total far less than $300 billion. Such a reduced mandate, however, will most likely produce only modest results absent robust independent efforts from private sector mortgage loan and securitized debt investors and servicers.

[525] It is entirely understandable that many taxpayers may have little sympathy for the plight of struggling financial institutions after the generous taxpayer-funded bailouts they received under the TARP. I appreciate and do not disagree with this sentiment but note that any action that impairs the capital of these financial institutions or increases mortgage loan interest rates is not in the best interest of the taxpayers.

[526] The investor most likely will also incur additional costs and expenses with respect to each mortgage loan modification.

dence subsequently appreciates by a like amount.[527] If four million home mortgage loans are restructured in a similar manner and if the housing market steadily recovers over the near to intermediate term, the taxpayers and the investment community will suffer the burden of transferring approximately $200 billion [528] of value to the homeowner participants in the Administration's foreclosure mitigation programs.[529]

In voluntary private sector foreclosure mitigation efforts, however, the participating investors may readily determine the extent to which voluntary reductions in mortgage principal will reduce or impair their regulatory capital. As such, each private-sector investor will have the opportunity to develop its own customized foreclosure mitigation program that carefully balances the costs and benefits to the investor that may arise from the write-down of outstanding mortgage principal. In my view, this approach is preferable to a government mandated, across-the-board mortgage principal reduction program where investors are required (or pressured) to write off a certain amount of mortgage principal in accordance with a static matrix or a generic ability-to-pay formula. Prudent investors and servicers recognize the purpose and *necessity* of offering their borrowers voluntary mortgage principal reductions in certain well-defined circumstances, and the government should welcome and encourage their active participation in and contribution to the foreclosure mitigation process without the imposition of an overarching one-size-fits-all mandate.

Cost Benefit Analysis of Voluntary Mortgage Modification vs. Foreclosure

In the Panel's October report on foreclosure mitigation, the Panel retained Professor Alan M. White to conduct a cost-benefit analysis of HAMP as well as an analysis of whether it is more cost effective to modify a mortgage loan (without the payment of any government sponsored subsidy to the servicer, the investor or the homeowner) or foreclose the property securing the mortgage loan.[530] Professor White concluded that, subject to certain reasonable assumptions, the investor's net gain from a non-subsidized mortgage modification could average $80,000 or more per loan versus the foreclosure of the property securing the mortgage loan.[531] If Professor White

[527] If the contract that governs the mortgage modification contains an equity participation feature, then some or all of the $50,000 of subsequent appreciation will inure to the benefit of the taxpayers and, perhaps, the investors.

[528] The $200 billion transfer is derived by multiplying four million mortgage modifications by a $50,000 principal reduction per mortgage modification.

[529] By comparison, TARP's Capital Purchase Program totaled $204.9 billion of which $129.8 billion has been repaid as of February 25, 2010. *See* Congressional Oversight Panel, *March Oversight Report: The Unique Treatment of GMAC under the TARP,* at 139 (Mar. 10, 2010) (online at cop.senate.gov/documents/cop-031110-report.pdf).

[530] *See* Congressional Oversight Panel, October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months: Additional Views of Congressman Jeb Hensarling (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report-hensarling.pdf); Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets: Additional Views of J. Mark McWatters and Paul S. Atkins* (Jan. 13, 2010) (online at cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf).

[531] It is important to note that the modification versus foreclosure analysis does not turn upon the realization of net gains anywhere near $80,000 per mortgage loan modification. As long as the mortgage lender breaks even (after considering all costs and expenses including any addition fees paid to the mortgage servicer as well as all cost savings from not foreclosing), the lender should prefer modification.

is correct in his assessment, it is difficult to appreciate why the government should undertake to subsidize mortgage loan modifications. Why should Treasury mandate that the taxpayers fund payments to motivate investors in mortgage loans and securitized debt instruments to take actions that are in their own best interests absent the subsidies?

If the difficulty with respect to modifying mortgage loans on a timely basis arises from the unwillingness of mortgage servicers to discharge their contractual duties without the receipt of additional fee income, investors may respond by either suing the servicers for breach of their obligations under their pooling and servicing agreements or—perhaps more prudently—agreeing to share a portion of their $80,000 or so net gain per modification with the servicers. In either event, the taxpayers will not be required to subsidize the mortgage loan modification process, the investors will receive a substantial net gain from modifying their mortgage loans instead of foreclosing the underlying collateral, the servicers will receive the benefit of their contractual bargain as, perhaps, amended, and *the homeowners will not suffer the foreclosure of their residences.* If an investor stands to benefit from the modification of a mortgage loan it seems reasonable to ask the investor—*and not the taxpayers*—to share part of its "gain"[532] from the workout with the servicer so as to "motivate" the servicer to restructure the loan.[533] Treasury should not gum up the works by offering to subsidize the contractual commitments of mortgage servicers. Any such action will only motivate the investors and servicers to sit on their hands and wait for Treasury to turn on the TARP money machine. In other words, why should the government offer an expensive and needlessly complex taxpayer-funded subsidy when a cost-effective private sector solution is readily available?

I am troubled that the otherwise objective and transparent mortgage loan modification process has been arguably derailed by the enticement of TARP-funded subsidy payments and the expectation that the government will increase the subsidy rate if the mortgage loan and securitized debt investors and servicers continue to drag their feet and all but refuse to modify their portfolio of distressed mortgage loans. With the passage of EESA and the expectation that Treasury would soon introduce a foreclosure mitigation subsidy program, it is not surprising that some investors and servicers apparently elected to adopt a wait-and-see approach. Although unfortunate, such action is entirely rational and presents the investors and servicers with the opportunity to receive additional fee income and net gains by deferring their foreclosure mitigation efforts.[534] Without HAMP or a similar program, the investors and servicers would have arguably undertaken to modify many of their distressed mortgage loans on an expedited basis so as to benefit from Professor White's estimated $80,000 net gain. As long as the

[532] The investor's "gain" most likely will be realized in the form of cash proceeds received and cash expenditures not made over an extended period. As such, investors will need to balance their cash flow against the additional cash fees paid to the mortgage servicers.

[533] I certainly appreciate that mortgage servicers should not merit the payment of additional fees in order to discharge their contractual undertakings. Nevertheless, in order to provide prompt relief to distressed homeowners, such approach is preferable to doing nothing.

[534] Although such approach may qualify as "rational," I strongly disagree with any mortgage lender or servicer who delays its foreclosure mitigation actions based upon the expectation of additional TARP-sourced subsidy payments.

government continues to offer investors and servicers generous and ever-increasing subsidies to perform actions that are already in their best economic interests it should surprise no one if some of these recipients revert to stand-by mode and wait for the best deal. Since the TARP does not end until October 3, 2010, it is possible that some investors and servicers will wait on the sidelines for Treasury to again sweeten an already favorable offer.

Principles of Equity, Moral Hazard Risks and Implicit Guarantees

The public policy rationale underlying taxpayer-funded support for HAMP and the Administration's other foreclosure mitigation efforts appears inequitable when compared to the assistance offered other taxpayers who have suffered economic reversals during the recession. While many homeowners have recently lost equity value in their residences, others have suffered substantial losses in their investment portfolios, including in their 401(k) and IRA plans. Why should the taxpayers bail out a homeowner who has lost $100,000 of home equity value and neglect another taxpayer who has suffered a $100,000 loss of 401(k) and IRA retirement savings?

This problem is exacerbated if the homeowner was able to benefit from accrued home equity appreciation prior to the decline in housing prices. For example, a homeowner may have purchased a residence for $200,000 (with 100 percent financing), taken out a $100,000 home equity loan as the residence appreciated to $300,000, and used the $100,000 of cash proceeds from the home equity loan to purchase a ski boat, trailer, and all-wheel-drive SUV. If the residence subsequently fell in value to $200,000 it makes little sense for the taxpayers to subsidize any reduction in the outstanding principal balance of the home equity loan since the homeowner *actually received* the proceeds of the loan in the form of a ski boat, trailer, and all-wheel-drive SUV and not as overinflated house value. That is, what public policy goal is served by bailing out the homeowner who received a ski boat, trailer, and all-wheel-drive SUV as proceeds from a $100,000 home equity loan while neglecting the taxpayer who suffered a $100,000 investment loss in her 401(k) and IRA retirement savings accounts?[535]

[535] In other words, why should the homeowner who *did not suffer* an economic loss (because she retains the ski boat, trailer, and all-wheel-drive SUV) receive a $100,000 taxpayer-funded bailout, while the 401(k) and IRA investor who *actually suffered* a $100,000 economic loss in her retirement savings receives nothing? More broadly stated, why should those homeowners who benefitted from the use of their homes as an ATM expect other taxpayers to offer a bailout?

See Alyssa Katz, *How Texas Escaped the Real Estate Foreclosure Crisis,* Washington Post (Apr. 4, 2010) (online at www.washingtonpost.com/wp-dyn/content/article/2010/04/03/AR2010040304983.html?sub=AR) ("But there is a broader secret to Texas's success, and Washington reformers ought to be paying very close attention. If there's one thing that Congress can do to help protect borrowers from the worst lending excesses that fueled the mortgage and financial crises, it's to follow the Lone Star State's lead and put the brakes on "cash-out" refinancing and home-equity lending. A cash-out refinance is a mortgage taken out for a higher balance than the one on an existing loan, net of fees. Across the nation, cash-outs became ubiquitous during the mortgage boom, as skyrocketing house prices made it possible for homeowners, even those with bad credit, to use their home equity like an ATM. But not in Texas. There, cash-outs and home-equity loans cannot total more than 80 percent of a home's appraised value. There's a 12-day cooling-off period after an application, during which the borrower can pull out. And when a borrower refinances a mortgage, it's illegal to get even a dollar back. Texas really means it: All these protections, and more, are in the state constitution. The Texas restrictions on mortgage borrowing date from the first days of statehood in 1845, when the constitution banned home loans."

Continued

Suppose, instead, two taxpayers purchased condominiums in the same building for $200,000 each with 100 percent financing. After the condominiums appreciated to $300,000 each, the first homeowner secured a $100,000 home equity loan to pay the college tuition of the first homeowner's son; the second homeowner declined to accept a home equity loan (expressing a "this is too good to believe" skepticism) and the second homeowner's daughter financed her college tuition with a $100,000 student loan. If the condominiums subsequently drop in value to $200,000 each, why should the taxpayers subsidize the write-off of the first homeowner's home equity loan and in effect finance the college tuition of the first homeowner's son while the second homeowner's daughter remains committed on her $100,000 student loan? I do not concur with any public policy that would yield such an inequitable treatment, particularly since the second homeowner acted in a prudent and fiscally responsible manner by electing not to over leverage the residence.

Other examples come to mind. What about the retired homeowner whose residence drops in value by $100,000 after she has diligently paid each installment on her $300,000 mortgage over 30 years? The homeowner has certainly suffered an economic loss, but she does not qualify for relief under HAMP or otherwise because she has repaid her mortgage in full. What about the taxpayer who rents her primary residence and purchases (with a $300,000 mortgage loan) real property for investment purposes that subsequently drops in value by $100,000? As in the prior example, the renter has certainly suffered a $100,000 economic loss, but she does not qualify for relief under HAMP or otherwise. What about the homeowner suffering from a protracted illness or disability who loses $100,000 of equity value upon the foreclosure of her residence for failure to pay property taxes? Again, the taxpayer has suffered a $100,000 economic loss, but HAMP and the Administration's other foreclosure mitigation programs offer no assistance.

These examples illustrate the inequity of assisting only one group of Americans to the exclusion of others who have also suffered from the recession. Since it is neither possible nor prudent [536] for the government to subsidize the taxpayers for the trillions of dollars of economic losses that have arisen over the past two years, the government should not undertake to allocate its limited re-

See also Did Consumer Protection Laws Prevent Texas Housing Bubble?, Wall Street Journal (Apr. 6, 2010) (online at blogs.wsj.com/developments/2010/04/06/did-consumer-protection-laws-prevent-texas-housing-bubble/tab/print/) ("Texas avoided a bubble to begin with, in part because it didn't have a rampant speculation and house flipping that arguably sparked the bubble markets in Florida, Nevada and Arizona. Indeed, real-estate investors have argued that higher property taxes in Texas made it less attractive to hold properties as investments versus states such as California, while urban planners have argued that less restrictive land-use laws didn't drive up prices by constraining supply. Texas, of course, may also have fresh memories of a real-estate bubble, as housing economist Thomas Lawler notes, given that the state had the "absolute worst regional downturn in home prices in the post-World War II period" prior to the current downturn during the "oil patch" boom and bust of the 1980s. (The bulk of "default asset management" operations—how to dispose of foreclosures—for Fannie Mae and Freddie Mac are still headquartered in Dallas as a byproduct of that era.) Mr. Lawler says while any actions designed to discourage excessive borrowing is an "incredibly good idea, I'm not sure that Texas is an all around 'good' example."

