<u>State of Foreclosure: A Case for New Direction</u>

According to the latest data from RealtyTrac (September 10, 2009) California continues to have the third highest foreclosure rate in the nation, with one in every 144 homes receiving a foreclosure filing. Additional data finds that of the existing homes sold in September, 40% were properties that had been foreclosed on during the past year. Foreclosures continue to put pressure on families, communities, and governments. Thus far, federal and state government policy makers and regulators have engaged in several attempts to mitigate foreclosures so that borrowers can stay in their homes. Additionally, servicers have their own mitigation programs and procedures for evaluating the potential for loan modifications.

As discussed in a recent report from the National Consumer Law Center (NCLC), (State and Local Foreclosure Mediation Programs: Can They Save Homes, September 2009), foreclosure continues to be an inefficient market mechanism for dealing with delinquent borrowers. While the actual way in which servicers judge the costs of foreclosure varies based on numerous factors, the NCLC report reveals that the average loss for servicers per foreclosure is $124,000 equaling an average of 57 percent in lost value.

In spite of numerous state, local and federal programs foreclosures continue to occur at record rates. Some of these foreclosures are unrelated to the type of loan securing the property and instead are a result of economic conditions including rising unemployment rates. Anecdotal evidence from counseling groups and consumer advocates point to the numerous cases of borrowers who may indeed benefit from a loan modification but are looked over, either through error, lack of communication, or lack of review on the part of servicers.

The second quarter *OCC and OTS Mortgage Metrics Report* issues by the Office of Comptroller of Currency and the Office of Thrift Supervision reveal the following:

- The percentage of current and performing mortgages in the portfolio decreased by 1.4 percent from the previous quarter to 88.6 percent of all mortgages in the portfolio. All categories of delinquencies increased from the previous quarter, with serious delinquencies—loans 60 or more days past due and loans to delinquent bankrupt borrowers—reaching 5.3 percent of all mortgages in the portfolio, an increase of 11.5 percent from the previous quarter. Foreclosures in process reached 2.9 percent of all mortgages, a 16.2 percent increase.

- Serious delinquencies increased relatively evenly across all risk categories. The percentage of prime loans that was seriously delinquent totaled 3.0 percent, a 10.5 percent increase from the previous quarter and a 13 percent increase from a year ago. The percentage of Alt-A loans that was seriously delinquent was 10.3 percent, an 11.1 percent increase from the previous quarter, and the percentage of subprime loans that was seriously delinquent was 17.8 percent, a 12.9 percent increase from the previous quarter.

- In the second quarter, 15.2 percent of Payment Option ARMs were seriously delinquent, compared with 5.3 percent of all mortgages, and 10 percent were in the process of foreclosure, more than triple the 2.9 percent rate for all mortgages.

- Mortgages guaranteed by the U.S. government, primarily through the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA), also showed higher delinquencies than the overall servicing portfolio. Serious delinquencies increased to 7.5 percent of all government guaranteed mortgages, up from 6.8 percent in the previous quarter.

- Home retention (***Loan Modifications and Payment Plans)*** actions increased by 21.7 percent from the previous quarter. This increase was driven by the 73.9 percent rise in payment plans reflecting, in part, the 114,538 trial period plans initiated under the "Making Home Affordable" program. No "Making Home Affordable" trial payment plans were converted to permanent modifications through second quarter, with all recorded modifications reflecting other programs offered by servicers and investors.

- Modifications made during the second quarter of 2009 lowered monthly principal and interest payments in 78.2 percent of all modified loans, up from 53.5 percent in the previous quarter. The percentage of modifications that reduced payments by 20 percent or more increased to 38.6 percent of all modifications made in the second quarter, up from 28.8 percent in the previous quarter. Modifications that increased monthly payments declined to 17.4 percent of all modifications during the quarter, down from 18.1 percent in the previous quarter and from 32.7 percent a year ago. Actions that left payments unchanged decreased significantly to 4.3 percent of all modifications during the quarter from 28.4 percent last quarter, a decline of almost 85 percent.

- Nearly three-quarters of all modifications were "combination modifications" that involved two or more changes to the terms of the loan. During the second quarter, 64.3 percent of loan modifications capitalized missed payments and fees, and 70.1 percent of modifications reduced rates. Extending the term of the mortgage became much more common in the second quarter, with 46 percent of modifications extending the term compared with 25.8 percent in the first quarter. The number of modifications that reduced principal more than doubled to 10 percent of modifications compared with 3.1 percent in the first quarter.

- While the inventory of foreclosures in process continued to grow, reaching 992,554 or 2.9 percent of all serviced loans, the number of newly initiated foreclosures remained about the same as the previous quarter. Newly initiated foreclosures decreased for all risk categories other than prime loans. Among prime loans, new foreclosures increased by 5.8 percent from the previous quarter, reflecting the continued economic pressure on this largest group. Emphasis on home retention actions, including those taken under the "Making Home Affordable" program, helped keep the number of newly initiated foreclosures flat despite rising serious delinquencies.

