The Commonwealth of Massachusetts
Office of the Attorney General

One Ashburton Place
Boston, Massachusetts 02108

Martha Coakley
Attorney General

(617) 727-2200
www.mass.gov/ago

TESTIMONY OF MASSACHUSETTS ATTORNEY GENERAL MARTHA COAKLEY U.S. HOUSE FINANCIAL SERVICES COMMITTEE

Wednesday, September 17, 2008

Lenders and Servicers' Promises of Loan Modifications in Massachusetts are Not Matched by Meaningful Actions That Promote Sustainable Loans

I thank Chairman Frank and the Committee for allowing me the opportunity to submit testimony on this important issue of foreclosure mitigation efforts as it relates to the predatory lending crisis that has permeated our nation.

By way of background, I would like to provide a brief overview of our office's commitment to combating predatory lending and guarding against the impact of the foreclosure crisis. In Massachusetts, as in many parts of the country, we are experiencing a dramatic surge in home mortgage foreclosures, due in large measure to unsound and predatory lending practices. In fact many foreclosures have resulted from loan practices and products that were destined to fail because too many lenders departed from the bedrock lending principle that one should reasonably assess the borrower's ability to repay before lending money.

In response, our office has sought accountability through litigation, regulation and other advocacy. On the enforcement side, we have brought predatory lending cases against two major subprime lenders, Fremont Investment & Loan/Fremont General and H&R Block/Option One Mortgage Corporation. In the Fremont action, we obtained an unprecedented injunction that restricts foreclosure on certain loans that were doomed to foreclosure because of the specific combination of ultra risky loan features used by Fremont. The injunction is one of the first pronouncements by a court that it is an unfair trade practice to sell mortgage loans that require borrowers to refinance while making such refinancing virtually impossible to obtain, at least absent a perpetual increase in home values. We have also brought enforcement actions against mortgage professionals who engaged in loan application fraud and other loan origination misconduct.

On the regulatory side, our office enacted regulations to prevent predatory lending and worked together with the Massachusetts Division of Banks for the enactment of legislation that provides additional protections for borrowers facing foreclosure. Our office issued new regulations, effective in January 2008, governing the mortgage brokers and mortgage lenders in Massachusetts. These regulations, 940 CMR 8.00, amended and expanded regulations first issued in 1992, and significantly extended the applicability of the regulations to purchase-money and refinance mortgage loans. These consumer protection regulations now address an array of unfair and deceptive practices in home lending that have contributed to the ongoing foreclosure crisis and harmed thousands of Massachusetts residents and their communities.

Our office also has joined other states to seek real progress from lenders and servicers on the issue of loan modifications. We have coordinated training efforts for attorneys willing to take pro bono case assignments to help homeowners avoid foreclosure. In addition, we have advocated for stringent federal regulation of mortgage lenders and brokers. We recognize that combating the current foreclosure crisis will require the resources and cooperation of federal, state and local authorities.

A critical aspect of our enforcement efforts, specifically in the Fremont case, has been the successful demand that lenders' loan origination misconduct—selling loans that were doomed to foreclosure and selling loans without assessing a borrower's ability to repay—must be taken into account before a foreclosure proceeds. In February 2008, we obtained a preliminary injunction that prevents Fremont or its assignees from foreclosing on certain risk-layered loans until our office has reviewed the loan, and if we object, Fremont must obtain the court's approval. I am pleased that other enforcement agencies—State Attorneys General and last week the Federal Trade Commission—have seen fit to follow this law enforcement approach to combating unfair and deceptive lending and servicing practices. In lieu of always resorting to litigation, we have tried to combat unnecessary foreclosures in Massachusetts by engaging lenders and urging them to "do the right thing"—to modify loans in order to staunch the public harms of foreclosures while still protecting their economic interests. Federal authorities have urged the same thing, in a very public way. Regrettably, this approach has not been successful. Indeed, the "voluntary" approach to loan modifications has failed. In Massachusetts, our office, Governor Deval Patrick, and the Legislature have focused on avoiding unnecessary foreclosures for more than a year. Based on our experience in Massachusetts—and we have no reason to believe we are unique—we have reached the following conclusions:

- Loan modifications are not being achieved in significant numbers. When compared to the number of foreclosures in process, far too few borrowers are able to restructure their loans to generate a sustainable loan; and

- When so-called loan modifications do occur, they often do not result in a sustainable loan. Lenders and servicers routinely offer and complete so-called loan modifications that increase monthly payments and increase overall debt. They do not meaningfully avoid foreclosure. At best, they

> temporarily delay the inevitable delinquency and eventual foreclosure—they "kick the can down the road."

