Testimony of

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Testimony before the

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Hearing on

"HELPING FAMILIES SAVE THEIR HOMES: IS TREASURY'S STRATEGY REALLY WORKING?"

The Illinois Attorney General's Protection of Consumers From Predatory Mortgage Lending Practices

I. Introduction and Background

Senator Durbin and members of the subcommittee, thank you for inviting me to testify at today's hearing on the implementation of the Troubled Asset Relief Program (TARP), which is the centerpiece of the recently enacted Emergency Economic Stabilization Act (EESA). As the chief consumer advocate for a state that has been especially hard hit by the nationwide foreclosure crisis, I am pleased to share my thoughts on how the Department of Treasury can best use its authority under EESA to ensure that millions of distressed homeowners receive the sustainable loan modifications they need to remain in their homes.

Since taking office as Illinois Attorney General nearly six years ago, I have made a priority of protecting homeowners from predatory and irresponsible mortgage lenders. In my role as prosecutor, I have brought enforcement actions against some of the largest mortgage lenders in the nation for engaging in the kinds of reckless lending practices that attracted headlines only after the collapse of the housing market threatened to bring the global economy to its knees. In my role as policymaker, I have drafted and lobbied successfully for the passage of state legislation to curb the excesses of a mortgage industry that, during the housing bubble, had grown all too willing to abandon time-honored prudent lending standards in pursuit of fast and easy profits.

Despite all these efforts, there is only so much that one state official can do to address a foreclosure crisis of global proportions. This is especially true in view of the ongoing and lamentable movement in Washington to limit the authority of the states to regulate mortgage lending within their own borders. Additionally, the last two years have seen a massive shift in mortgage lending to nationally-chartered financial institutions. With more than 90,000 foreclosure filings expected in Illinois this year, this clearly is the moment for the federal government to exercise the full extent of its power to regulate the conduct of the mortgage industry. If we are to stem the rising tide of foreclosures, the federal government must use TARP resources and other legislative initiatives to incentivize the mortgage industry to implement comprehensive loan modification programs that will keep hardworking families in their homes and preserve surrounding communities—not only in Illinois but throughout the nation.

My testimony today is divided into two main parts. First, I will review my office's investigation of Countrywide Home Loans and my subsequent lawsuit against that company. This review will include a summary of the landmark loan modification program at the center of our recent settlement agreement with Countrywide's new owner, Bank of America. The terms of the Countrywide settlement provide an excellent template for the kind of wide-scale loan modification programs that are necessary to address the foreclosure crisis at its root cause: namely, the mortgage industry's insistence on originating millions of home loans to borrowers who could not afford them in the first place.

In the second part of my testimony, I will identify some of the key impediments standing in the way of implementing systematic loan modifications and offer policy and legislative recommendations for overcoming those obstacles.

II. The Illinois Attorney General's Prosecution of Predatory Mortgage Lending: Ameriquest and Countrywide

As I indicated earlier, I am not a newcomer to the idea that the mortgage industry is in serious need of tighter government control. One of my early major enforcement actions as Illinois Attorney General was to join with several other state attorneys general in an investigation of the lending practices of Ameriquest, the nation's largest subprime mortgage lender at the time. That investigation, which was launched more than five years ago, revealed that Ameriquest was engaged in many of the abusive business practices that, in the last year or so, have come to characterize the mortgage industry as a whole. Those predatory practices included: inflating appraisals of homes, inflating borrowers' income, and using deceptive means to put homeowners into loans they could not afford. For example, Ameriquest would switch homeowners from fixed loans to loans with adjustable rates at the last moment, when many borrowers felt it was too late to back out. In an especially pernicious practice, Ameriquest would switch borrowers to a loan with a higher rate at closing, promising to re-finance borrowers before the loan became unaffordable, even as they were locking the borrowers into the loans with exorbitant prepayment penalties.

As a result of our investigation, Ameriquest settled with 49 states and the District of Columbia, in an agreement worth $325 million. Just as importantly, the settlement's relief package contained four essential components that went to the heart of the industry's unfair and misleading lending practices: (1) early disclosure of essential terms of the loan and the additional requirement that, if the terms changed, they would be re-disclosed prior to closing; (2) scripts to be used during the sale of the loan setting out what borrowers would be told about the essential terms of their loan; (3) provisions ensuring that Ameriquest would deal at arms-length with appraisers; and (4) restrictions on placing prepayment penalties on hybrid ARMs, so that borrowers would not be trapped in loans when their interest rates reset upward.

Having learned to recognize the signs of abusive mortgage lending from our investigation of Ameriquest and other mortgage lenders, we knew by the fall of 2007 that Countrywide merited a closer look. In September 2007, we launched an investigation into the lending practices of the largest mortgage lender in the nation. The story that our investigation revealed is an allegory; it is in many ways the story of the rise and collapse of our nation's mortgage industry. Here, in abridged form, is what went wrong at Countrywide.