- Completed foreclosures increased 16.9 percent from the prior quarter primarily as a result of the end of various national, state, local, and servicer-imposed moratoria. New short sales increased by 34.8 percent to 23,102, but remained a small percentage of total loss mitigation actions.

The *OCC and OTS Mortgage Metrics Report* presents data on first lien residential mortgages serviced by national banks and thrifts, focusing on credit performance, loan modifications, payment plans, foreclosures, short sales, and deed-in-lieu-of-foreclosure actions. The OCC and OTS collect these data from the nine national banks and three thrifts that have the largest mortgage servicing portfolios among all national banks and thrifts. As a result of mergers and acquisitions, these 12 depository institutions are now owned by nine holding companies. The data represent 64 percent of all first lien residential mortgages outstanding in the country.

The Federal government's most robust home retention effort thus far, the Home Affordable Modification Program (HAMP) has also faced challenges. Initial data reveals that only 12 percent of distressed homeowners eligible for HAMP have been helped so far, even though it's an improvement over the previously reported 9 percent covering April through July 2009.

HAMP has faced multiple challenges ranging from a lack of outreach by some servicers, the voluntary nature of the program, lack of adequate home retention staff, and continued confusion for borrowers. The NCLC report, referenced earlier, provides a list of various servicer practices that have prevented HAMP from reaching its full potential:

- Soliciting eligible homeowners to waive their right to be considered for a loan modification under the HAMP guidelines;

- Offering homeowners loan modifications that do not comply with the HAMP affordability guidelines, including modifications with unaffordable payments, impermissibly high interest rates, and modifications for short time periods not authorized by the guidelines;

- Falsely informing eligible homeowners that the servicer does not participate in the HAMP program;

- Proceeding with sales and commencing foreclosure actions while delaying decisions on requests for a loan modification;

- Charging fees to consider or implement loan modifications despite HAMP guidelines prohibiting such charges;

- Refusing to inform homeowners of the grounds for denial of a HAMP modification, including refusal to disclose how a payment level was calculated, what NPV test was performed, and failing to provide any documentation related to denial or approval decision;

- Altering terms of trial modifications when it is time to implement the permanent modification;

- Adding improper late fees and other post-default fees;

- Demanding excessive documents from homeowners beyond what HAMP requires, and denying modifications for lack of documentation;

- Denying any review or appeal from denial decisions, and failure to inform the homeowner of decisions;

- Extensive delays in deciding modification requests or requiring homeowners to sign documents on short notice without a chance for review;

- Failing to coordinate modification negotiations with second lienholders.

Committee staff has received numerous letters and phone calls from consumers seeking help with loan modifications after difficulties dealing with their servicers. These letters and calls reveal similar stories as revealed in the aforementioned list. For example, constituents reveal the following obstacles:

- Employee of servicer tells borrower, without seeing any documentation, that the borrower most likely does not qualify for any modification plans.

- Borrower that is not yet delinquent, but struggling to pay mortgage, is told by servicer that in order to be a priority they must be delinquent on their mortgage.

- Collections department of servicer continues collection activity even though borrower is working with home retention department.

- Many complaints received from borrowers that servicers claim they never receive paperwork, or that documents are incomplete.

- Credit ramifications of loan modification never fully discussed.

- Lack of disclosure of total fees and costs associated with modification.

- Modification was temporary with no guarantee of continuing even if borrower were successful with payments.

During the first half of the year, mortgage servicers have offered 1.5 million "in-house" loan modification plans that do not comply with HAMP (Compliance is not mandatory). The major dilemma with this approach is the majority of these modifications are trial modifications. However, anecdotal information reveals that many of these trial modifications are not designed for long-term affordability, but instead, are designed to save borrowers over the short-term while the servcers may be betting on an overall change in economic conditions that would mitigate the need for a more long-term solution. Another substantive problem arises on how many of the mortgages were originally structure. Most subprime mortgage did not include impound accounts for property taxes and hazard insurance. Servicers, when conducting modifications of these loans, are now requiring impound accounts which can actually cause the monthly payment to go up after modification.

Additionally, borrowers and counseling groups continue to report problems with the responsiveness of servicers to inquire regarding modifications.

Federal Responses:

Since the origin of the global financial crisis, Congress, and federal regulators have engaged in several programs aimed at preventing foreclosure. These programs have been discussed and analyzed during previous hearings of the Assembly Banking and Finance Committee. For purposes of the current endeavor, this background will only examine the latest federal effort, particularly, HAMP.

On February 19th, 2009, President Obama announced HAMP. Designed to assist 7-9 million homeowners nationwide, HAMP was implemented to restructure or refinance troubled mortgages.