[536] If the government undertook to cover explicitly or implicitly the investment losses of the taxpayers, such a policy would—in addition to bankrupting the government—most likely encourage many taxpayers to select high-risk investments for their portfolios with the expectation that they will retain all of the upside from such investments but that the government would subsidize any losses on the downside.

sources to one group of taxpayers while ignoring the equally (or more) legitimate economic losses incurred by other groups.

It is also worth noting that only a relatively modest (although certainly not insignificant) percentage of Americans are facing foreclosure after properly considering the number of taxpayers who are current on their mortgage obligations, who are renting their primary residences and who own their homes free of mortgage debt.[537] Is it fair to ask the overwhelming majority of Americans who are struggling each month to meet their own financial obligations to bail out the relatively modest group of homeowners who are actually facing foreclosure? This issue becomes far more compelling when considering the economic difficulties facing many members of the majority group—as noted in the foregoing examples—that have received next to no attention from the Administration. I do not believe that it is equitable to ask these taxpayers to shoulder the burden of funding HAMP and the Administration's other foreclosure mitigation programs.

In addition to a compelling sense of inequity, the bailout of distressed homeowners creates profound moral hazard risks and all but establishes the U.S. government as the implicit guarantor of homeowners who overextend their mortgage obligations. What message does the government send to the taxpayers by treating a discrete group of homeowners as per se "victims" of predatory lending activity and undertaking to substantially subsidize their mortgage indebtedness at the direct expense of the vast majority of taxpayers who meet their financial obligations each month? Will the former group of homeowners modify their behavior and become more fiscally prudent, or will they continue to over-leverage their households with the expectation that the government will offer yet another taxpayer-funded bailout as needed? Will formerly prudent homeowners look at the windfall others have received and modify their behavior in an adverse manner? Such behavior, while certainly not commendable, is by no means irrational and only demonstrates that consumers will respond to economic incentives that are in their own self-interest. If the government offers to subsidize a homeowner's mortgage payments (or credit card debt), it is arguably difficult to criticize the homeowner for accepting the misguided offer, yet I would be remiss if I did not question any government-sanctioned policy that encourages taxpayers to act in a fiscally imprudent manner.

This analysis is in no way intended to diminish the financial hardship that many Americans are suffering as they attempt to modify or refinance their underwater home mortgage loans, and I fully acknowledge and empathize with the stress and economic uncertainty created from the bursting of the housing bubble. It is particularly frustrating—although not surprising—that many of the hardest hit housing markets are also suffering from seemingly intractable rates of unemployment and underemployment. As such, I *strongly encourage* each mortgage loan and securitized debt investor and servicer to work with each of their borrowers in *good faith, in a transparent and accountable manner,* to reach an economically

[537] *See* Congressional Oversight Panel, *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months: Additional Views of Congressman Jeb Hensarling* (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report-hensarling.pdf).

reasonable resolution prior to pursuing foreclosure. If Professor White is correct in his analysis, it is clearly in the best economic interest of the investors and servicers to modify the distressed mortgage loans in their portfolios rather than to seek foreclosure of the underlying residential collateral. It is regrettable that HAMP and the Administration's other foreclosure mitigation programs create disincentives for investors and servicers as well as homeowners by rewarding their dilatory behavior with the expectation of enhanced subsidies.

Home Ownership as a "Put Option"

I remain troubled that HAMP *itself* may have exacerbated the mortgage loan delinquency and foreclosure problem by encouraging homeowners to refrain from remitting their monthly mortgage installments based upon the expectation that they will ultimately receive a favorable restructure or principal reduction subsidized by the taxpayers.[538] This "strategic default" issue is magnified by single-action and anti-deficiency laws in effect in several states that permit homeowners to walk away from their mortgage obligations with relative impunity.[539] These laws together with the curious incentives offered by HAMP arguably convert the concept of home ownership into the economic reality of a "put option"[540]—as long as a homeowner's residence continues to appreciate in value the homeowner will not exercise the put option, but as soon as the residence falls in value the homeowner will elect to exercise the put option and walk away or threaten to walk away if a favorable bailout is not offered.[541] I am also concerned that Treasury's attempt to "streamline" the loan modification process will result in materially lower underwriting standards that may lead to the creation of a new class of Treasury-sanctioned and subsidized subprime loans that may inflate yet another housing bubble. Any inappropriate loosening of prudent underwriting standards may also cause the re-default rate to surpass the already distressing projected rate of 40 percent.

[538] Although such approach may qualify as "rational," I strongly disagree with any homeowner who purposely declines to make a mortgage payment based upon the expectation of a TARP-sourced bailout.

[539] A "bankruptcy cram down" law pursuant to which a bankruptcy judge would be authorized to change (i.e., cram down) the terms of a mortgage loan over the objection of the mortgage loan holder could arguably encourage homeowners to act in a similar manner.

[540] A put option is a contract providing the owner with the right—but not the obligation—to sell a specified amount of an underlying security or asset at a specified price within a specified period of time. The right afforded the homeowner in a jurisdiction with an anti-deficiency or one-action law is arguably the functional equivalent of a put option.

[541] If a homeowner exercises the put option, her credit rating will suffer and she may not qualify for another home mortgage loan for several years. It may, however, be in the best long term financial interest of the homeowner to walk away from her house and mortgage obligations in favor of renting a residence until her credit rating recovers.

Taxpayer Protection—the Importance of Equity Participation Rights [542]

The TARP-funded HAMP program carries a 100 percent subsidy rate according to the General Accounting Office (GAO).[543] This means that the United States government expects to recover *none* of the $50 billion of taxpayer-sourced TARP funds invested in the HAMP foreclosure mitigation program.[544] The projected shortfall will become more burdensome to the taxpayers as Treasury contemplates expanding HAMP or introducing additional programs targeted at modifying or refinancing distressed home mortgage loans. Since Treasury is charged with protecting the interests of the taxpayers who funded HAMP and the other TARP programs, I recommend that Treasury's foreclosure mitigation efforts be structured so as to incorporate an effective exit strategy by allowing Treasury to participate in any subsequent appreciation in the home equity of any mortgagor whose loan is modified under HAMP or any other taxpayer subsidized program.[545]

In order to encourage the participation of mortgage lenders in Treasury's foreclosure mitigation efforts, such lenders could also be granted the right—subordinate to the right granted Treasury—to participate in any subsequent equity appreciation. Understandably, many feel little sympathy for lenders on the other side of the mortgage contract. However, if the lenders are not allowed to partake in a slice of the equity appreciation after they agree to take an upfront loss in a principal reduction, homeowners could suffer across-the-board by being required to pay higher premiums for loans in the future.

The mechanics of an equity participation right may be illustrated by the following example of a typical home mortgage loan modification.[546]

Assume a homeowner borrows $200,000 and purchases a residence of the same amount.[547] The home subsequently declines in value to $175,000; the homeowner and the mortgage lender agree to restructure the loan under a TARP-sponsored foreclosure mitigation program, pursuant to which the outstanding principal balance of the loan is reduced to $175,000, and Treasury advances

[542] *See* Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets: Additional Views of J. Mark McWatters and Paul S. Atkins* (Jan. 13, 2010) (online at cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf). I have incorporated such Additional Views into my analysis of equity participation rights.

[543] Government Accountability Office, *Financial Audit: Office of Financial Stability (Troubled Asset ReliefProgram) Fiscal Year 2009 Financial Statements,* at 15 (Dec. 2009) (online at www.gao.gov/new.items/d10301.pdf).

[544] Congressional Budget Office, *The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009* (June 2009) (online at www.cbo.gov/ftpdocs/100xx/doc10056/06–29–TARP.pdf).

[545] Doing so will also mitigate the moral hazard risk of homeowners who could undertake problematic loans in the future based on the assumption that the government will act as a backstop with no strings attached. See Congressional Oversight Panel, December Oversight Report: Taking Stock: What has the Troubled Asset Relief Program Achieved?: Additional Views of Congressman Jeb Hensarling (Dec. 9, 2009) (online at cop.senate.gov/documents/cop-120909-report-hensarling.pdf).

[546] The incorporation of an equity participation right may be achieved by the filing of a one-page document in the local real property records when the applicable home mortgage loan is modified.

[547] These facts illustrate the zero ($0.00) down-payment financings that were more common a few years ago.

$10,000 [548] in support of the restructure. Immediately after the modification the mortgage lender has suffered a $25,000 [549] economic loss and Treasury has advanced $10,000 of TARP funds. If the homeowner subsequently sells the residence for $225,000, the $50,000 of realized equity proceeds [550] would be allocated in accordance with the following waterfall—the first $10,000 [551] is remitted to reimburse Treasury for the TARP funds advanced under the foreclosure mitigation program; the next $25,000 [552] is remitted to the mortgage lender to cover its $25,000 economic loss; and the balance of $15,000 is paid to the homeowner.[553]

Prior to the repayment of all funds advanced by Treasury and the economic loss suffered by the mortgage lender, the homeowner should not be permitted to borrow against any appreciation in the net equity value of the mortgaged property unless the proceeds are applied in accordance with the waterfall noted above. That is, instead of selling the residence for $225,000 as assumed in the foregoing example, the homeowner should be permitted to borrow against any net equity in the residence, provided that $10,000 is remitted to Treasury and $25,000 is paid to the mortgage holder prior to the homeowner retaining any such proceeds.[554] Such flexibility allows the homeowner to cash out the interests of Treasury and the mortgage lender without selling the residence securing the mortgage loan. The modified loan documents should also permit the homeowner to repay Treasury and the mortgage lender from other sources such as personal savings or the disposition of other assets.[555]

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[548] The $10,000 of TARP-sourced funds advanced by Treasury may be, for example, remitted to the mortgage loan servicer and the homeowner under HAMP.

[549] The $25,000 loss equals the $200,000 outstanding principal balance of the original loan, less the $175,000 original principal balance of the modified loan. The example does not consider the consequences of modifying the interest rate on the loan.

[550] The $50,000 of realized equity proceeds equals the $225,000 sales price of the residence, less the $175,000 outstanding principal balance of the modified loan. The example makes certain simplifying assumptions such as the absence of transaction and closing fees and expenses.

[551] In order to more appropriately protect the taxpayers, the $10,000 advanced under the TARP-sponsored foreclosure mitigation program could accrue interest at an objective and transparent rate. For example, if the 30-year fixed rate of interest on mortgage loans equals five percent when the mortgage loan is modified, the $10,000 advance would accrue interest at such a rate, and Treasury would be reimbursed the aggregate accrued amount upon realization of the equity proceeds. If at such time $2,500 of interest has accrued, Treasury would be reimbursed $12,500 ($10,000 originally advanced, plus $2,500 of accrued interest) instead of only the $10,000 of TARP proceeds originally advanced.

[552] The mortgage lender may also argue that its $25,000 loss should accrue interest in the same manner as provided Treasury. In such event, the mortgage lender would be entitled to recover $25,000, plus accrued interest upon the realization of sufficient equity proceeds.

[553] Treasury, the mortgage lender, and the homeowner may also agree to share the $50,000 net gain in a manner that is more favorable to the homeowner. For example, the parties could agree to allocate the net gain as follows—(i) 50 percent to Treasury, but not to exceed 75 percent of Treasury's aggregate advances; (ii) 25 percent to the mortgage lender, but not to exceed 50 percent of the mortgage lender's economic loss; and (iii) the remainder to the homeowner. Under such an agreement the $50,000 net gain would be allocated as follows—(i) $7,500 to Treasury (50 percent x $50,000 net gain, but not to exceed 75 percent x $10,000 aggregate advances by Treasury); (ii) $12,500 to the mortgage lender (25 percent x $50,000 net gain, but not to exceed 50 percent x $25,000 economic loss of the mortgage lender); and (iii) $30,000 to the homeowner ($50,000 net gain, less $7,500, less $12,500).