In pursuit of market share, Countrywide engaged in a wide range of unfair and deceptive practices, including the loosening of underwriting standards, structuring unfair loan products with risky features, engaging in misleading marketing and sales techniques, and incentivizing employees and brokers to sell more and more loans with risky features.

Countrywide's business practices resulted in unaffordable mortgage loans and increased delinquencies and foreclosures for Illinois homeowners, and, as we now know, for homeowners nationwide.

Countrywide's explosive growth was paralleled by the demand on the secondary market for loans with non-traditional risky features. Through the securitization process, Countrywide shifted the risk of the failure of these non-traditional loans to investors. Moreover, securitization allowed Countrywide to gain much needed capital to fuel the origination process and reach its goal of capturing more and more market share. As the risky Countrywide loans began to fail, the company was contractually obligated to repurchase or replace the failing loans in the investor pools. This created further pressure to increase the volume of loan origination. It was a vicious cycle.

To facilitate the increase in loan origination volume, Countrywide relaxed its underwriting standards and sold unaffordable, and unnecessarily expensive, home loans. Reduced documentation underwriting guidelines were heavily used to qualify many borrowers for unaffordable loans. Countrywide mass-marketed so-called "affordability" loan products, such as hybrid adjustable rate mortgages and interest-only loan products that only required qualifying borrowers at less than the fully indexed/fully amortized rate. Countrywide pushed products containing layers of unduly risky features, such as pay option ARMs and mortgage loans for 100% of the value of borrowers' homes. Unfair and deceptive advertising, marketing and sales practices were utilized to push mortgages, while hiding the real costs and risks to borrowers. These practices included enticing borrowers with low teaser rates, low monthly payments, and "no closing cost" loans that failed to make clear disclosures of the products' risks.

For a while, these business practices paid off for Countrywide. By the first quarter of 2007, Countrywide had become the largest originator of subprime loans, with a total subprime loan volume of roughly $7.8 billion. By 2008, the company was well-established as America's largest mortgage lender. In just the first quarter of 2008, the company originated $73 billion dollars nationally in mortgage loans. Countrywide is also the nation's largest loan servicer. The company administers $1.5 trillion in loans made by both it and other institutions. Countrywide's servicing operation generated $1.4 billion in revenue in the first quarter of 2008. Our focus on Countrywide's large servicing operation was key to achieving my lawsuit's primary goal of keeping as many families as possible in their homes: a mass loan modification program is impossible without the cooperation of the servicing industry.

III. Countrywide Settlement

On October 6, 2008, I announced a nationwide settlement with Countrywide. The settlement established the first mandatory loan modification program in the country, and I hope it serves as a model for others lenders and for the federal government.

The settlement covers approximately 400,000 borrowers nationwide and provides 8.7 billion dollars in loan modifications to homeowners.

As we here today already know, the most immediate need at this moment is to help homeowners to stay in their homes and stabilize our communities. The features of the Countrywide settlement loan modification program should be a part of any national home retention program. Those features are as follows:

- A uniform and routinized approach to modifying loans to sustainable payment levels. This should include establishing clear guidelines for servicing staff to follow in offering loan modifications on a standardized basis.
- Proactively reviewing loans with certain features for automatic loan modification eligibility. Eligible borrowers will receive notification of the modification, with the option of contacting Countrywide if more assistance is needed.
- A streamlined documentation process that minimizes the amount of time and financial data necessary to affect the loan modification. There is not time for in-depth analyses of the homeowner's finances. A review of current income should be sufficient for many borrowers to enter into a sustainable loan modification.
- Options for crafting a loan modification that offers the borrower affordable payments in the present and also eases the borrower into a sustainable market rate loan for the future. In the Countrywide settlement, this goal is achieved with a number of options, including:
    - A reduction of the interest rate to as low as 3.5% for five years, at which time the loan will be converted to a fixed interest rate set at the greater of the Fannie Mae rate or the introductory interest rate on the loan. If that rate is still unaffordable, the reduced interest rate can be extended for another two years;
    - A reduction of the interest rate to as low as 2.5% with annual step rate increases, subject to a lifetime cap on the interest rate on the loan; and
    - A 10-year interest-only modification, with an interest rate reduction to as low as 3.5% for these modifications and yearly step rate increases, subject to a lifetime cap on the interest rate on the loan.
- Principal reductions to 95% LTV for pay option ARM loans in which the borrower has no equity in the home. Principal reductions of at least this amount – for any type of loan – should be used as a tool to assist any homeowner in trouble if the reduction contributes to a sustainable loan modification. Homeowners have less financial incentive to stay, even with more affordable payments, if they have no or little equity in their home.
- Reasonable and sustainable debt-to-income guidelines, to lessen the possibility of defaulting on the loan modification.
- A hold on foreclosures while loans are being reviewed for eligibility, to ensure that homes are not lost during implementation of the Countrywide settlement.
- Loan modification availability to homeowners in default as well as for those for whom default is reasonably foreseeable. We believe this is permitted by most pooling and servicing agreements.