- Shared Effort to Reduce Monthly Payments: Treasury will partner with financial institutions and investors to reduce homeowners' monthly mortgage payments. The lender will have to first reduce monthly payments on mortgages to a specified affordability level (specifically, the lender must bring down monthly payments so that the borrower's monthly mortgage payment is no greater than 38 percent of his or her income).

- Next, the program will match further reductions in monthly payments dollar-for-dollar, from 38 percent down to 31 percent debt-to-income ratio for the borrower.

- To ensure long-term affordability, the modified payments will be kept in place for five years and the loan rate will be capped for the life of the loan. After five years, the interest rate can be gradually stepped-up by 1 percent per year to the conforming loan survey rate in place at the time of the modification.

- To reach the target affordability level of 31 percent, interest payments will first be reduced down to as low as 2 percent. If at that rate the debt to income level is still over 31 percent, lenders then extend the term or amortization period up to 40 years, and finally forbear principal at no interest, until the payment is reduced to the 31 percent target.

- Treasury will share the costs of reducing the payment from 38 percent DTI to 31 percent DTI dollar for dollar.

- "Pay for Success" Incentives to Servicers: Servicers will receive an up-front fee of $1,000 for each eligible modification meeting guidelines established under this initiative. Servicers will also receive "pay for success" fees –as long as the borrower is successful at staying in the program – of $1,000 each year for three years, subject to a de minimis threshold. Servicers will get similar incentives if they modify FHA, VA, or Agriculture Department loans, or refinance loans according to the Hope for Homeowners or similar FHA programs.

- Responsible Modification Incentives: Because loan modifications are more likely to succeed if they are made before a borrower misses a payment, the plan will include an incentive payment of $1,500 to mortgage holders and $500 for servicers for modifications made while a borrower at risk of imminent default is still current on their payments. The servicer portion of this incentive will also be available for modifications of FHA, VA, or Agriculture Department loans, or refinance loans under the Hope for Homeowners or similar FHA programs.

- Incentives to Help Borrowers Stay Current: To provide an extra incentive for borrowers to keep paying on time under the modified loan, the initiative will provide a monthly pay for performance success payment that goes straight towards reducing the principal balance on the mortgage loan. As long as the borrower stays current on his or her payments, he or she can get up to $1,000 each year for five years, subject to a de minimis threshold. As with the servicer incentives, these borrower incentives are also available for modifications of FHA, VA, or Agriculture Department loans, or refinance loans under the Hope for Homeowners or similar FHA programs.

- Home Price Decline Payments: To encourage the modification of more mortgages and enable more families to keep their homes, the Administration -- together with the FDIC -- has developed an innovative payment that provides compensation that can partially offset losses from failed modification when home prices decline, but is structured as a simple cash payment on every eligible loan. The Treasury Department will make payments totaling up to $10 billion to discourage lenders, servicers and investors from opting to foreclose on mortgages that could be viable now out of fear that home prices will fall even further later on. This initiative provides servicers with the security to undertake more mortgage modifications by assuring that if home price declines continue to occur or worsen, investor losses are partially offset. Holders of mortgages modified under the program would be provided with an additional payment on each modified loan, linked to declines in the home price index.

- Approximately 85 percent of mortgages are covered by HAMP participating servicers.

- 38 services have signed servicer participation agreements to modify loans under HAMP.

The latest data from the Making Home Affordable Website is presented in the following 2 pages and is also available at
http://www.treas.gov/press/releases/docs/MHA_public_report.pdf

The previously mentioned efforts are designed to assist with the millions of loans that are already delinquent. It would be a mistake for policy makers and regulators to believe that the worst-case loans are already delinquent, or that the problematic loans have already revealed themselves. On contrary, recent media reports highlight that 2010 could provide additional pressures in the foreclosure market. An article in the San Francisco Chronicle, *$30 Billion Home Loan time Bomb Set for 2010*, highlights another wave of option ARMS set to readjust next year. First American CoreLogic, a mortgage research firm, finds that 54,000 option ARMS are in the Bay Area of California with a value of $30.9 billion. Fitch Ratings has found that the new payments on these option ARMS will typically average 63% higher than the minimum payment. Additionally, these borrowers owe 126 percent of their homes value preventing refinancing as an option for most of the borrowers.

Modification Difficulties:

Earlier, several servicing related obstacles were highlighted that demonstrate the continued difficulties in modifying mortgage loans. The following discussion encompasses those obstacles that have existed since the start of the foreclosure crisis, but may have been mitigated to some extent by the creation of federal programs.

Staff of the Federal Reserve Board, Division of Research and Statistics and Monetary Affairs, published a report, *The Incentives of Mortgage Servicers: Myths and Realities* (Cordell et al, 2008) and hereon referred to as The Report. This report provides much of the background information for the following discussion.

Re-default.

Many borrowers who received modifications default at rates that range from 15%-40% depending on the type, length and scale of the modification. The November 14th, 2008 FDIC announcement of uniform mortgage modification program, mentioned earlier, of a nationwide solution takes into account a 31 percent re-default rate.