Treasury may also wish to structure its foreclosure mitigation efforts so as to encourage the early repayment of TARP funds by homeowners. Treasury, for example, could agree to a 20 percent discount or waive the accrual of interest on the TARP funds advanced if a homeowner repays such funds in full within three years following the restructure. Any such sharing arrangements and incentives should appear reasonable to the taxpayers and should not negate the intent of the equity participation right. Mortgage lenders may also agree to similar incentives.

[554] Prudent underwriting standards should apply to all such home equity loans.

[555] As noted above, Treasury, the mortgage lender, and the homeowner may agree to share the $50,000 of refinancing proceeds in a manner that is more favorable to the homeowner.

I also recommend that to the extent permitted by applicable law Treasury consider structuring all mortgage loan modifications and refinancings under HAMP and any other foreclosure mitigation programs as recourse obligations to the homeowners. If the loans are structured as non-recourse obligations under state law or otherwise, the homeowners may have a diminished incentive to repay Treasury the funds advanced under TARP.

In my view, the incorporation of these specifically targeted modifications into each TARP funded foreclosure mitigation program will enhance the possibility that Treasury will exit the programs at a reduced cost to the taxpayers.

The Overstated Case against Second Lien Mortgage Holders

Some advocate that holders of out-of-the-money second lien mortgages walk away from their loans so as to facilitate the timely modification of in-the-money first lien mortgage loans.[556] In my view, this approach—although certainly not without merit—is generally unrealistic and inequitable to the holders of second lien mortgage loans. In many instances it is unlikely that holders of second lien mortgage loans are *truly* out-of-the-money since today's fire-sale valuations are not representative of the actual intermediate to long-term fair market value of the residential collateral securing the underlying loans.[557] I am not unsympathetic to the argument that an 80-year historic low in the housing market does not reflect a true representation of fair market value, particularly given the tepid mortgage loan and refinancing markets.

Second lien lenders may refrain from writing down their mortgage loans if their internal projections reasonably reflect a recovery in the housing market within the next year or so. In addition, if the second lien lenders previously advanced cash to their borrowers under home equity loans, they may also be reluctant to write off such loans since the homeowners received *actual cash value* from the home equity loans and not just more over-inflated house value. In both instances second lien holders may argue that such analysis is based upon their exercise of prudent business judgment as well as the discharge of their fiduciary duties to their shareholders.

While these arguments are compelling, they perhaps mask the real problem arising from the wholesale write-off of second lien

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[556] *See* James S. Hagerty, *Banks Rebel Against Push to Redo Loans,* Wall Street Journal (Apr. 13, 2010) (online at online.wsj.com/article/SB10001424052702304506904575180320655553224.html?mod=rss_com_mostcommentart) ("To write down loans enough to bring those debts down to no more than the home values would cost $700 billion to $900 billion, JPMorgan Chase estimated in its testimony. That would include costs of $150 billion to the Federal Housing Administration and government-controlled mortgage investors Fannie Mae and Freddie Mac, the bank said. J.P. Morgan also said broad-based principal reductions could raise costs for borrowers if mortgage investors demand more interest to compensate for that risk. Borrowers probably would have to increase down payments, and credit standards would tighten further, the bank said. Wells Fargo said principal forgiveness "is not an across-the-board solution" and "needs to be used in a very careful manner." Bank of America said that it supports principal reductions for some customers whose debts are high in relation to their home values and who face financial hardships but that "solutions must balance the interests of the customer and the (mortgage) investor").

[557] For example, if a homeowner has encumbered her residence with a first lien mortgage of $200,000 and a second lien mortgage of $100,000, the holder of the second lien mortgage loan is completely out-of-the-money if the residence has a current—fire sale—market value of only $175,000. If the holder of the second lien mortgage in *good faith* anticipates that the residence will appreciate to $240,000 within the next year or so, I can understand why the holder may not be inclined to write off $40,000 of its loan ($240,000 projected fair market value of the residence, less $200,000 outstanding principal balance of the first lien loan).

mortgage loans. It is entirely possible that holders of second lien mortgages are reluctant to write down their loans past a certain level for fear of impairing their regulatory capital, which could trigger another round of TARP funded bailouts, the failure of second lien holders or worse. This problem may be particularly acute given the high concentration of second lien mortgage loans held by a relatively few financial institutions. Holders of first lien mortgage loans and homeowners may have more success in motivating holders of second lien mortgages to write off part or all of their loans if they offer the holders a contractual equity participation right that permits the subordinate lenders to share in any subsequent appreciation in the fair market value of the underlying residential collateral.

Government Support of Housing Programs through Fannie Mae and Freddie Mac

Since the collapse in home values, the federal government has undertaken extraordinary and unprecedented actions in the housing market. Fannie Mae and Freddie Mac together own or guarantee approximately $5.5 trillion of the $11.8 trillion in U.S. residential mortgage debt and financed as much as 75 percent of new U.S. mortgages during 2009.[558] On December 24, 2009, Treasury announced that it would provide an *unlimited* amount of additional assistance to the two GSEs as required over the next three years.[559] Treasury also revised upwards to $900 billion the cap on the retained mortgage portfolio of the GSEs, which means the GSEs will not be forced to sell mortgage-backed securities (MBS) into a distressed market just as the Federal Reserve ends its program to purchase up to $1.25 trillion of MBS. Treasury apparently took these actions out of concern that the $400 billion of support that it previously committed to the GSEs could prove insufficient as well as to provide stability to an industry still teetering. Additional assistance by Treasury has allowed the GSEs to honor their MBS guarantee obligations and absorb further losses from the modification or write-down of distressed mortgage loans. It also has provided an advantage by allowing them to raise additional funds through the issuance of debt viewed by markets as virtually risk-free.

The additional commitment and revised cap increase the likelihood that the GSEs will undertake to make significant purchases of distressed MBS for which they provided a guarantee. Presumably, the GSEs may make such purchases from TARP recipients and other holders and issuers, and it will be interesting to note how the GSEs elect to employ the proceeds of the unlimited Treasury facility. It does not seem unreasonable to conclude that the GSEs may use the facility to finance the modification of the residential mortgages they own or guarantee. Since the actions of the

[558] *See* Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets: Additional Views of J. Mark McWatters and Paul S. Atkins* (Jan. 13, 2010) (online at cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf). I have incorporated such Additional Views into my analysis of the foreclosure mitigation programs of Fannie Mae and Freddie Mac.

[559] *See* U.S. Department of the Treasury, *Treasury Issues Update on Status of Support for Housing Programs* (Dec. 24, 2009) (online at treasury.gov/press/releases/2009122415345924543.htm).

GSEs may directly influence Treasury's foreclosure mitigation programs under TARP, I recommend that the GSEs conduct their own foreclosure mitigation efforts in an equitable, fully transparent and accountable manner. The Federal Reserve, Treasury and the GSEs should disclose on a regular and periodic basis a detailed analysis of the amount and specific use of all taxpayer-sourced funds they have spent and expect to spend on their foreclosure mitigation efforts.

In addition, it must be a clear goal that all of these extraordinary actions taken to stabilize markets are temporary in nature. If not, another crisis could result from an over-inflated, government-backed housing market, led by the too-big-to-fail—and getting bigger—GSEs, in which a TARP-like bailout of equal or greater magnitude could occur. While stability is a priority in the short-term, in the medium- to long-term Treasury must make certain that its actions do not exacerbate the same issues that caused the last meltdown and that it enables the return of a viable private sector for housing.

Legal Authority for Treasury to Fund HAMP with TARP Proceeds

EESA authorizes Treasury "to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution."[560] In response to a request from Panelist Paul Atkins as to whether Treasury was authorized to fund HAMP under EESA, Treasury's General Counsel delivered a legal opinion to the Panel concluding that Treasury was so authorized. Interestingly, Treasury has requested that the Panel not publish the opinion in the Panel's report even though Treasury has permitted the Panel to quote extensively from the opinion in the report and deliver a copy of the opinion to outside experts. It is my understanding that Treasury has not asserted an attorney-client privilege regarding the opinion, but, instead, has suggested that disclosure of the opinion may impact its ability to assert attorney-client privilege over related material in other contexts. After reviewing the opinion and the basis upon which the opinion was rendered, I can think of no legal theory in support of Treasury's assertion that an attorney-client privilege could be waived by disclosure of the opinion now that Treasury has agreed that the Panel may quote extensively from the opinion in the Panel's report and deliver a copy of the opinion to outside experts. Treasury's legal analysis regarding the subject matter of the opinion is fully disclosed and discussed by the Panel and the outside experts in the Panel's report. I request that Treasury promptly abandon any position—including the assertion of an attorney-client privilege—that would keep the opinion confidential.

[560] 12 U.S.C. § 5211.

SECTION THREE: CORRESPONDENCE WITH TREASURY UPDATE

On behalf of the Panel, Chair Elizabeth Warren sent a letter on April 13, 2010,[561] to Secretary of the Treasury Timothy Geithner, presenting a series of questions about the failure of financial institutions which had received funds under the Capital Purchase Program (CPP), and asking Treasury to estimate its remaining exposure to future bank failures. The Panel has requested a written response from Treasury by April 27, 2010.

[561] *See* Appendix I of this report, *infra*.

SECTION FOUR: TARP UPDATES SINCE LAST REPORT

A. TARP Repayments

In March 2010, four institutions completely redeemed the preferred shares given to Treasury as part of their participation in the TARP's Capital Purchase Program (CPP). Treasury received $5.9 billion in CPP repayments from these institutions. Of this total, $3.4 billion was repaid by Hartford Financial Services Group, Inc., and $2.25 billion was repaid by Comerica Inc. A total of eight banks have fully repaid their preferred stock TARP investments provided under the CPP in 2010.

B. CPP Warrant Dispositions

As part of its investment in senior preferred stock of certain banks under the CPP, Treasury received warrants to purchase shares of common stock or other securities in those institutions. During March, one institution repurchased its warrants from Treasury for $4.5 million, and Treasury sold the warrants of five other institutions at auction for $344 million in proceeds. Treasury has liquidated the warrants it held in 48 institutions for total proceeds of $5.6 billion.

C. Treasury Named Two Appointees to AIG Board of Directors

On April 1, 2010, Treasury announced that it had exercised its right to appoint two directors to the AIG board of directors. Treasury was afforded this right because AIG did not make dividend payments for four consecutive quarters on the preferred stock held by Treasury. Treasury named Donald H. Layton, the former chairman and chief executive officer of E8Trade Financial Corporation, and Ronald A. Rittenmeyer, former president, chairman and chief executive officer of Electronic Data Systems, to the AIG board.

D. Term Asset-Backed Securities Loan Facility

At the March 19, 2010 facility, investors requested $1.25 billion in loans for legacy commercial mortgage-backed securities (CMBS), of which $857 million settled. In comparison, at the February facility, investors requested $1.25 billion in loans for legacy CMBS, of which $1.1 billion settled. Investors did not request any loans for new CMBS in March. The only request for new CMBS loans during TALF's operation was for $72.2 million at the November facility.

The New York Federal Reserve's March 4, 2010 facility was a non-CMBS facility, offering loans to support the issuance of ABS collateralized by loans in the credit card, equipment, floorplan, premium financing, small business, and student loan sectors. In total, $4.1 billion in loans were requested at this facility. There were no requests at this facility for auto or servicing advance loans. At the February 5, 2010 facility, $974 million of the $987 million in requested loans settled.

E. Sale of Treasury's Interest in Citigroup

On March 29, 2010, Treasury announced that it intended to fully dispose of the $7.7 billion shares of Citigroup, Inc. common stock it owns during 2010. Treasury has employed Morgan Stanley to act on its behalf in the sale of these securities.

F. Special Master Issues Executive Compensation Rulings

On March 24, 2010, the Special Master for TARP Executive Compensation, Kenneth R. Feinberg, issued rulings on the 2010 pay packages for the "Top 25" executives at the five remaining firms that received "exceptional assistance" from the government: AIG, Chrysler, Chrysler Financial, General Motors, and GMAC. The Special Master decreased total compensation for the 119 executives who fell under this distinction by 15 percent as compared to the 2009 levels.

G. Expansion of Housing Programs

On March 26, 2010, the Administration announced adjustments to its foreclosure mitigation efforts. The adjustments to the Home Affordable Modification Program (HAMP) allow for the mortgage rates of an eligible unemployed borrower to be reduced for a period of time while looking for work. Furthermore, the Administration announced on this date that it would allow lenders to expand the number of refinancing options for eligible borrowers.