Put simply, lenders, holders and servicers have not lived up to their very public promises of avoiding foreclosures by achieving loan modifications. As this Committee, and federal agencies, and state law enforcement continue to combat foreclosures and the unfair lending practices that caused this crisis, that reality should impact your decisions.

I would like to explain our office's experience with respect to loan modifications as well as the specific bases for my conclusions.

Very early in my involvement in the subprime lending crisis, as our office was developing enforcement actions, we realized, like many others, that a vital part of combating foreclosures was to work with lenders to modify loans. Our office has explored wide scale loan modifications in the litigation we are conducting against predatory subprime lenders, with some success (discussed below). We also have been part of the States Foreclosure Prevention Working Group that has collected data from most of the nation's top twenty subprime servicers and engaged them in discussions on implementing wide scale loan modifications. Iowa Attorney General Tom Miller, among others, has testified before this Committee on that group's goals and findings. More recently, the Massachusetts legislature enacted a 90 day right to cure period, requiring that lenders provide 90 days of breathing room before foreclosure during which, hopefully, borrowers and servicers would explore ways to restructure a sustainable loan and avoid foreclosure. Together with Governor Deval Patrick and Banking Commissioner Steve Antonakes, on May 1, 2008 we urged lenders and servicers to use that 90 day period as a real opportunity for loan modifications, not simply a new procedural hurdle for foreclosing attorneys. We state officials used that initial 90 day period to engage some of the nation's largest creditors, asking them to agree to a loan modification protocol to ensure that avoidable foreclosures did not take place. We asked only that they commit to loan modifications consistent with their own economic interests. Nonetheless, we got the brush-off. And Massachusetts, like the rest of the country, still is not witnessing real loan modifications in meaningful numbers.

We continue to believe that, especially in the current real estate market, a significant portion of foreclosures should be avoided through loan modifications. The loan modifications that I speak of would serve both borrowers and holders: borrowers, of course, would achieve a monthly payment that they can afford, usually achieved by reducing interest rates and, as necessary, addressing arrearages, not necessarily by erasing them, but in a manner that still promotes an affordable monthly payment. The holder benefits because they can significantly adjust the monthly payment to achieve a sustainable income stream that still exceeds the value recovered following a foreclosure. To be clear: we do not contend that every loan must be restructured. We have seen enough fraudulent subprime loans in our office to know that many are beyond saving. Our approach—at least with non-defendants—has always been focused on (i) evaluating the borrower's current ability to pay, (ii) comparing the value of that income stream to the expected losses at foreclosure, and (iii) demanding that lenders/servicers achieve a loan modification when it serves borrower interests as well as the holder's economic interest.

If implemented, this simple approach can result in massive numbers of loan modifications. It is not controversial. Indeed, when shared with servicers, we hear a chorus of agreement, much like the chorus of "helping borrowers" that emanates from Hope Now. But results have not followed.

One year after our office first zeroed in on seeking voluntary loan modifications, and four months after the start of the initial 90 day right to cure period under Massachusetts law (which commenced May 1, 2008 and ended August 1, 2008), we in Massachusetts can fairly assess the results of asking lenders and servicers to modify loans to avoid foreclosures: The results are dismal. Successful modifications continue to be a tiny fraction of loans that are in foreclosure. Likewise, the number of modifications pales when compared to the number of loans that are delinquent. Just as important, when so-called loan modifications are completed, they routinely fail to provide an affordable monthly payment, and therefore fail to result in a sustainable loan. Instead, they almost always increase, not decrease, principal and often increase, not decrease, the borrower's monthly payments. By any measure, those types of loan modifications are not helping borrowers and are not helping solve this foreclosure crisis.

I will briefly touch on the bases for these conclusions. First, back in April 2008, the State Foreclosure Prevention Working Group released its second data report based on loss mitigation statistics collected from thirteen major servicers. That data indicated that an unacceptably small number of loans in serious delinquency were the subject of loss mitigation efforts—7 out of 10 borrowers in serious delinquency were not on track for any type of loan work-out or loss mitigation to help them avoid foreclosure. An even lower percentage of troubled loans actually accomplished a loan modification or other loss mitigation approach. The intervening months have not changed this prognosis. For example, in Massachusetts the number of loan modifications filed with the Registry of

Deeds in recent months (144 loan modifications in last three months) is miniscule compared to the number of loans in active foreclosure; in the same period there were 4,721 foreclosure starts (Orders of Notice filed with Land Court) and 4,324 foreclosure deeds (signaling a completed foreclosure process). Even presuming the loan modification figure understates actual loan modifications (because some creditors may not file loan modifications) the number of solutions pales compared to the scope of the problem.