Historically, the re-default rate on modified conforming Freddie Mac loans is 20 percent according to Cutts and Merrill. An Alt-A servicer in the Report conveyed that recidivism rate was an average of 30 percent. So even on loans that are at the margins, re-default is serious concern. Investors reviewing these numbers may actually find some comfort in the finality of such processes as foreclosure. At this time with HAMP only reaching 10-15 percent of eligible borrowers it is unclear the impact of the program's efforts on redefault rates.

Staffing & Costs.

First, the foreclosure process itself, is costly and time consuming compared to the costs associated with loan modifications. Typically, this is the reasoning for FDIC and others using a net present value determination to measure the costs of foreclosure versus modification and the possibility of achieve sustainability of the loan. The potential loan losses after foreclosure would seem to provide an economic incentive to modify loans, except for the complications that arise when loans are in securitize pools (An issue discussed later). Credit Suisse has reported a loan loss severity rate in value of the mortgage of 55 percent on securitized mortgages in the six months ending in May 2008. Typically the range of losses to the investor or holder of the mortgage note is somewhere in range of 40-50 percent.

Servicers, typically, have not had the staff or resources to engage in large-scale modifications. The servicing industry is built on a streamlined business model to maximize the flow of funds from borrowers to lien holders. This system has not responded well to the time and staff requirements to meet the needs of borrowers at the levels witnessed over the last 18 months. Loss mitigation requires time and resources to contact borrowers, verify data, obtain home value estimates, determine whether the borrower is facing a temporary or permanent setback, coordinate with second lien holders and calculate net present value assumptions verses foreclosure. Some recent evidence has shown that many servicers have made good faith efforts to shift their models to accommodate an influx of modifications, as well as, an increase in staff presence. The recent announcements by the largest servicers covered earlier in this analysis all reveal a set aside of resources for increased staff and infrastructure to meet loan modification needs. Fannie Mae and Freddie Mac, the government sponsored entities (GSEs) will pay fees for approved workouts to offset the costs, however investors in private label MBS typically do not pay for such services.

Pooling and servicing agreements (PSAs) as will be discussed below, typically require that servicers advance all the principal and interest payments, as well as tax, insurance, maintenance, and foreclosure costs, to investors regardless of whether the borrower is paying.

Servicers get reimbursed for expenses incurred while a loan is delinquent but only after the property goes into foreclosure, so getting repaid can take nine months to a year. A foreclosure moratorium would indefinitely extend the advances that servicers pay to investors and come as borrowing facilities that servicers rely on to make advance payments are strained by the liquidity crunch.

Lastly, an indirect cost of potential loan modifications can be accounting requirements that may require an immediate absorption of losses on a restructured debt. If a depository institution restructures a loan before it becomes seriously delinquent the institution must take on that debt as an immediate loss on the books and can increase the amount of capitol that the institution must hold. This dilemma provides insight into why many institutions have either failed or have been bought out by other entities. When the scale of the bad debt was realized these entities had to take immediate debt write downs that required a commensurate back-up of capital that never materialized, nor was possible in a stale market lacking liquidity.

Securitization and Contractual obligations.

The take-off of the mortgage industry over the last decade was product of the securitization process. Historically, financial institutions made mortgage loans and retained those loans on their books. This system has a direct impact on the liquidity of the institution because the more loans on the balance sheets means less money to lend to consumers. Securitization allowed institutions to sell loans to the secondary market and remove those liabilities off of their balance sheets. Doing this allows institutions to make more loans and increase overall market liquidity.

Loans are sold in the secondary market and pooled into investment portfolios. This process also allowed non-depository lenders who concentrated on mortgage lending to make loans out of lines of credit. This process requires the dividing of the pool into segments, called tranches. The senior tranche might carry the highest rating (AAA), while the “mezzanine” tranche carries AA to BBB. The lowest segment, the so-called equity tranche, is typically unrated. Again, the entire pool might be made up of the most risky subprime loans, but the senior tranche may still merit the AAA rating because it always claims priority of payment and gets its rating sometimes relative to the other loans in the pool. The senior tranche gets the first dollar of cash flow, while the lowest tranche takes the first dollar of loss. Because most borrowers pay their mortgages, money managers can buy AAA tranches with a relative degree of confidence. For a more detailed description of securitization please see this committee's background report, Assembly Banking and Finance Committee Informational Hearing *Subprime Mortgage Crisis In California: Impact of Mortgage Turmoil on California Communities,* November 1, 2007.

These securitized pools are governed by complex contractual obligations between investors and servicers. These PSAs vary widely but generally provide that the servicer is obligated to maximize the interest of the investors or certificate holders. The GSEs provide in their PSA language specific directions on how to deal with delinquent loans, while private label MBSs may only give general guidance leaving it up to the servicer to interpret the best course of action. Several key features of private label MBS pools distinguish them from GSE pools and can have drastic impacts on the potential loan modifications.