On March 29, 2010, Treasury announced a second initiative directing aid to states suffering the most from the economic downturn. As an expansion of the Hardest Hit Fund announced on February 19, 2010, this program will allocate $600 million to five additional states: North Carolina, Ohio, Oregon, Rhode Island, and South Carolina. For further discussion of these program expansions and adjustments, please see Section C.2 of this report.

H. Metrics

Each month, the Panel's report highlights a number of metrics that the Panel and others, including Treasury, GAO, SIGTARP, and the Financial Stability Oversight Board, consider useful in assessing the effectiveness of the Administration's efforts to restore financial stability and accomplish the goals of EESA. This section discusses changes that have occurred in several indicators since the release of the Panel's March report.

- **Interest Rate Spreads.** Interest rate spreads have continued to flatten since the Panel's March report. The conventional mortgage spread, which measures the 30-year mortgage rate over 10-year Treasury bond yields, declined by 12.5 percent during March. The interest rate spread for AA asset-backed commercial paper, which is considered mid-investment grade, has decreased by 26.3 percent since the Panel's March report.

FIGURE 54: INTEREST RATE SPREADS

Indicator	Current Spread (as of 4/5/10)	Percent Change Since Last Report (3/11/10)
Conventional mortgage rate spread [562]	1.19	(12.5)
Overnight AA asset-backed commercial paper interest rate spread [563]	0.08	(26.3)
Overnight A2/P2 nonfinancial commercial paper interest rate spread [564]	0.13	0.8

[562] Conventional Mortgages (Weekly), *supra note* 353 (accessed Apr. 12, 2010); U.S. Government Securities/Treasury Constant Maturities/Nominal, *supra note* 353 (accessed Apr. 12, 2010).

[563] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Asset-Backed Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (hereinafter "Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings") (accessed Apr. 12, 2010); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Nonfinancial Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed Apr. 12, 2010). In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

[564] Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings, *supra* note 519 (accessed Apr. 12, 2010). In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

• **Housing Indicators.** Both the Case-Shiller Composite 20-City Composite as well as the FHFA Housing Price Index remained relatively flat in January 2010. The Case-Shiller and FHFA indices remain 6.5 percent and 4.3 percent below the levels at the time EESA was enacted in October 2008. Foreclosure filings decreased by 2.3 percent from December to January, and are 10.4 percent above their October 2008 level.

FIGURE 55: HOUSING INDICATORS

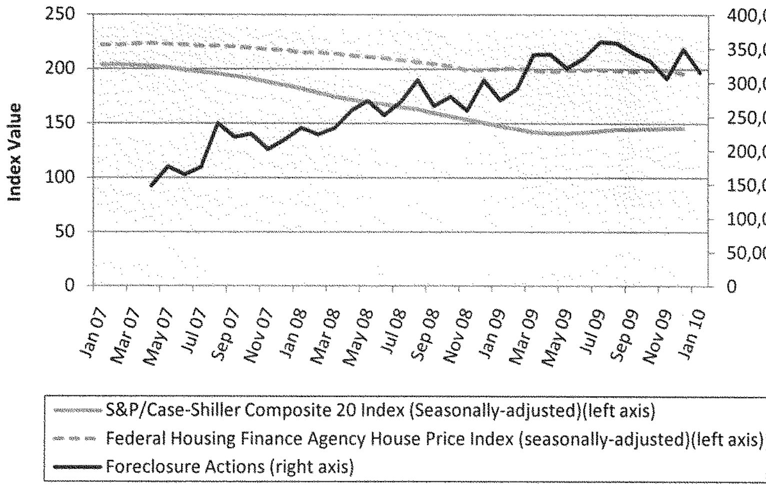
Indicator	Most Recent Monthly Data	Percent Change from Data Available at Time of Last Report	Percent Change Since October 2008
Monthly foreclosure actions [565]	308,524	(2.3)	10.4
S&P/Case-Shiller Composite 20-City Composite [566]	146.3	0.31	(6.5)
FHFA Housing Price Index [567]	194	(1.1)	(4.3)

[565] RealtyTrac Foreclosure Press Releases, *supra* note 96 (accessed Apr. 12, 2010). Most recent data available for February 2010.

[566] S&P/Case-Shiller Home Price Indices, *supra* note 330 (accessed Apr. 12, 2010). Most recent data available for January 2010.

[567] U.S. and Census Division Monthly Purchase Only Index, *supra* note 330 (accessed Apr. 12, 2010). Most recent data available for January 2010.

FIGURE 56: FORECLOSURE ACTIONS AS COMPARED TO THE HOUSING INDICES (AS OF JANUARY 2010) [568]



• **Bank Conditions.** Fourth quarter data on the condition of domestic banks continue to reflect the decline in loan quality. As Figure 57 illustrates, loan loss reserves as a percentage of all loans continued to increase during the fourth quarter of 2009. This measure has increased over 43 percent since the enactment of EESA and is at its highest level ever. Figure 58 displays nonperforming loans as a percentage of total loans for all U.S. banks. Nonperforming loans are defined here as those loans 90+ days past due as well as loans in nonaccrual status. This metric has increased over 86 percent since the enactment of EESA and by nearly 580 percent since the first quarter of 2007.

[568] Realty Trac Foreclosure Press Releases, *supra* note 96 (accessed Apr. 12, 2010); S&P/Case-Shiller Home Price Indices, *supra* note 330 (accessed Apr. 12, 2010); U.S. and Census Division Monthly Purchase Only Index, *supra* note 330 (accessed Apr. 12, 2010). The most recent data available for the housing indices are as of January 2010.

FIGURE 57: LOAN LOSS RESERVE/TOTAL LOANS FOR DOMESTIC BANKS [569]

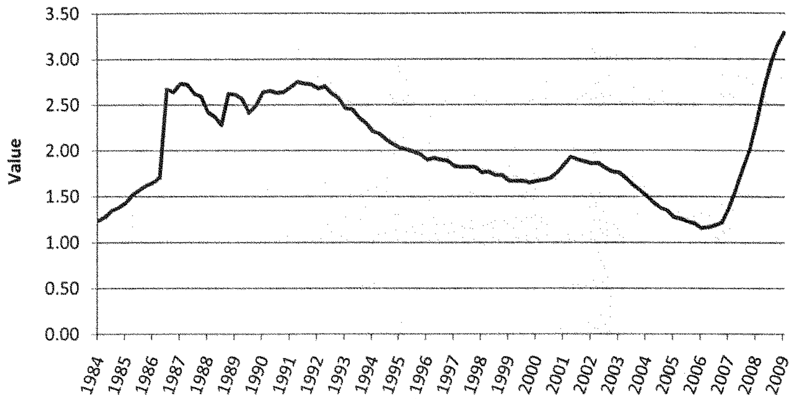
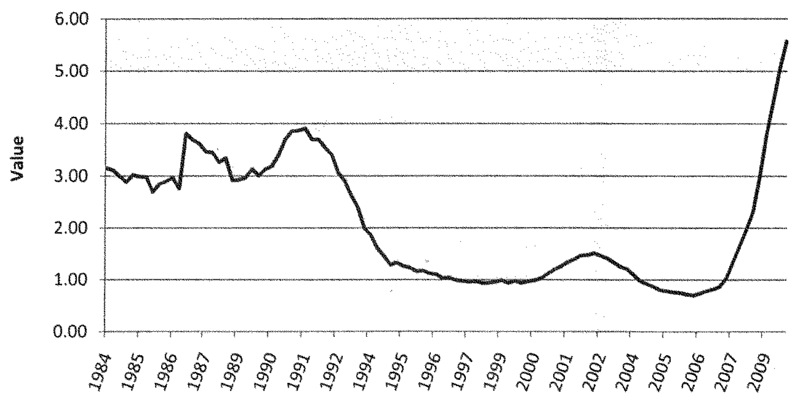


FIGURE 58: NONPERFORMING LOANS/TOTAL LOANS [570]

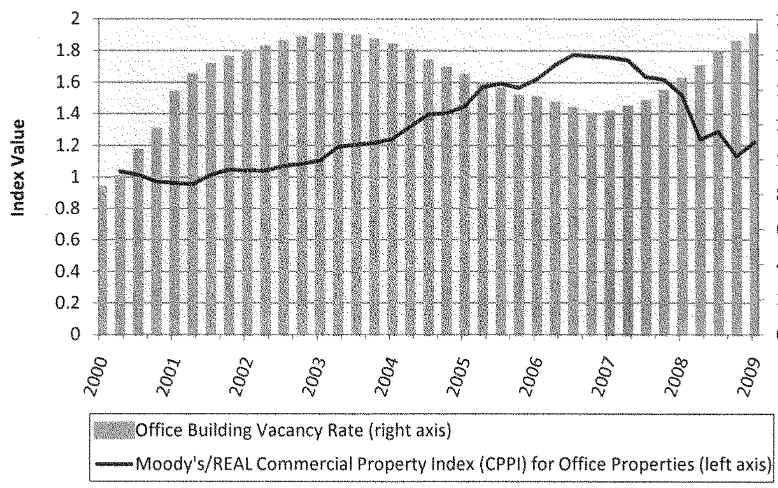


[569] Federal Reserve Bank of St. Louis, *Loan Loss Reserve/Total Loans for all U.S. Banks* (accessed Apr. 12, 2010) (online at research.stlouisfed.org/fred2/series/USLLRTL).

[570] Federal Reserve Bank of St. Louis, *Nonperforming Loans (past due 90+ days plus non-accrual)/Total Loans for all U.S. Banks* (accessed Apr. 12, 2010) (online at research.stlouisfed.org/fred2/series/USNPTL?cid=93).

• **Commercial Real Estate.** Conditions for commercial real estate have continued to decline since the most recent data contained in the Panels February report on the subject. As Figure 59 shows, the vacancy rate for office properties was 17 percent at the end of 2009, nearly a 30 percent increase since the first quarter of 2007. Conversely, the Moody's/REAL Commercial Property Price Index for office properties declined by nearly 29 percent since the same period.[571]

FIGURE 59: OFFICE PROPERTIES VACANCY RATES AND CPPI INDEX VALUE [572]



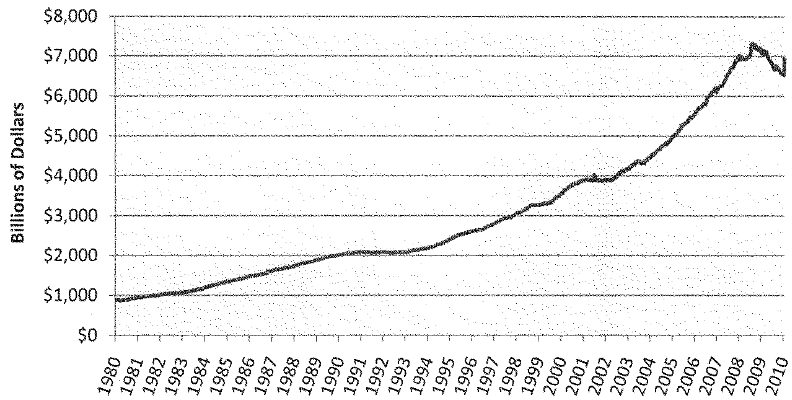
• **Total Loans and Leases at Commercial Banks.** The total dollar amount of loans and leases outstanding at domestic commercial banks has continued to decline. This measure reached its peak of $7.3 trillion on October 22, 2008. Since that point, the total amount of loans and leases outstanding decreased by 11 percent to $6.5 trillion outstanding from October 22, 2008 to March 24, 2010. However, the total dollar amount of loans and leases outstanding increased by 6.5 percent to $6.95 trillion from March 24, 2010 to March 31, 2010.[573]

[571] Vacancy rate data provided by Reis, Inc., a New York-based commercial real estate research firm. Reis, Inc. provides quarterly data on commercial real estate properties and trends in 169 metropolitan areas and this data reflect aggregation of Reis primary markets. MIT Center for Real Estate, *Moody's/REAL Commercial Property Price Index (CPPI)* (Instrument: Index_O_Natl_CY) (accessed Apr. 12, 2010) (online at web.mit.edu/cre/research/credl/rca.html) (hereinafter "Moody's/REAL Commercial Property Price Index").

[572] Vacancy rate data provided by Reis, Inc., a New York-based commercial real estate research firm. Reis, Inc. provides quarterly data on commercial real estate properties and trends in 169 metropolitan areas and this data reflect aggregation of Reis primary markets. The CPPI: Office data was provided by the MIT Center for Real Estate. Moody's/REAL Commercial Property Price Index, *supra* note 527.