Equally troubling is the type of modifications that are actually being completed by servicers. They may be captioned "loan modification," and lenders and Hope Now may call them loan modifications and claim they are helping borrowers, but they fail to promote a sustainable loan and thus fail to provide a meaningful solution to foreclosure.

On this point, I commend a recent study by Professor Alan White of Valparaiso Law School. Professor White analyzed a sample of 106,000 securitized subprime loans, 4,344 had been the subject of a loan modification, defining that term broadly. Analyzing those modifications, Professor White concluded:

- Although technically the number of "modifications" has increased in recent months, the modifications rarely decrease debt and often do not promote affordability.
- The modifications reviewed virtually never reduced the principal debt owed, and often increased the principal.
- Only 50% of modifications reduced, in any amount, monthly payments; increased monthly payments are just as likely to result from these loan modifications.
- There is no consistency among lenders or servicers as to their approach to loan modifications—how much benefit may be extended and how modifications are actually achieved.

These conclusions from August 2008 are consistent with the State Foreclosure Prevention Working Group's conclusions in April 2008. They are likewise entirely consistent with the Center for Responsible Lending's testimony before this Committee on July 25, 2008 which, among other things, warned that servicers were completing loan modifications that failed to promote loans that were sustainable over the long term.

We have analyzed loan modification information from the Massachusetts registries of deeds to attempt to answer the same questions addressed by Professor White's study. Namely, to the extent loan modifications are occurring in Massachusetts, do they result in sustainable loans? Based on our Massachusetts investigation, the answer is a resounding "No." My office reviewed 144 loan modification documents, reflecting all loan modifications filed in 14 counties. Although not all loan modifications are necessarily filed with the registries, this is at least a representative sample. We found:

- *Not one of the 144 loan modifications reduced the principal mortgage balance of Massachusetts homeowners* (identical to Professor White's conclusion drawn from a national sample). I do not suggest that loan modifications need to reduce principal to afford meaningful relief. It is worth noting, however, that many holders have already written down these assets significantly, but that does not appear to translate into a willingness to reduce principal in the loan modification process.

- *Virtually none of the 144 loan modifications reduced the monthly payments for Massachusetts homeowners, so the distressed loans are no more affordable after "modification" than before*. This finding is startling. It undermines the notion that servicers are helping to preserve home ownership. Our analysis shows that servicers almost always capitalize arrearages, penalties, attorneys fees and the like, increasing the principal balance. Therefore, even though they may also reduce the interest rate, the impact of the reduction is offset by capitalizing arrearages. While the loan terms technically have been modified, the resulting loan is neither affordable nor sustainable.

We are not suggesting that arrearages must be forgiven or that principal must be invaded for loan modifications to be meaningful. But if the point is sustainable loans instead of foreclosure—a premise with which lenders publicly agree—that clearly is not achieved when both principal and monthly payments increase.

This sobering analysis of Massachusetts loan modifications is matched by the feedback we receive from those on the front lines of the foreclosure crisis. Our office is in constant contact with housing counselors, legal services lawyers and bankruptcy court personnel, and recently surveyed them to learn about their experiences in obtaining loan modifications from servicers. The reports we have received say loan modifications are few and far between. Some servicers never offer them, some servicers still cannot manage to answer the phones, and some get started on loss mitigation but cannot deliver the necessary papers, or worse, retract initial promises of restructuring.

Whether national reports like Professor White's, Massachusetts-specific analysis by our office, or anecdotal reports from the field, the evidence we have received is uniform: the voluntary call for loan modifications, by this Committee, by state government, and by federal officials, has failed to succeed. Our direct experience points in the same direction. We engaged three major creditors—Bank of America, Citigroup, and Wells Fargo—in an effort to explore a reasonable loan modification protocol, one that would memorialize the mutual interests of holders and borrowers, and which would allow their commitment to be measured. Once we proposed to move beyond general principles to measurable details, silence fell. These lenders have simply refused to move beyond platitudes and press releases.