1) Credit Suisse, in a study of 31 PSAs, found that only 2 expressly prohibited modification for a loan in default. 12 of the 29 allowed modifications with restrictions, such as a limit on the number of loans that could be modified in a particular pool.

2) Some trusts require approval of modifications by the trustee, who is generally not a servicer and thus not in a position to evaluated a potential workout, so the trustee sends the proposal back to the servicer to use the PSA language as guidance. This can become particularly complex and time consuming as many servicers look for express guidance on vague PSA language, yet when questions arise are told to refer

back to the very language that originated the complication.

3) Investors in private label PSAs may not be informed on the language in many PSAs nor actively monitor servicer performance.

Obviously, the ability to modify securitized loans is not only complex, but complicated by contractual agreements and often counter incentives to modify loan in a pool. Furthermore, modifying a loan in a securitized pool requires a withdrawal of the loan from that pool, which is not a simple task considering the leveraged nature of these MBSs and which may require a immediate value write down of the assets on the books.

Even government plans to get at the securitized mortgage problem may not be able to solve the issue. While the TARP plan allowed the government to by troubled assets and to encourage loan modifications via the purchase of those assets backed by MBS, it would still meet with complications due to the securitization process. Adam Levitin, Associate Professor of Law, at Georgetown University concludes that the buying up of MBS by the government is not enough to give the government the ability to unilaterally modify mortgages. Typical pooling and servicing agreements (PSAs) specify that it takes two-thirds of all the MBS holders in a pool to consent to a modification. Under this scenario, Treasury would have to buy up two-thirds of the MBS in a pool to force across the board modifications. However, even if Treasury could or was willing to purchase the necessary amount, the conversion of MBS into collateralized debt obligations further dilutes the ability to purchase the sufficient number of securities. Professor Levitin advocates the best way to engage in loan modifications is too allow judges to write down values in bankruptcy proceedings.

Tranche warfare.

Private label MBS pools are carved into tranches from AAA ratings down through B. Holders of different varieties of MBS tranches can have different an conflicting interest that can make loan modifications difficult or even impossible. A servicer's obligation under a PSA is to maximize the returns to investors as a whole and not just particular tranches, certain modifications or outcomes may only benefits one tranche. For example, the biggest conflicting interest is the investor in a subordinate tranche could benefit from a loan modification where otherwise foreclosure would eliminate their equity because higher tranches would receive the proceeds first of a foreclosure sale. So those investors at the top have an incentive not to approve loan modifications, because the structure of the pools means they will get whatever proceeds are realized from the foreclosure at the expense of the lower tranches. With the high recidivism rates of modified loans, senior tranches may perform foreclosure as an option in order to take advantage of losses now versus further losses later.

Second liens.

Second lien mortgage loans, or "piggy back" mortgages gained popularity in the subprime boom as a workaround for borrowers who could not make a down payment on the property. Most of these mortgages were split into a loan of 80 percent of the properties value and junior lien for the remaining 20 percent. Among securitized subprime loans the average loan to value (LTV) ratio on loans with a junior lien was 99 percent. Some borrowers used home equity lines of credit after the origination of the first mortgage as a way to tap accumulated home equity, or at least tap the appearance or promise of increased home equity. To put this risks into further perspective, the share of subprime loans, according to the Report, that were 2/28s (meaning 2 years fixed and adjusting thereafter) coupled with junior liens reached 35 percent in 2006. Data from First American LoanPerformance estimates that 22 percent of properties with subprime loans had a junior lien at origination and 31 percent of loans that seriously delinquent have a junior lien. The true number may be even higher as many borrowers were able to attain second liens from a different lender than the first lien holder.

Attempted loan modifications where a second lien exists become difficult because the second lien holder must agree to the modification and possible extinguishment of their lien holder rights when they stand to make no benefit. Junior lien holders have been slow and reluctant to agree to re-subordinate in this episode and have held up refinancing, modifications, and short sales.

Given the legal uncertainties surrounding modifications, senior lien holders generally require the junior lien holder to affirmatively agree to subordinate their claim to the modified senior lien before agreeing to the modification. In today's depressed housing market, when a mortgage is being modified it is likely that the junior lien holder has essentially no equity; thus, a big part of the value of the lien is the ability to extract a payment from the senior lien holder in a workout. Other issues with junior liens include:

1) Newer liens usually have lower priority then older liens.

2) Given the legal uncertainty regarding the seniority of their claim following a modification, senior lien holders are reluctant to undertake a major modification of a loan and then become junior to another lien-holder. In practice, senior lien holders generally require the junior lien holder to affirmatively agree to the modification by agreeing to re-subordinate.

3) Conversations with servicers indicate that the GSEs routinely paid junior lien holders to agree to re-subordinate. These payments ranged from $1,000 to $2,000 to as much as $5,000 in some circumstances.