[573] Federal Reserve Bank of St. Louis, *Total Loans and Leases of Commercial Banks* (accessed Apr. 12, 2010) (online at research.stlouisfed.org/fred2/series/TOTLL?rid=22&soid=1) (hereinafter "Total Loans and Leases of Commercial Banks").

FIGURE 60: TOTAL LOANS AND LEASES OF COMMERCIAL BANKS [574]



I. Financial Update

Each month, the Panel summarizes the resources that the federal government has committed to economic stabilization. The following financial update provides: (1) an updated accounting of the TARP, including a tally of dividend income, repayments, and warrant dispositions that the program has received as of April 2, 2010; and (2) an updated accounting of the full federal resource commitment as of March 31, 2010.

1. TARP

a. Costs: Expenditures and Commitments

Treasury has committed or is currently committed to spend $520.3 billion of TARP funds through an array of programs used to purchase preferred shares in financial institutions, provide loans to small businesses and automotive companies, and leverage Federal Reserve loans for facilities designed to restart secondary securitization markets.[575] Of this total, $229 billion is currently outstanding under the $698.7 billion limit for TARP expenditures set by EESA, leaving $408.2 billion available for fulfillment of anticipated funding levels of existing programs and for funding new programs and initiatives. The $229 billion includes purchases of preferred and common shares, warrants and/or debt obligations under the CPP, AIGIP/SSFI Program, PPIP, and AIFP; and a loan to TALF LLC, the special purpose vehicle (SPV) used to guarantee Federal Reserve TALF loans.[576] Additionally, Treasury has spent $57.8 million under the Home Affordable Modification Program, out of a projected total program level of $50 billion.

[574] *Id.*

[575] EESA, as amended by the Helping Families Save Their Homes Act of 2009, limits Treasury to $698.7 billion in purchasing authority outstanding at any one time as calculated by the sum of the purchase prices of all troubled assets held by Treasury. 12 U.S.C. § 5225 (a)–(b); Helping Families Save Their Homes Act of 2009, Pub. L. No. 111–22, § 402(f) (reducing by $1.26 billion the authority for the TARP originally set under EESA at $700 billion).

[576] Treasury Transactions Report, *supra* note 102.

b. Income: Dividends, Interest Payments, CPP Repayments, and Warrant Sales

As of April 2, 2010, a total of 65 institutions have completely repurchased their CPP preferred shares. Of these institutions, 40 have repurchased their warrants for common shares that Treasury received in conjunction with its preferred stock investments; Treasury sold the warrants for common shares for eight other institutions at auction.[577] In March 2010, one CPP participant repurchased its warrants for $4.5 million and the warrants of five other institutions were sold at auction for $344 million in proceeds. Treasury received $5.9 billion in repayments for complete redemptions from four CPP participants during March. The largest repayment was the $3.4 billion repaid by Hartford Financial Services Group, Inc.[578] In addition, Treasury receives dividend payments on the preferred shares that it holds, usually five percent per annum for the first five years and nine percent per annum thereafter.[579] Net of these losses under the CPP, Treasury has received approximately $19.5 billion in income from warrant repurchases, dividends, interest payments, and other considerations deriving from TARP investments,[580] and another $1.2 billion in participation fees from its Guarantee Program for Money Market Funds.[581]

c. TARP Accounting

FIGURE 61: TARP ACCOUNTING, AS OF APRIL 2, 2010 [582]

[Dollars in billions]

TARP Initiative	Anticipated Funding	Actual Funding	Total Repayments/Reduced Exposure	Funding Outstanding	Funding Available
Capital Purchase Program (CPP) [583]	$204.9	$204.9	$135.8	[584] $69.1	$0
Targeted Investment Program (TIP) [585]	40.0	40.0	40	0	0
AIG Investment Program (AIGIP)/Systemically Significant Failing Institutions Program (SSFI)	69.8	[586] 49.1	0	49.1	20.7
Automobile Industry Financing Program (AIFP)	81.3	81.3	4.19	77.1	0
Asset Guarantee Program (AGP) [587]	5.0	5.0	[588] 5.0	0	0
Capital Assistance Program (CAP) [589]					
Term Asset-Backed Securities Lending Facility (TALF)	20.0	[590] 0.10	0	0.10	19.9
Public-Private Investment Partnership (PPIP) [591]	30.0	30.0	0	30.0	0
Supplier Support Program (SSP)	[592] 3.5	3.5	0	3.5	0
Unlocking SBA Lending	15.0	[593] 0.021	0	0.021	14.98

[577] *Id.*

[578] *Id.*

[579] U.S. Department of the Treasury, *Factsheet on Capital Purchase Program* (Mar. 17, 2009) (online at www.financialstability.gov/ roadtostability/ CPPfactsheet.htm).

[580] U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of December 31, 2009* (Jan. 20, 2010) (online at www.financialstability.gov/docs/dividends-interest-reports/December%202009%20Dividends%20and%20Interest%20Report.pdf); Treasury Transactions Report, *supra* note 102.

[581] U.S. Department of the Treasury, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 18, 2009) (online at www.treasury.gov/press/releases/tg293.htm).

FIGURE 61: TARP ACCOUNTING, AS OF APRIL 2, 2010 [582]—Continued

[Dollars in billions]

TARP Initiative	Anticipated Funding	Actual Funding	Total Repayments/Reduced Exposure	Funding Outstanding	Funding Available
Home Affordable Modification Program (HAMP)	[594] 50	[595] 0.06	0	0.06	49.9
Community Development Capital Initiative (CDCI)	[596] 0.78	0	0	0	0.78
Total Committed	520.3	414		229	106.3
Total Uncommitted	178.4		185		[597] 363.4
Total	**$698.7**	**$414**	**$185**	**$229**	**$469.7**

[582] Treasury Transactions Report, *supra* note 102.

[583] As of December 31, 2009, the CPP was closed. U.S. Department of the Treasury, *FAQ on Capital Purchase Program Deadline* (online at www.financialstability.gov/docs/FAQ%20on%20Capital%20Purchase%20Program%20Deadline.pdf).

[584] Treasury has classified the investments it made in two institutions, CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million), as losses on the Transactions Report. Therefore, Treasury's net current CPP investment is $66.8 billion due to the $2.3 billion in losses thus far. Treasury Transactions Report, *supra* note 102.

[585] Both Bank of America and Citigroup repaid the $20 billion in assistance each institution received under the TIP on December 9 and December 23, 2009, respectively. Therefore, the Panel accounts for these funds as repaid and uncommitted. U.S. Department of the Treasury, *Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup* (Dec. 22, 2009) (online at www.treas.gov/press/releases/20091229716198713.htm) (hereinafter "Treasury Receives $45 Billion from Wells Fargo and Citigroup").

[586] AIG has completely utilized the $40 billion made available on November 25, 2008 and drawn-down $7.54 billion of the $29.8 billion made available on April 17, 2009. This figure also reflects $1.6 billion in accumulated but unpaid dividends owed by AIG to Treasury due to the restructuring of Treasury's investment from cumulative preferred shares to non-cumulative shares. American International Group, Inc., *Form 10–K for the Fiscal Year Ending December 31, 2009* (Feb. 26, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000104746910001465/a2196553z10-k.htm); Treasury Transactions Report, *supra* note 102; Information provided by Treasury staff in response to Panel request.

[587] Treasury, the Federal Reserve, and the Federal Deposit Insurance Company terminated the asset guarantee with Citigroup on December 23, 2009. The agreement was terminated with no losses to Treasury's $5 billion second-loss portion of the guarantee. Citigroup did not repay any funds directly, but instead terminated Treasury's outstanding exposure on its $5 billion second-loss position. As a result, the $5 billion is now counted as uncommitted. U.S. Department of the Treasury, *Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup* (Dec. 23, 2009) (online at www.ustreas.gov/press/releases/20091229716198713.htm).

[588] Although this $5 billion is no longer exposed as part of the AGP and is accounted for as available, Treasury did not receive a repayment in the same sense as with other investments. Treasury did receive other income as consideration for the guarantee, which is not a repayment and is accounted for in Figure 61.

[589] On November 9, 2009, Treasury announced the closing of this program and that only one institution, GMAC, was in need of further capital from Treasury. GMAC received an additional $3.8 billion in capital through the AIFP on December 30, 2009. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html); Treasury Transactions Report, *supra* note 102.

[590] Treasury has committed $20 billion in TARP funds to a loan funded through TALF LLC, a special purpose vehicle created by the Federal Reserve Bank of New York. The loan is incrementally funded and as of March 31, 2010, Treasury provided $103 million to TALF LLC. This total includes accrued payable interest. Treasury Transactions Report, *supra* note 102; Federal Reserve Bank of New York, *Factors Affecting Reserve Balances(H.4.1)* (Apr. 1, 2010) (online at www.federalreserve.gov/releases/h41).

[591] On January 29, 2010, Treasury released its first quarterly report on the Legacy Securities Public-Private Investment Program. As of that date, the total value of assets held by the PPIP managers was $3.4 billion. Of this total, 87 percent was non-agency residential mortgage-backed securities and the remaining 13 percent was commercial mortgage-backed securities. U.S. Department of the Treasury, *Legacy Securities Public-Private Investment Program*, at 4 (Jan. 29, 2010) (online at www.financialstability.gov/docs/External%20Report%20-%2012-09%20FINAL.pdf).

[592] On July 8, 2009, Treasury lowered the total commitment amount for the program from $5 billion to $3.5 billion. This action reduced GM's portion from $3.5 billion to $2.5 billion and Chrysler's portion from $1.5 billion to $1 billion. GM Supplier Receivables LLC, the special purpose vehicle (SPV) created to administer this program for GM suppliers, has made $290 million in partial repayments and Chrysler Receivables SPV LLC, the SPV created to administer the program for Chrysler suppliers, has made $123 million in partial repayments. These were partial repayments of drawn-down funds and did not lessen Treasury's $3.5 billion in total exposure under the ASSP. Treasury Transactions Report, *supra* note 102.

[593] On March 24, 2010, Treasury settled on the purchase of three floating rate Small Business Administration 7a securities. As of April 2, 2010 the total amount of TARP funds invested in these securities was $21.37 million. Treasury Transactions Report, *supra* note 102, at 29.

[594] On February 19, 2010, President Obama announced the Help for the Hardest-Hit Housing Markets (Hardest Hit Fund) program, his proposal to use $1.5 billion of the $50 billion in TARP funds allocated to HAMP to assist the five states with the highest home price declines stemming from the foreclosure crisis: Arizona, California, Florida, Nevada, and Michigan. The White House, *President Obama Announces Help for Hardest Hit Housing Markets* (Feb. 19, 2010) (online at www.whitehouse.gov/the-press-office/president-obama-announces-help-hardest-hit-housing-markets). On March 29, 2010, Treasury announced $600 million in funding for a second HFA Hardest Hit Fund which includes North Carolina, Ohio, Oregon Rhode Island, and South Carolina. U.S. Department of the Treasury, *Administration Announces Second Round of Assistance for Hardest-Hit Housing* Markets (Mar. 29, 2010) (online at www.financialstability.gov/latest/pr__03292010.html). Until further information on these programs is released, the Panel will continue to account for the $50 billion commitment to HAMP as intact and as the newly announced programs as subsets of the larger initiative. For further discussion of the newly announced HAMP programs, and the effect these initiatives may have on the $50 billion in committed TARP funds, please see Section D.1 of this report.

[595] In response to a Panel inquiry, Treasury disclosed that, as of February 2010, $57.8 million in funds had been disbursed under the HAMP. As of April 2, 2010, the total of all the caps set on payments to each mortgage servicer was $39.9 billion. Treasury Transactions Report, *supra* note 102, at 28.

[596] On February 3, 2010, the Administration announced an initiative under TARP to provide low-cost financing for Community Development Financial Institutions (CDFIs). Under this program, CDFIs are eligible for capital investments at a 2-percent dividend rate as compared to the 5-percent dividend rate under the CPP. In response to Panel request, Treasury stated that it projects the CDCI program to utilize $780.2 million.

[597] This figure is the sum of the uncommitted funds remaining under the $698.7 billion cap ($178.4 billion) and the repayments ($185 billion).