The evidence and experience I have described here will undoubtedly contradict what this Committee will hear from the lending and servicing community. It certainly contradicts the glowing press releases issued by Hope Now every time state officials or housing advocates suggest the pace of modifications is slow. Hope Now and the major lenders may reiterate their supposed commitment to avoiding foreclosures; may cite increased servicing staff; and may point to improved raw numbers of loss mitigation contacts. But I urge this Committee, and the public, to compare the number of modifications to the astounding number of loans in delinquency and foreclosure. I urge you to look behind the numbers to determine what type of loan modifications are actually being completed—whether they provide affordability, whether it is temporary or sustainable, whether it just delays inevitable failure of the loan. The answers to those questions are a critical part of the story. The superficial tale told by lenders and Hope Now must be tested and, when tested, there is no denying that it fails. The disconnect between words and action has lasted more than a year. It is time to end this disconnect and for lenders to make good on their promises.

Our recent experience indicates that loan modifications can occur on a broad scale when the holders are motivated. It is possible to memorialize a loan modification protocol that provides significant relief to borrowers and accounts for the economic interests of holders. For example, in the Fremont matter, we negotiated with WMD Capital, the purchaser of a bundle of Fremont-originated subprime loans, to account for the Fremont's loan origination misdeeds. Specifically, WMD Capital agreed to provide payment relief for borrowers who could not afford their current scheduled payment. If their current ability to pay warranted it, borrowers could reduce their monthly payment dramatically (as much as 50%) and still remain in their home. WMD, in my view, was willing to do so because it was willing to acknowledge the other side of the ledger—its expected losses if it was forced to foreclose in a difficult real estate market. While it is true that WMD presumably purchased that bundle of loans at a serious discount, this agreement is a perfect example of how economic realities can justify meaningful loan modifications.

In closing, I turn to some policy implications of this failure of the voluntary model for loan modifications. First, I sincerely hope that October 1 brings a significant change to the loan modification landscape. The incentive toward meaningful, sustainable loan modifications provided by the Hope for Homeowners Act appears to be very real. I hope it works, and breaks the logjam. We cannot predict whether that will happen because, in the end, it remains the choice of lenders and servicers to participate in the program.

Second, unless the Hope for Homeowners Act proves successful in achieving broad scale sustainable loan modifications, more must be done. The economic incentives of mortgage holders continue to point in the same direction as borrower interests and the public interest—loan modifications should occur. I urge Congress to continue to consider its points of leverage to motivate real loan modifications. At the state level, we are frustrated by the chorus of agreement but absence of meaningful action. Because our cooperative efforts have not borne fruit, we will bolster our litigation efforts when appropriate, and we also will be exploring legislative and regulatory approaches to stimulating industry solutions to this very real, very public problem.

Finally, I would like to touch on our office's Abandoned Housing Initiative, as it is a creative state-based approach to combating the impact of foreclosures. One way Massachusetts is addressing the rising number of abandoned properties created as a result of the foreclosure crisis, is through the Massachusetts Attorney General Office's Abandoned Housing Initiative.

In the mid-1990s, our office created its Abandoned Housing Initiative, which in large part provides legal assistance with respect to the receivership process. In its current form, the Initiative addresses abandoned housing problems throughout the state by coordinating the resources of our office, municipal officials, local community groups and local residents. When local outreach and coordination does not work, Assistant Attorneys General utilize civil code enforcement protocols and the Massachusetts Sanitary Code's receivership provision, G.L. c.111, §127*I*, to rehabilitate dangerous and abandoned homes in these neighborhoods. This rehabilitation is significant because evidence has shown that abandoned properties within a community bring with them increased crime including violence, drugs, and arson.

This program has been extremely successful in providing cities and towns with the necessary tools to take properties into receivership in order to revitalize neighborhoods. Because of its success, our office is currently working towards expanding this Initiative. By expanding the Massachusetts Attorney General's Abandoned Housing Initiative, Massachusetts can increase its enforcement of the state receivership provision; expand its coordinated outreach with local officials and community groups; and ultimately reduce the amount of abandoned properties in the state. That is why I respectfully ask for any federal assistance that might aid us in our expansion, so that we can begin to hire more attorneys to conduct outreach within the community and assist in the receivership process.

Thank you again for the opportunity to provide testimony to the Committee today. I applaud the Chairman and the Committee members for their work on this issue, particularly, the recently enacted Housing and Economic Recovery Act of 2008, and I look forward to working with you on this issue in the future.