4) Servicers may not have the operational controls or experience to get second-lien lenders to agree to re-subordinate quickly.

5) Sources at the GSEs indicate that junior lien holders have started demanding larger payments in order to agree to re-subordinate. This may be because junior liens are no longer always the traditional piggyback, but may be HELOCs with balances of $50,000 or more.

6) In the past year, prices for pools of delinquent closed end subprime second liens were around 1 to 3 cents on the dollar, and prices for lower-rated tranches of securitized subprime second liens were in the same low range, between 0 and 5 cents.

7) In the case of short sales, junior lien holders must agree to release their liens and take a loss. Servicers have reported instances where delays in resolving disputes between junior and senior lien holders results in prospective buyers of the property going elsewhere, forcing the loan into foreclosure.

CALIFORNIA'S RESPONSE

Senate Bill 1137 (Perata, Corbett, Machado) Chapter 69, Statutes of 2008

The first major legislative effort in California to tackle the growing foreclosure crisis was the introduction of SB 1137. SB 1137 went through several amended forms as its was negotiated through the legislative process. The intent was to ensure that servicers contact borrowers prior to the first filing of the foreclosure process, the notice of default. The following is a summary of the provisions of SB 1137.

- At least 30 days prior to filing a notice of default, lenders must either make contact to borrowers or satisfy other due diligence requirements.

    - Contact with the borrower must be in person or by telephone "in order to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure." The borrower must be advised that he or she has the right to request a subsequent meeting, and if requested, the meeting must be scheduled to occur within 14 days. The borrower must be provided with the toll-free telephone number made available by the United States Department of Housing and Urban Development to find a HUD-certified housing counseling agency.

    - The notice of default may be filed without actual "contact", if there has been "due diligence" of the mortgagee, beneficiary or authorized agent. Satisfaction of "due diligence" requires all of the following: (1) a first-class letter that includes a toll-free number for HUD-certified housing counseling agencies; (2) after the letter has been sent, at least three phone calls at different hours and on different days (an automated system may be used to dial borrowers); and (3) if there is no response within two weeks of the required phone calls, a certified letter, return receipt requested, must be sent. Due diligence would also require that the mortgagee, trustee, beneficiary, or authorized agent setup a toll-free number that provides access to a live representative during business hours, and to post a prominent link on its homepage, if any, to the following information: (1) options that may be available to the borrowers who are unable to afford their mortgage payments and who wish to avoid foreclosure; (2) a list of financial documents the borrower should collect in order to discuss those options; (3) a toll-free

- Applies to loans made between January 1, 2003 and December 31, 2007, secured by residential real property and are owner-occupied residences.

- Requires, where the residential billing address is difference than the property address, that the foreclosing entity, at the time of posting a Notice of Sale, to mail a form notice addressed to "resident" that informs any tenant on the property that the foreclosure process has begun on their rental property. The outside of the envelope containing the notice will prominently state: "IMPORTANT: Information contained in this letter may affect your right to live in this property." This bill would require the notice and text on the envelope to be in English, Spanish, Chinese, Tagalog, Vietnamese, or Korean
- Provides that a tenant or subtenant in possession of a rental housing unit at the time the property is sold in foreclosure must be given 60 days' written notice to quit before the tenant or subtenant may be removed from the property.

- Requires legal owners to maintain vacant foreclosed residential properties. Governmental entities are allowed to impose civil fines and penalties of up to $1,000 per day for violations, after the legal owner has received a notice of the claimed violation, including a description of the conditions giving rise to the claim, and opportunity to remedy the violation at least 14 days prior to imposing those fines and penalties. "Failure to maintain" would include failure to adequately care for the property, including, but not limited to, permitting excessive foliage growth that diminishes the value of surrounding properties, failing to take action to prevent trespassers or squatters from remaining on the property, and failing to take action to prevent growth of mosquito larva in standing water.

- Sunsets on January 1, 2013

California Foreclosure Prevention Act- Civil Code Section 2923.52(a)

On February 20, 2009 the Governor of California signed the California Foreclosure Prevention Act (CFPA) as an urgency statute. Implementation of the CFPA occurred 90 days after the signing of the bill and subsequent to California's three mortgage regulators (Department of Financial Institutions, Department of Corporations and Department of Real Estate) drafting emergency regulations, culminating on June 1, 2009. The CFPA modified the foreclosure process by providing for a delay of 90-days to give borrowers an opportunity to work with their servicers on a loan modification. However, a 90-day delay in foreclosure proceedings does not apply in those cases where a mortgage loan servicer has received an exemption based on the existence of a comprehensive loan modification program. A servicer seeking an exemption must have a loan modification program that meets the following requirements:

- The program is designed to keep borrowers in their homes when the anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis.
- The program targets a ratio of the borrower's housing related debt to gross income of 38 percent or less, on an aggregate basis in the program.
- The program includes a combination of the following:
- An interest rate reduction, as needed, for at least five years.