FIGURE 62: TARP PROFIT AND LOSS

[Dollars in millions]

TARP Initiative	Dividends [598] (as of 2/28/10)	Interest [599] (as of 2/28/10)	Warrant Repurchases [600] (as of 4/2/10)	Other Proceeds (as of 2/28/10)	Losses [601] (as of 4/2/10)	Total
Total	$13,236	$491	$5,609	$2,518	($2,334)	$19,520
CPP	8,820	28	4,338	–	(2,334)	10,852
TIP	3,004	–	1,256	–		4,260
AIFP	1,091	443	15	–		1,549
ASSP	N/A	14	–	–		14
AGP	321	–	0	[602] 2,234		2,555
PPIP	–	6	–	[603] 8		14
Bank of America Guarantee	–	–	–	[604] 276		276

[598] U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of February 28, 2010* (Mar. 17, 2010) (online at www.financialstability.gov/docs/dividends-interest-reports/February%202010%20Dividends%20and%20 Interest%20Report.pdf) (hereinafter "Cumulative Dividends and Interest Report").

[599] Cumulative Dividends and Interest Report, *supra* note 598.

[600] Treasury Transactions Report, *supra* note 102.

[601] Treasury classified the investments it made in two institutions, CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million), as losses on the Transactions Report. A third institution, UCBH Holdings, Inc. received $299 million in TARP funds and is currently in bankruptcy proceedings. Treasury Transactions Report, *supra* note 102.

[602] As a fee for taking a second-loss position up to $5 billion on a $301 billion pool of ring-fenced Citigroup assets as part of the AGP, Treasury received $4.03 billion in Citigroup preferred stock and warrants; Treasury exchanged these preferred stocks for trust preferred securities in June 2009. Following the early termination of the guarantee, Treasury cancelled $1.8 billion of the trust preferred securities, leaving Treasury with a $2.23 billion investment in Citigroup trust preferred securities in exchange for the guarantee. At the end of Citigroup's participation in the FDIC's TLGP, the FDIC may transfer $800 million of $3.02 billion in Citigroup Trust Preferred Securities it received in consideration for its role in the AGP to the Treasury. Treasury Transactions Report, *supra* note 102.

[603] As of February 28, 2010, Treasury has earned $8 million in membership interest distributions from the PPIP. Cumulative Dividends and Interest Report, *supra* note 554.

[604] Although Treasury, the Federal Reserve, and the FDIC negotiated with Bank of America regarding a similar guarantee, the parties never reached an agreement. In September 2009, Bank of America agreed to pay each of the prospective guarantors a fee as though the guarantee had been in place during the negotiations. This agreement resulted in payments of $276 million to Treasury, $57 million to the Federal Reserve, and $92 million to the FDIC. U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Bank of America Corporation, *Termination Agreement*, at 1–2 (Sept. 21, 2009) (online at www.financialstability.gov/docs/AGP/BofA%20-%20Termination%20Agreement%20-%20executed.pdf).

d. Rate of Return

As of March 26, 2010, the average internal rate of return for all financial institutions that participated in the CPP and fully repaid the U.S. government (including preferred shares, dividends, and warrants) was 10.7 percent. The internal rate of return is the annualized effective compounded return rate that can be earned on invested capital.

e. TARP Warrant Disposition

FIGURE 63: WARRANT REPURCHASES FOR FINANCIAL INSTITUTIONS WHO HAVE FULLY REPAID CPP FUNDS AS OF MARCH 26, 2010

Institution	Investment Date	Warrant Repurchase Date	Warrant Repurchase/ Sale Amount	Panel's Best Valuation Estimate at Repurchase Date	Price/ Est. Ratio	IRR (Percent)
Old National Bancorp	12/12/2008	5/8/2009	$1,200,000	$2,150,000	0.558	9.3
Iberiabank Corporation	12/5/2008	5/20/2009	1,200,000	2,010,000	0.597	9.4
Firstmerit Corporation	1/9/2009	5/27/2009	5,025,000	4,260,000	1.180	20.3
Sun Bancorp, Inc	1/9/2009	5/27/2009	2,100,000	5,580,000	0.376	15.3
Independent Bank Corp.	1/9/2009	5/27/2009	2,200,000	3,870,000	0.568	15.6
Alliance Financial Corporation	12/19/2008	6/17/2009	900,000	1,580,000	0.570	13.8
First Niagara Financial Group	11/21/2008	6/24/2009	2,700,000	3,050,000	0.885	8.0
Berkshire Hills Bancorp, Inc.	12/19/2008	6/24/2009	1,040,000	1,620,000	0.642	11.3
Somerset Hills Bancorp	1/16/2009	6/24/2009	275,000	580,000	0.474	16.6
SCBT Financial Corporation	1/16/2009	6/24/2009	1,400,000	2,290,000	0.611	11.7
HF Financial Corp	11/21/2008	6/30/2009	650,000	1,240,000	0.524	10.1
State Street	10/28/2008	7/8/2009	60,000,000	54,200,000	1.107	9.9
U.S. Bancorp	11/14/2008	7/15/2009	139,000,000	135,100,000	1.029	8.7

FIGURE 63: WARRANT REPURCHASES FOR FINANCIAL INSTITUTIONS WHO HAVE FULLY REPAID CPP FUNDS AS OF MARCH 26, 2010—Continued

Institution	Investment Date	Warrant Repurchase Date	Warrant Repurchase/ Sale Amount	Panel's Best Valuation Estimate at Repurchase Date	Price/ Est. Ratio	IRR (Percent)
The Goldman Sachs Group, Inc.	10/28/2008	7/22/2009	1,100,000,000	1,128,400,000	0.975	22.8
BB&T Corp.	11/14/2008	7/22/2009	67,010,402	68,200,000	0.983	8.7
American Express Company	1/9/2009	7/29/2009	340,000,000	391,200,000	0.869	29.5
Bank of New York Mellon Corp	10/28/2008	8/5/2009	136,000,000	155,700,000	0.873	12.3
Morgan Stanley	10/28/2008	8/12/2009	950,000,000	1,039,800,000	0.914	20.2
Northern Trust Corporation	11/14/2008	8/26/2009	87,000,000	89,800,000	0.969	14.5
Old Line Bancshares Inc.	12/5/2008	9/2/2009	225,000	500,000	0.450	10.4
Bancorp Rhode Island, Inc.	12/19/2008	9/30/2009	1,400,000	1,400,000	1.000	12.6
Centerstate Banks of Florida Inc.	11/21/2008	10/28/2009	212,000	220,000	0.964	5.9
Manhattan Bancorp	12/5/2008	10/14/2009	63,364	140,000	40.453	9.8
Bank of Ozarks	12/12/2008	11/24/2009	2,650,000	3,500,000	0.757	9.0
Capital One Financial	11/14/2008	12/3/2009	148,731,030	232,000,000	0.641	12.0
JP Morgan Chase & Co.	10/28/2008	12/10/2009	950,318,243	1,006,587,697	0.944	10.9
TCF Financial Corp	1/16/2009	12/16/2009	9,599,964	11,825,830	0.812	11.0
LSB Corporation	12/12/2008	12/16/2009	560,000	535,202	1.046	9.0
Wainwright Bank & Trust Company	12/19/2008	12/16/2009	568,700	1,071,494	0.531	7.8
Wesbanco Bank, Inc.	12/5/2008	12/23/2009	950,000	2,387,617	0.398	6.7
Union Bankshares Corporation	12/19/2008	12/23/2009	450,000	1,130,418	0.398	5.8
Trustmark Corporation	11/21/2008	12/30/2009	10,000,000	11,573,699	0.864	9.4
Flushing Financial Corporation	12/19/2008	12/30/2009	900,000	2,861,919	0.314	6.5
OceanFirst Financial Corporation	1/16/2009	2/3/2010	430,797	279,359	1.542	6.2
Monarch Financial Holdings, Inc.	12/19/2008	2/10/2010	260,000	623,434	0.417	6.7
Bank of America	[605] 10/28/2008 [606] 1/9/2009 [607] 1/14/2009	3/3/2010	1,566,210,714	1,006,416,684	1.533	6.5
Washington Federal Inc./ Washington Federal Savings & Loan Association	11/14/2008	3/9/2010	15,623,222	10,166,404	1.537	18.6
Signature Bank	12/12/2008	3/10/2010	11,320,751	11,458,577	0.988	32.4
Total			**$5,618,174,187**	**$5,395,308,333**	**1.041**	**10.7**

[605] Investment date for Bank of America in CPP.
[606] Investment date for Merrill Lynch in CPP.
[607] Investment date for Bank of America in TIP.

FIGURE 64: WARRANT VALUATION OF REMAINING STRESS TEST INSTITUTION WARRANTS

[Dollars in millions]

	Warrant Valuation		
	Low Estimate	High Estimate	Best Estimate
Stress Test Financial Institutions with Warrants Outstanding:			
Wells Fargo & Company	$501.15	$2,084.43	$813.70
Citigroup, Inc.	39.44	1,049.16	271.52
The PNC Financial Services Group Inc	143.19	613.12	234.15
SunTrust Banks, Inc.	25.51	366.75	142.05
Regions Financial Corporation	19.70	233.11	102.31
Fifth Third Bancorp	122.37	385.90	179.47
Hartford Financial Services Group, Inc.	681.95	875.05	681.95
KeyCorp	23.24	166.23	80.12
All Other Banks	1,265.00	3,565.99	2,564.68
Total	$2,821.55	$9,339.74	$5,069.95

2. Other Financial Stability Efforts

Federal Reserve, FDIC, and Other Programs

In addition to the direct expenditures Treasury has undertaken through TARP, the federal government has engaged in a much broader program directed at stabilizing the U.S. financial system. Many of these initiatives explicitly augment funds allocated by Treasury under specific TARP initiatives, such as FDIC and Federal Reserve asset guarantees for Citigroup, or operate in tandem with Treasury programs, such as the interaction between PPIP and TALF. Other programs, like the Federal Reserve's extension of credit through its section 13(3) facilities and SPVs and the FDIC's Temporary Liquidity Guarantee Program, operate independently of TARP.

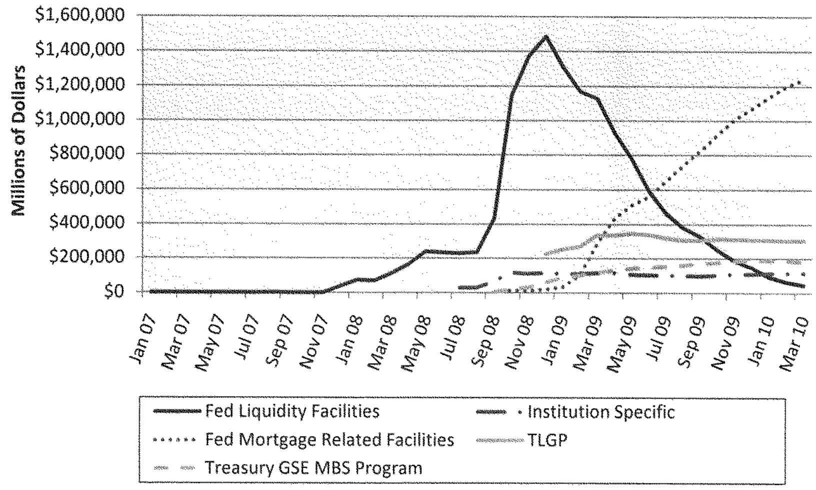
Figure 65 below reflects the changing mix of Federal Reserve investments. As the liquidity facilities established to address the crisis have been wound down, the Federal Reserve has expanded its facilities for purchasing mortgage related securities. The Federal Reserve announced that it intended to purchase $175 billion of federal agency debt securities and $1.25 trillion of agency mortgage-backed securities.[608] As of March 31, 2010, $169 billion of federal agency (government-sponsored enterprise) debt securities and $1.1 trillion of agency mortgage-backed securities were purchased. The Federal Reserve has announced that these purchases will be completed by April 2010.[609] These purchases are in addition to the $181.6 billion in GSE MBS that remain outstanding as of March 2010 under the GSE Mortgage-Backed Securities Purchase Program.[610]

[608] Board of Governors of the Federal Reserve System, *Minutes of the Federal Open Market Committee,* at 10 (Dec. 15–16, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/fomcminutes20091216.pdf) ("[T]he Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt").