- Waiving certain fees as part of the loan modification.
- A reporting requirement to provide us with data on the results of Countrywide's loan modification program.

IV. Impediments to Implementing Wide-Scale Loan Modification Programs

After the announcement of the Countrywide/Bank of America settlement, I worked with a group of my colleagues from around the country and called upon all servicers to initiate loan modification programs similar to the one negotiated with Countrywide. As a result of that outreach, we have been engaged in a series of discussions with the servicers. However, we continue to identify obstacles that limit the number of loan modifications being carried out:

- **Investor concerns:** Servicers have continued to voice concern about potential investor lawsuits based on an alleged violation of the Pooling and Servicing Agreements. In fact, a group of investors sued Countrywide earlier this week.
- **Second liens:** Additional liens can serve as an impediment in the loan modification process. Many of the homes purchased in 2006 with subprime mortgages have second mortgages and open home equity lines of credit secured by their home.
- **Servicer staffing:** Many lenders and servicers have announced plans for expanded loss mitigation programs and increased staffing. However, many homeowners continue to complain to my Office that when they contact their lender, they are unable to reach a live person or someone with loan modification decision-making authority.
- **Servicer incentives:** The loan modification process is a labor intensive process that increases servicers' costs, and yet servicers are not often compensated for loan modifications by lenders. In contrast, servicers are reimbursed for foreclosure costs at the end of the process.

V. Recommendations

Seriously delinquent loans are at a record high for both subprime and prime loans (See footnote 6 of the CRL/ Martin Eakes testimony.). In October 2008, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008. Similarly, my colleagues and I, through our State Foreclosure Working Group, have confirmed that the current progress in stopping foreclosures is disappointing. The data in our report indicates that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome. What further actions can be taken? We need to incentivize servicers quickly to enter into more sustainable loan modifications and require that they make their process more transparent so that we can evaluate it. Below are my suggestions:

- **Transparency and Uniformity in the Loan Modification vs. Foreclosure Calculation.** Require transparency and uniformity from

lenders in the analyses they use to determine whether a loan modification or foreclosure is the more cost-effective choice. Servicers must engage in a net present value analysis in order to justify a loan modification to their investors. It is my understanding that the American Securitization Forum is currently working on servicer industry guidance to provide some uniformity in this net present value calculation.

- **Waiver of Fees.** For all loan modifications, lenders should waive late fees and other fees resulting from the homeowner's default.
- **Payments to Servicers for Restructuring Loans.** Servicers receive compensation for the cost of foreclosing on a home, but are often paid little or nothing for the cost of doing a loan modification. Loan servicers should receive payments to perform loan modifications on a per transaction basis, similar to what the FDIC has proposed.
- **Guarantee Home Mortgages in Exchange for Loan Modifications.** TARP money should be utilized to provide federal loan guarantees to servicers to incentivize more loan modifications. These federal loan guarantees should be provided when the lender can demonstrate the modification is affordable and sustainable. The guarantee on restructured loans will provide a new incentive for servicers to act on behalf of investors in modifying a loan. The FDIC has proposed such a plan.
- **Indemnification for Servicers.** Congress should consider enacting an indemnification program against investor suits for servicers who act reasonably in modifying loans. This legislation should amend EESA to establish that, in *all* situations, servicers owe their duty to investors as a whole and not to any particular class of investors who may be harmed by a modification.
- **Homeowner Tax Relief.** The Mortgage Debt Forgiveness Relief Act of 2007 should be amended to ensure that any debt forgiven in a modification is not taxable to the homeowner, not just in instances when the loan was for the purchase or improvement of the home.
- **Loan Modifications and Bankruptcy Proceedings.** Senator Durbin has championed legislation to authorize judicial loan modifications for homeowners in bankruptcy. I strongly support his efforts. It is paradoxical that all homeowner debts may be modified in bankruptcy, except for their most important debt – the mortgage on their home. This inequity in the bankruptcy code must be remedied.

VI. Conclusion

Thank you for the opportunity to testify before the subcommittee today. I am grateful that you chose to conduct this field hearing in Chicago, a city in which every neighborhood is suffering the devastating effects of the foreclosure crisis. As I have described, it is my belief that strong, comprehensive loan modification programs are the most effective means for stemming the rising tide of foreclosures. I call on Congress to immediately use its powers to incentivize such programs.