    - An extension of the amortization period for the loan term, to no more than forty years from the original date of the loan.
    - A deferral of some portion of the unpaid principal balance until the maturity of the loan.

    - A reduction of principal.

    - Compliance with a federally mandated loan modification program.

    - Any other factor the Commissioner determines is appropriate, as identified and described in this application and approved by the Commissioner (see 10 CCR § 2031.5(e)(1)(F)).

- In determining a loan modification solution for the borrower, the program seeks to achieve long-term sustainability for the borrower.

As of this writing a majority of mortgage loan servicers operating in the state have received an exemption from the 90-day foreclosure moratorium (More information on those who have received exemptions can be found at http://www.corp.ca.gov/FSD/CFP/default.asp). Based on press articles and anecdotal evidence, it appears that the CFPA has created some consumer confusion as they believe that they automatically get an additional 90 days before the foreclosure process continues. Again, the CFPA does not require that a borrower receive a modification, only that a servicer has a plan in place. Furthermore, nothing in the statute or its regulations require any performance standards that could be used to measure compliance with the law, as compliance is the mere existence of a program without a requirement of results.

A recent report from the Center for American Progress, *Its Time We Talked, Mandatory Mediation in the Foreclosure Process* said the following in relation to CFPA:

> *"In practice, it appears that the statute will have little effect because most servicers will be able to obtain an exemption. Any servicer with a loan modification program consistent with HAMP would be eligible for an exemption under the language of the statute. To qualify, a program must permit loan*

modifications of first mortgage on owner-occupied residential properties where the NPV test to the servicer and its note holders is positive, the resulting debt-to-income ratio of the homeowner is 38 percent or less, and the modifications include those allowed under HAMP or the reduction of principal. The statute explicitly states that servicers having a program in "[c]ompliance with a federally mandated loan modification program" could be deemed exempt."

<u>AB 1588</u>

On September 9, 2009, in the closing days of the California Legislative session, Speaker Karen Bass, Assemblymember Pedro Nava, Chair of Assembly Banking & Finance Committee and Assemblymember Ted Lieu, Chair of Assembly Rules Committee introduced Assembly Bill 1588. AB 1588 was introduced in response to growing concern that loan modification options are not reaching all borrowers in need. AB 1588 follows a growing nationwide momentum of states and local jurisdictions implementing borrower-lender mediation programs. Typically, these types of efforts occur in states that have a judicial foreclosure process, meaning that foreclosure filings and actions occur in a courtroom and are subject to judicial review. This process makes it somewhat easier for mediation programs to have an effect as a complex process already exist for dealing with foreclosures. California, on the other hand, has a non-judicial foreclosure process in which the courts typically are not involved in the statutory actions associated with the foreclosure process. While policy makers have struggled to find a foreclosure solution that works in a non-judicial foreclosure state, Nevada, which has a non-judicial process passed Nevada Assembly Bill 149 that established the Nevada Foreclosure Mediation Program (NFMP). The NFMP requires lenders to participate in mediation with eligible homeowners who are facing foreclosure and have requested the service. AB 1588 is largely designed on the Nevada model that provides for the right for borrowers to request a workout program when they receive a notice of default. Specifically, AB 1588

Establish a Monitored Mortgage Workout (MMW) Program that would be offered to all borrowers who receive a notice of default to provide them with an opportunity to explore options to avoid foreclosure. This bill would require that any notice of default of a residential real property, as defined, sent to a borrower include a notice of the borrower's right to participate in the MMW Program as well as the documents that authorize the borrower to elect to participate in the MMW Program.

As previously mentioned in this background, the National Consumer Law Center and the Center for American Progress have both recently issued reports regarding the nature and benefit of various mortgage loan mediation programs. Both reports are attached to this background for review.

Summary of U.S. Senate Bill 1731 "Preserving Homes and Communities Act of 2009" Introduced by Senator Jack Reed on September 30, 2009

Congress has also recognized the growing use of mediation programs through the introduction of U.S. Senate Bill 1731 which requires certain lenders to make loan modifications, establishes a grant program for state and local government mediation programs and creates databases on foreclosures.

1) Loan Modification Requirements

- Borrower must have a mortgage loan
- Home must be principal residence
- Borrower is not able to make payments due to a financial hardship
- Modification must produce a greater net present value than a foreclosure to the lender

Loan Modification Required

- A lender may not initiate or continue foreclosure proceedings against a borrower unless:
  - The lender has determined whether or not the borrower is eligible for a loan modification
  - If the borrower is eligible, the lender must offer a loan modification to the borrower
  - If the borrower is not eligible, the lender must make available the note, deed of trust or any other document necessary to establish the right of the lender to foreclose.
- A lender may not sell the property until the lender determines whether or not the borrower is eligible for a loan modification and submit a certification to DOC.
- Provides a defense to foreclosure
- Nothing precludes the lender from making a loan modification with a lower payment, lower interest rate, or principal reductions that goes beyond the requirements of the home loan modification protocol.