[609] Board of Governors of the Federal Reserve System, *FOMC Statement* (Dec. 16, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/20091216a.htm) ("In order to promote a smooth transition in markets, the Committee is gradually slowing the pace of these purchases, and it anticipates that these transactions will be executed by the end of the first quarter of 2010"); Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (Feb. 4, 2010) (online at www.federalreserve.gov/Releases/H41/Current).

[610] U.S. Department of the Treasury, MBS Purchase Program: *Portfolio by Month* (accessed Apr. 12, 2010) (online at www.financialstability.gov/docs/Mar%202010%20Portfolio%20by%20month.pdf). Treasury received $39.1 billion in principal repayments $9.6 billion in interest payments from these securities. U.S. Department of the Treasury, *MBS Purchase Program Principal and Interest* (accessed Apr. 12, 2010) (online at www.financialstability.gov/docs/Mar%202010%20MBS%20Principal%20and%20Interest%20Monthly%20Breakout.pdf).

FIGURE 65: FEDERAL RESERVE AND FDIC FINANCIAL STABILITY EFFORTS AS OF FEBRUARY 28, 2010[611]



3. Total Financial Stability Resources as of February 28, 2010

Beginning in its April 2009 report, the Panel broadly classified the resources that the federal government has devoted to stabilizing the economy through myriad new programs and initiatives as outlays, loans, or guarantees. Although the Panel calculates the total value of these resources at nearly $3 trillion, this would translate into the ultimate "cost" of the stabilization effort only if: (1) assets do not appreciate; (2) no dividends are received, no warrants are exercised, and no TARP funds are repaid; (3) all loans default and are written off; and (4) all guarantees are exercised and subsequently written off.

With respect to the FDIC and Federal Reserve programs, the risk of loss varies significantly across the programs considered here, as do the mechanisms providing protection for the taxpayer against such risk. As discussed in the Panel's November report, the

[611] Federal Reserve Liquidity Facilities include: Primary credit, Secondary credit, Central Bank liquidity swaps, Primary dealer and other broker-dealer credit, Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-backed Securities Loan Facility. Federal Reserve Mortgage-related Facilities include: Federal agency debt securities and mortgage-backed securities held by the Federal Reserve. Institution Specific Facilities include: Credit extended to American International Group, Inc., the preferred interests in AIA Aurora LLC and ALICO Holdings LLC, and the net portfolio holdings of Maiden Lanes I, II, and III. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (Mar. 31, 2010). For related presentations of Federal Reserve data, *see* Board of Governors of the Federal Reserve System, *Credit and Liquidity Programs and the Balance Sheet,* at 2 (Nov. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf). The TLGP figure reflects the monthly amount of debt outstanding under the program. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program* (Dec. 2008–Jan. 2010) (online at www.fdic.gov/regulations/resources/TLGP/reports.html). The total for the Term Asset-Backed Securities Loan Facility has been reduced by $20 billion throughout this exhibit in order to reflect Treasury's $20 billion first-loss position under the terms of this program.

FDIC assesses a premium of up to 100 basis points on TLGP debt guarantees.[612] In contrast, the Federal Reserve's liquidity programs are generally available only to borrowers with good credit, and the loans are over-collateralized and with recourse to other assets of the borrower. If the assets securing a Federal Reserve loan realize a decline in value greater than the "haircut," the Federal Reserve is able to demand more collateral from the borrower. Similarly, should a borrower default on a recourse loan, the Federal Reserve can turn to the borrower's other assets to make the Federal Reserve whole. In this way, the risk to the taxpayer on recourse loans only materializes if the borrower enters bankruptcy. The only loan currently "underwater"—where the outstanding principal amount exceeds the current market value of the collateral—is the loan to Maiden Lane LLC, which was formed to purchase certain Bear Stearns assets.

FIGURE 66: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT AS OF MARCH 31, 2010 [i]

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Total	**$698.7**	**$1,626.1**	**$670.4**	**$2,995.2**
Outlays [ii]	272.8	1,288.4	69.4	1,630.6
Loans	42.5	337.7	0	380.1
Guarantees [iii]	20	0	601	621
Uncommitted TARP Funds	363.4	0	0	363.4
AIG	**69.8**	**92.3**	**0**	**162.1**
Outlays	[iv] 69.8	[v] 25.4	0	95.2
Loans	0	[vi] 66.9	0	66.9
Guarantees	0	0	0	0
Citigroup	**25**	**0**	**0**	**25**
Outlays	[vii] 25	0	0	25
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Purchase (Other)	**50.1**	**0**	**0**	**50.1**
Outlays	[viii] 50.1	0	0	50.1
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Assistance Program	**N/A**	**0**	**0**	[ix] **N/A**
TALF	**20**	**180**	**0**	**200**
Outlays	0	0	0	0
Loans	0	[xi] 180	0	180
Guarantees	[x] 20	0	0	20
PIP (Loans) [xii]	**0**	**0**	**0**	**0**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	0	0
PIP (Securities)	[xiii] **30**	**0**	**0**	**30**
Outlays	10	0	0	10
Loans	20	0	0	20
Guarantees	0	0	0	0
Home Affordable Modification Program	**50**	**0**	**0**	**50**
Outlays	[xiv] 50	0	0	50
Loans	0	0	0	0
Guarantees	0	0	0	0
Automotive Industry Financing Program	[xv] **77.1**	**0**	**0**	**77.1**
Outlays	58.9	0	0	58.9
Loans	18.2	0	0	18.2
Guarantees	0	0	0	0

[612] Congressional Oversight Panel, *Guarantees and Contingent Payments in TARP and Related Programs,* at 36 (Nov. 11, 2009) (online at cop.senate.gov/documents/cop-110609-report.pdf).

FIGURE 66: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT AS OF MARCH 31, 2010 [i]—Continued

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Auto Supplier Support Program	**3.5**	**0**	**0**	**3.5**
Outlays	0	0	0	0
Loans	[xvi] 3.5	0	0	3.5
Guarantees	0	0	0	0
Unlocking SBA Lending	[xvii] **15**	**0**	**0**	**15**
Outlays	15	0	0	15
Loans	0	0	0	0
Guarantees	0	0	0	0
Community Development Capital Initiative	[xviii] **0.78**	**0**	**0**	**0.78**
Outlays	0	0	0	0
Loans	0.78	0	0	0.78
Guarantees	0	0	0	0
Temporary Liquidity Guarantee Program	**0**	**0**	**601**	**601**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	[xix] 601	601
Deposit Insurance Fund	**0**	**0**	**69.4**	**69.4**
Outlays	0	0	[xx] 69.4	69.4
Loans	0	0	0	0
Guarantees	0	0	0	0
Other Federal Reserve Credit Expansion	**0**	**1,353.8**	**0**	**1,353.8**
Outlays	0	[xxi] 1,263	0	1,263
Loans	0	[xxii] 90.8	0	90.8
Guarantees	0	0	0	0
Uncommitted TARP Funds	**363.4**	**0**	**0**	**363.4**

[i] All data in this exhibit is as of March 31, 2010 except for information regarding the FDIC's Temporary Liquidity Guarantee Program (TLGP). This data is as of February 28, 2010.

[ii] The term ''outlays'' is used here to describe the use of Treasury funds under the TARP, which are broadly classifiable as purchases of debt or equity securities (e.g., debentures, preferred stock, exercised warrants, etc.). The outlays figures are based on: (1) Treasury's actual reported expenditures; and (2) Treasury's anticipated funding levels as estimated by a variety of sources, including Treasury pronouncements and GAO estimates. Anticipated funding levels are set at Treasury's discretion, have changed from initial announcements, and are subject to further change. Outlays used here represent investment and asset purchases and commitments to make investments and asset purchases and are not the same as budget outlays, which under section 123 of EESA are recorded on a ''credit reform'' basis.

[iii] Although many of the guarantees may never be exercised or exercised only partially, the guarantee figures included here represent the federal government's greatest possible financial exposure.

[iv] This number includes investments under the AIGIP/SSFI Program: a $40 billion investment made on November 25, 2008, and a $30 billion investment committed on April 17, 2009 (less a reduction of $165 million representing bonuses paid to AIG Financial Products employees). As of January 5, 2010, AIG had utilized $45.3 billion of the available $69.8 billion under the AIGIP/SSFI and owed $1.6 billion in unpaid dividends. This information was provided by Treasury in response to a Panel inquiry.

[v] As part of the restructuring of the U.S. Government's investment in AIG announced on March 2, 2009, the amount available to AIG through the Revolving Credit Facility was reduced by $25 billion in exchange for preferred equity interests in two special purpose vehicles, AIA Aurora LLC and ALICO Holdings LLC. These SPVs were established to hold the common stock of two AIG subsidiaries: American International Assurance Company Ltd. (AIA) and American Life Insurance Company (ALICO). As of March 31, 2010, the book value of the Federal Reserve Bank of New York's holdings in AIA Aurora LLC and ALICO Holdings LLC was $16.26 billion and $9.15 billion in preferred equity respectively. Thereby the book value of these securities is $25.416 billion, which is reflected in the corresponding table. Federal Reserve Bank of New York, *Factors Affecting Reserve Balances (H.4.1)* (Apr. 1, 2010) (online at www.federalreserve.gov/releases/h41/).

[vi] This number represents the full $35 billion that is available to AIG through its revolving credit facility with the Federal Reserve ($26.2 billion had been drawn down as of February 25, 2010) and the outstanding principal of the loans extended to the Maiden Lane II and III SPVs to buy AIG assets (as of March 31, 2010, $14.9 billion and $16.9 billion respectively). Income from the purchased assets is used to pay down the loans to the SPVs, reducing the taxpayers' exposure to losses over time. Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* at 17 (Oct. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200910.pdf). On December 1, 2009, AIG entered into an agreement with FRBNY to reduce the debt AIG owes the FRBNY by $25 billion. In exchange, FRBNY received preferred equity interests in two AIG subsidiaries. This also reduced the debt ceiling on the loan facility from $60 billion to $35 billion. American International Group, *AIG Closes Two Transactions That Reduce Debt AIG Owes Federal Reserve Bank of New York by $25 billion* (Dec. 1, 2009) (online at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MjE4ODI8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1).

[vii] As of April 2, 2010, the U.S. Treasury held $25 billion of Citigroup common stock under the CPP. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 2, 2010* (Apr. 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-6-10%20Transactions%20Report%20as%20of%204-2-10.pdf).

[viii] This figure represents the $204.9 billion Treasury disbursed under the CPP, minus the $25 billion investment in Citigroup identified above, and the $135.8 billion in repayments that are reflected as available TARP funds. This figure does not account for future repayments of CPP investments, dividend payments from CPP investments, or losses under the program. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 2, 2010* (Apr. 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-6-10%20Transactions%20Report%20as%20of%204-2-10.pdf).

[ix] On November 9, 2009, Treasury announced the closing of the CAP and that only one institution, GMAC, was in need of further capital from Treasury. GMAC, however, received further funding through the AIFP, therefore the Panel considers CAP unused and closed. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html).

[x] This figure represents a $20 billion allocation to the TALF SPV on March 3, 2009. However, as of March 31, 2010, TALF LLC had drawn only $103 million of the available $20 billion. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (Mar. 31, 2010) (online at www.federalreserve.gov/Releases/H41/Current/); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 2, 2010* (Apr. 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-6-10%20Transactions%20Report%20as%20of%204-2-10.pdf). As of January 28, 2010, investors had requested a total of $73.3 billion in TALF loans ($13.2 billion in CMBS and $60.1 billion in non-CMBS) and $71 billion in TALF loans had been settled ($12 billion in CMBS and $59 billion in non-CMBS). Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: CMBS* (accessed Apr. 4, 2010) (online at www.newyorkfed.org/markets/CMBS_recent_operations.html); Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: non-CMBS* (accessed Apr. 4, 2010) (online at www.newyorkfed.org/markets/talf—operations.html).

[xi] This number is derived from the unofficial 1:10 ratio of the value of Treasury loan guarantees to the value of Federal Reserve loans under the TALF. U.S. Department of the Treasury, *Fact Sheet: Financial Stability Plan* (Feb. 10, 2009) (online at www.financialstability.gov/docs/fact-sheet.pdf) (describing the initial $20 billion Treasury contribution tied to $200 billion in Federal Reserve loans and announcing potential expansion to a $100 billion Treasury contribution tied to $1 trillion in Federal Reserve loans). Because Treasury is responsible for reimbursing the Federal Reserve Board for $20 billion of losses on its $200 billion in loans, the Federal Reserve Board's maximum potential exposure under the TALF is $180 billion.

[xii] It is unlikely that resources will be expended under the PPIP Legacy Loans Program in its original design as a joint Treasury-FDIC program to purchase troubled assets from solvent banks. *See also* Federal Deposit Insurance Corporation, *FDIC Statement on the Status of the Legacy Loans Program* (June 3, 2009) (online at www.fdic.gov/news/news/press/2009/pr09084.html) and Federal Deposit Insurance Corporation, *Legacy Loans Program—Test of Funding Mechanism* (July 31, 2009) (online at www.fdic.gov/news/news/press/2009/pr09131.html). The sales described in these statements do not involve any Treasury participation, and FDIC activity is accounted for here as a component of the FDIC's Deposit Insurance Fund outlays.

[xiii] As of February 25, 2010, Treasury reported commitments of $19.9 billion in loans and $9.9 billion in membership interest associated with the program. On January 4, 2010, the Treasury and one of the nine fund managers, TCW Senior Management Securities Fund, L.P., entered into a "Winding-Up and Liquidation Agreement." U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 2, 2010* (Apr. 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-6-10%20Transactions%20Report%20as%20of%204-2-10.pdf).

[xiv] Of the $50 billion in announced TARP funding for this program, $39.9 billion has been allocated as of April 2, 2010. However, as of February 2010, only $57.8 million in non-GSE payments have been disbursed under HAMP. Disbursement information provided in response to Panel inquiry; U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 2, 2010* (Apr. 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-6-10%20Transactions%20Report%20as%20of%204-2-10.pdf).

[xv] A substantial portion of the total $81 billion in loans extended under the AIFP have since been converted to common equity and preferred shares in restructured companies. $18.2 billion has been retained as first-lien debt (with $5.6 billion committed to GM, $12.5 billion to Chrysler). This figure ($77.1 billion) represents Treasury's current obligation under the AIFP after repayments.

[xvi] *See* U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending April 2, 2010* (Apr. 6, 2010) (online at www.financialstability.gov/docs/transaction-reports/4-6-10%20Transactions%20Report%20as%20of%204-2-10.pdf).

[xvii] U.S. Department of the Treasury, *Fact Sheet: Unlocking Credit for Small Businesses* (Oct. 19, 2009) (online at www.financialstability.gov/roadtostability/unlockingCreditforSmallBusinesses.html) ("*Jumpstart Credit Markets For Small Businesses By Purchasing Up to $15 Billion in Securities*").

[xviii] This information was provided by Treasury staff in response to Panel inquiry.

[xix] This figure represents the current maximum aggregate debt guarantees that could be made under the program, which is a function of the number and size of individual financial institutions participating. $305.4 billion of debt subject to the guarantee is currently outstanding, which represents approximately 51 percent of the current cap. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program: Debt Issuance Under Guarantee Program* (Dec. 31, 2009) (online at www.fdic.gov/regulations/resources/tlgp/total_issuance12-09.html) (Feb. 28, 2010). The FDIC has collected $10.4 billion in fees and surcharges from this program since its inception in the fourth quarter of 2008. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program* (Nov. 30, 2009) (online at www.fdic.gov/regulations/resources/tlgp/total_issuance02-10.html) (updated Feb. 4, 2010).

[xx] This figure represents the FDIC's provision for losses to its deposit insurance fund attributable to bank failures in the third and fourth quarters of 2008 and the first, second and third quarters of 2009. Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Fourth Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_4qtr_08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (First Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_1stqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Second Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_2ndqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_09/income.html). This figure includes the FDIC's estimates of its future losses under loss-sharing agreements that it has entered into with banks acquiring assets of insolvent banks during these five quarters. Under a loss-sharing agreement, as a condition of an acquiring bank's agreement to purchase the assets of an insolvent bank, the FDIC typically agrees to cover 80 percent of an acquiring bank's future losses on an initial portion of these assets and 95 percent of losses of another portion of assets. See, for example Federal Deposit Insurance Corporation, *Purchase and Assumption Agreement Among FDIC, Receiver of Guaranty Bank, Austin, Texas, FDIC and Compass Bank,* at 65–66 (Aug. 21, 2009) (online at www.fdic.gov/bank/individual/failed/guaranty-tx_p_and_a_w_addendum.pdf). In information provided to Panel staff, the FDIC disclosed that there were approximately $132 billion in assets covered under loss-sharing agreements as of December 18, 2009. Furthermore, the FDIC estimates the total cost of a payout under these agreements to be $59.3 billion. Since there is a published loss estimate for these agreements, the Panel continues to reflect them as outlays rather than as guarantees.

[xxi] Outlays are comprised of the Federal Reserve Mortgage Related Facilities and the preferred equity holdings in AIA Aurora LLC and ALICO Holdings LLC. The Federal Reserve balance sheet accounts for these facilities under Federal agency debt securities, mortgage-backed securities held by the Federal Reserve, and the preferred interests in AIA Aurora LLC and ALICO Holdings LLC. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed Apr. 4, 2010). Although the Federal Reserve does not employ the outlays, loans and guarantees classification, its accounting clearly separates its mortgage-related purchasing programs from its liquidity programs. *See* Board of Governors of the Federal Reserve, *Credit and Liquidity Programs and the Balance Sheet November 2009,* at 2 (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf).

On September 7, 2008, the Treasury announced the GSE Mortgage-Backed Securities Purchase Program (Treasury MBS Purchase Program). The Housing and Economic Recovery Act of 2008 provided Treasury the authority to purchase Government Sponsored Enterprise (GSE) MBS. Under this program, Treasury purchased approximately $214.4 billion in GSE MBS before the program ended on December 31, 2009. As of March 2010, there was $181.6 billion still outstanding under this program. U.S. Department of the Treasury, *MBS Purchase Program: Portfolio by Month* (accessed Apr. 5, 2010) (online at www.financialstability.gov/docs/Mar%202010%20Portfolio%20by%20month.pdf). Treasury received $39.1 billion in principal repayments and $9.6 billion in interest payments from these securities. U.S. Department of the Treasury, *MBS Purchase Program Principal and Interest* (accessed Apr. 5, 2010) (online at www.financialstability.gov/docs/Mar%202010%20MBS%20Principal%20and%20Interest%20Monthly%20Breakout.pdf).

[xxii] Federal Reserve Liquidity Facilities classified in this table as loans include: Primary credit, Secondary credit, Central bank liquidity swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-Backed Securities Loan Facility, and loans outstanding to Bear Stearns (Maiden Lane I LLC). Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed Apr. 4, 2010); *see id.*

SECTION FIVE: OVERSIGHT ACTIVITIES

The Congressional Oversight Panel was established as part of the Emergency Economic Stabilization Act (EESA) and formed on November 26, 2008. Since then, the Panel has produced 16 oversight reports, as well as a special report on regulatory reform, issued on January 29, 2009, and a special report on farm credit, issued on July 21, 2009. The Panel's March oversight report evaluated Treasury's exceptional assistance provided to GMAC under the TARP as well as the approach taken by GMAC's new management to return the company to profitability and, ultimately, return the taxpayers' investment.

Upcoming Reports and Hearings

The Panel will release its next oversight report in May. The report will examine the ongoing contraction in lending, with a focus on small business lending, and discuss Treasury's current initiatives and proposals to improve market liquidity and access to credit for small businesses.

The Panel is planning a hearing in Phoenix, Arizona on April 27, 2010, to discuss the topic of the May report. The Panel will hear from local small business owners, community bankers, and relevant government officials about the status of small business lending and their perspectives on the current proposals to improve access to credit.

SECTION SIX: ABOUT THE CONGRESSIONAL OVERSIGHT PANEL

In response to the escalating financial crisis, on October 3, 2008, Congress provided Treasury with the authority to spend $700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stability (OFS) within Treasury to implement the Troubled Asset Relief Program. At the same time, Congress created the Congressional Oversight Panel to "review the current state of financial markets and the regulatory system." The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury's actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury's actions are in the best interests of the American people. In addition, Congress instructed the Panel to produce a special report on regulatory reform that analyzes "the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers." The Panel issued this report in January 2009. Congress subsequently expanded the Panel's mandate by directing it to produce a special report on the availability of credit in the agricultural sector. The report was issued on July 21, 2009.

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Director of Policy and Special Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL–CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School, to the Panel. With the appointment on November 19, 2008, of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel. Effective August 10, 2009, Senator Sununu resigned from the Panel, and on August 20, 2009, Senator McConnell announced the appointment of Paul Atkins, former Commissioner of the U.S. Securities and Exchange Commission, to fill the vacant seat. Effective December 9, 2009, Congressman Jeb Hensarling resigned from the Panel and House Minority Leader John Boehner announced the appointment of J. Mark McWatters to fill the vacant seat.

Acknowledgements

The Panel thanks Adam J. Levitin, Associate Professor of Law at the Georgetown University Law Center, for the significant contribution he made to this report. Special thanks also go to Professor Eric Posner of the University of Chicago Law School and Professors John A.E. Pottow and Stephen P. Croley from the University of Michigan Law School.

APPENDIX I: LETTER TO SECRETARY TIMOTHY GEITHNER FROM CHAIR ELIZABETH WARREN RE: FOLLOW UP QUESTIONS ON TARP–RECIPIENT BANKS, DATED APRIL 13, 2010

ELIZABETH WARREN, CHAIR
PAUL S. ATKINS
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

April 13, 2010

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
Room 3330
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

Thank you for the March 18th briefing from staff of the Office of Financial Stability on the subject of evaluating proposals from TARP-recipient institutions concerning CPP restructurings or other recapitalizations.

The fact that Treasury has had to establish policies and structure a process for handling TARP-assisted banks that are on the brink of failure raises questions that the Panel would like to pursue further. Of the 707 TARP-assisted banks, three have now failed, resulting in losses of $2.3 billion and an additional $300 million in potential losses to the TARP. The number of TARP-assisted institutions missing at least one regular dividend payment has now risen to 82 as of February 2010. Among TARP-recipient banks with publicly traded stock, 84 have both commercial real estate loans in excess of 300 percent of their total capital and construction and land development loans in excess of 100 percent of their total capital – criteria that the regulators have established for determining whether an institution has a commercial real estate concentration risk. Further, although we do not have access to the names of the banks on the FDIC's problem institution list, it appears that of the 702 institutions currently on that list, approximately 15-20 are likely to be TARP-assisted banks. With this information as background, we would like answers to the following questions:

- What is the extent of Treasury's exposure to failing TARP-assisted banks? What factors or indicators did Treasury consider in estimating its exposure? How many TARP-assisted banks are on the FDIC's problem institutions list and what are their sizes? What is the current condition of these problem institutions, both in terms of capital and loan losses? What other indicators are you tracking in order to assess the condition of all TARP-assisted banks? Have your analyses uncovered any trends in the condition of TARP-assisted banks? If so, what are these trends?

- In meetings with Treasury soon after the COP was established, the Panel was repeatedly assured that TARP assistance was going only to "healthy banks." What happened to these banks after the infusion of TARP funds that caused them to go from healthy to unhealthy? What was the condition of these institutions (both failed and in serious jeopardy of failing in the next 24 months) at the time they received CPP funds? What information did the regulators convey to you concerning the condition of these banks at the time they received CPP funds? How has their capital position and overall balance sheet changed since then? To what degree is the deterioration in the condition of these banks attributable to mismanagement after the infusion of TARP funds? If the decline is attributable to the severe recession, why did it affect these banks but not others? Did these particular banks deteriorate for other reasons? If so, what were these reasons? Further, why did Treasury not perceive that these institutions were unhealthy at the time of their initial investment? Have you discovered any information since the time of the initial CPP investment that suggests that Treasury's decision to provide TARP funds to particular institutions was, in retrospect, ill-advised?

- How many additional failures of TARP-assisted institutions do you project in 2010 and 2011? Are the risks of loan losses concentrated in banks with particular loan profiles (e.g., CRE exposure or sub-prime mortgage loans and securities) or in particular geographic areas of the country? Are there particular patterns or sources of erosion in loan quality at these institutions?

The Panel seeks written responses to these questions by April 27, 2010. I would be happy to answer any questions about this letter that you may have. If you would prefer, a member of your staff may contact the Panel's Executive Director, Naomi Baum, at [redacted].

Sincerely,

Elizabeth Warren
Chair
Congressional Oversight Panel

Cc: Mr. Paul Atkins
Mr. Mark McWatters
Mr. Richard H. Neiman
Mr. Damon A. Silvers