Fees

- A lender may not charge any fees for participating in this program.
- A lender cannot impose a foreclosure related fee before the lender has determined whether or not the borrower is eligible for a loan modification and before the mortgage has entered the foreclosure process.
- A lender may not charge a fee for a late payment
- A lender can charge fees specified in advance by the mortgage agreement.
- A lender who violates the fee section will be fined $6,000 for each fee.

Regulations

- The secretary of housing and urban development can issue final regulations as he/she deems necessary.

2) Grant and Loan Assistance to States

- A borrower is eligible for grant assistance if:
  - Permanent resident of the state where the mortgage exists

- Agrees to seek counseling if the he/she receives a loan or grant made using funds under this section
- Suffers from a financial hardship which is unexpected and beyond the control of the borrower
- Unable to correct any delinquencies without financial assistance
- Has requested a loan modification
- Unable to make a full loan payment
- Probable after receiving loan or grant assistance that the borrower will be able to resume full loan payments within 15 months
- Has not previously received any loan or grant assistance.

- Mortgage Requirements:
  - Mortgage must be secured by a 1 to 4 family owner occupied residence that is used as a principal residence.
  - Interest cannot exceed the prime rate of interest at the time of loan origination-prime rate is determined by not less than 75% of the 30 largest depository institutions in the US.
  - Amount cannot exceed the conforming loan limit for conventional mortgages.
- Grants will be awarded to an eligible state agency for the purpose of:
  - 1-time emergency money to assist borrowers in satisfying any amounts past due on their home loan.
  - Providing eligible homeowners a specified number of future mortgage payments
  - Stipends of not more than $1,500 to assist with relocation expenses for homeowners not eligible for the program.
- An eligible state agency shall all provide a borrower:
  - Sources for information for borrowers who are in default
  - Referrals to HUD certified counseling agencies if in default
  - Community resources related to homeownership
- An eligible state agency must have staff on hand who:
  - Conduct an assessment of the situation of a homeowner
  - Make appropriate referrals based on assessment
- Distribution of Funds
  - The secretary of HUD will determine within 3 months of enactment how the funds will be distributed. The formula shall include the following factors:
    - Population of the state
    - Rate of mortgages in the state that are 90 or more days delinquent
    - Ratio of foreclosures to owner-occupied households
    - The change of unemployment between 2007 and 2008
- <u>Appropriations</u>
  - $6,375,000,000 for fiscal year 2010
  - sums may be necessary for fiscal years 2011-2013

3) Mediation

- The program established under a grant shall:
  - Require participation by the lender who initiates a foreclosure
  - Require the lender or borrower to make a good faith effort to resolve issues related to foreclosure proceedings through mediation
  - Allow a borrower to request mediation before a foreclosure sale if it was not made available beforehand
  - Provide supervision by a state court
  - Provide selection and training of neutral third party mediators by the state court
  - Provides penalties imposed by state court if the lender fails to comply with mediation
  - Provides consideration by a state court for failing to fulfill requirements of the mediation program.
  - Require the lender to provide the borrower during the mediation program the following documentation:
    - Loan modification calculation or net present value calculation made by the lender
    - The loan origination, including note, deed of trust, or any document to establish the right to foreclose
    - Any pooling and servicing agreement that the lender believes prohibits a loan modification
    - Payment history of the borrower
    - Alternatives to foreclosure
  - Prohibits lenders from shifting costs of mediation onto the borrower
  - Allows junior lien holders to the mortgage to participate in mediation
  - Be free of charge to the lender and borrower
  - Require the state or local government to keep track of all mediations.
- If a state receives a grant, the state will be able to determine whether to establish a state-wide mediation program or a mediation program in specific locality based on the number of foreclosure in that locality and any other characteristics that contribute to the number of foreclosures.
- The federal share of cost of the mediation program shall not exceed 50%
- Appropriations
  - $80,000,000 for fiscal year 2010
  - Funds may be necessary for fiscal years 2011-2013

4) Efforts to Reduce Mortgage Defaults and Foreclosures

- Implements a plan to monitor conditions and trends in homeownership and the mortgage industry and the effectiveness of public efforts to reduce mortgage defaults and foreclosures
- Requires the Secretary of HUD to submit a report to congress a year after the development of the plan and every year thereafter that summarizes and

describes the findings of trends in homeownership and the mortgage industry. The report will also include recommendation and proposals.

- Develops recommendations for a national database on mortgage defaults and foreclosures
    - The Secretary of HUD will have 12 months after enactment to submit a report to congress on the estimate of the cost of maintaining the database
- Appropriations:
    - $5,000,000 for fiscal year 2010
    - Funds may be necessary for fiscal years 2011-2013