ONE HUNDRED TENTH CONGRESS

Congress of the United States
House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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November 17, 2008

The Honorable Barney Frank
Chairman
Committee on Financial Services
2129 Rayburn HOB
Washington, DC 20515

Dear Chairman Frank:

I write to commend you for your leadership in addressing the foreclosure crisis and repairing its effects on neighborhoods and to outline what I believe are the insufficient efforts of the Department of Treasury to combat the crisis. When the magnitude of the subprime and Alt-A mortgage crisis threatened the entire financial system, you led Congressional efforts in negotiating and drafting the Emergency Economic Stabilization Act of 2008 (EESA) to achieve the twin objectives of unfreezing capital markets and preventing unnecessary foreclosures. Giving the Department of Treasury broad latitude, EESA nonetheless explicitly authorized the purchase of troubled mortgage assets by the Troubled Asset Relief Program (TARP), to be accompanied by a plan to minimize foreclosures on those properties. Unfortunately, the Department of Treasury has not exercised its authority properly.

On November 12, 2008, Treasury Secretary Henry M. Paulson, Jr. announced that TARP would not acquire troubled mortgage assets, as Congress had envisioned. My Subcommittee held a hearing on November 14, 2008, where we heard testimony from Interim Assistant Secretary for Financial Stability Neel Kashkari, the top Treasury official in charge of the TARP, as well as a number of noted industry, academic, and legal experts. It was clear from Interim Assistant Secretary Kashkari's testimony that, contrary to Congressional intent, the Treasury Department has not and does not intend to use TARP for foreclosure prevention. In addition to breaking with Congressional intent, Secretary Paulson's policy reversal contradicts public assurances previously made by the Treasury Department and leaves the federal government without an adequate mechanism to stem the rising tide of home foreclosures. Because the Treasury Department refuses to spend the resources Congress made available for foreclosure prevention, I recommend that we inform the President that we will withhold the second installment of $350 billion until a new administration takes office.

Treasury Profoundly Misunderstands the EESA and the Mortgage Crisis

At the hearing, Interim Assistant Secretary Kashkari demonstrated a profound misunderstanding of both the purposes of EESA and the mortgage crisis underlying the financial crisis. Mr. Kashkari testified that the TARP must be limited to "investments" rather than other uses, such as the proposal by Chairman Sheila Bair of the Federal Deposit Insurance Corporation for federally guaranteed loan modifications. Not only is his interpretation inconsistent with the clear statutory authority granted the Treasury Department in EESA,[1] it is inconsistently applied by Mr. Kashkari. As Ranking Minority Member Darrell Issa pointed out at the hearing, the Treasury Department's use of TARP to make preferred equity purchases under its Capital Purchase Program hardly qualify as pursuing an investment strategy with TARP funds, if investment is understood as a means of maximizing profit. Mr. Kashkari was forced to admit that the equity purchases were subsidies, rather than investments: "our objective was to create a program that would encourage thousands of banks across our country to voluntarily apply… so we intentionally made it attractive for them to want to apply."

Second, Mr. Kashkari displayed a misunderstanding of the cause of and solution to the mortgage crisis. For instance, he testified, "[B]ringing mortgage rates down for borrowers is the best thing we could do to try to help homeowners avoid foreclosure and stabilizing our housing sector." While low interest rates would help to stimulate home sales and new home construction, they would neither protect current borrowers from imminent foreclosure nor provide certainty to lenders or the secondary market about the true cost of existing toxic mortgage assets, a crucial building block to restoring mortgage lending.

Third, Mr. Kashkari employed a verbal sleight of hand to create the impression that the EESA was being implemented to help prevent foreclosures, when in fact it was not. Mr. Kashkari often referred to "Treasury" to discuss foreclosure prevention efforts, when the subject of his testimony and his relevant job responsibilities is "TARP." We know, of course, that these terms relate to distinct entities and are not interchangeable. TARP is an asset acquisition fund, a subdivision of Treasury Department, created by EESA. Treasury, meanwhile, is the overarching regulator of the financial services industry and chief interpreter of the nation's tax laws. The Treasury Department issued three Revenue Procedures in the past year aimed at encouraging mortgage servicers to perform more loan modifications. TARP was created by Congress after those Revenue Procedures failed on their own to effect a sufficient increase in loan modifications.

Fourth, Mr. Kashkari argued that TARP's primary function was reestablishing liquidity and stability to the financial system. It is commonly known, however, that the troubles of the broader financial system trace their roots to millions of troubled subprime and Alt-A mortgages. Without addressing the underlying damage posed by troubled mortgage assets, Mr. Kashkari's strategy cannot accomplish the stabilization goal of EESA.

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[1] *See* EESA, Section 109(a) ("[T]he Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.").

<u>Reducing Principal is the Necessary Federal Objective</u>

TARP is being misused from the standpoint of EESA's twin objectives of unfreezing credit markets and preventing foreclosures. Loan modifications, rather than low interest rates, hold the key to realizing EESA's objectives. Indeed, as Professor Anthony Sanders testified, "[I]t is clear

that home preservation and solving system risk problems can be accomplished with a sensible loan modification template of Treasury decides to deploy it." Treasury should be pursuing mechanism by which troubled mortgage loans can be modified in large numbers to achieve the twin goals simultaneously.

However, not all loan modifications are equal. Research by Credit Suisse demonstrates that traditional loan modifications, including extensions of term, temporarily lower interest rate, and forbearance have high redefault rates, indicating that many borrowers are not more able to make mortgage payments after receiving traditional loan modifications.[2] However, two kinds of modifications demonstrated much lower redefault (higher success) rates: interest rate freezes for loans facing imminent reset of an adjustable rate mortgage, and principal reduction modifications for loans in default.

There is ample evidence that so-called "reset modifications" are being aggressively deployed by mortgage servicers. According to Credit Suisse, the real growth in loss- mitigation activity is largely attributable to reset modifications,[3] while other traditional modifications that result in a lower monthly payment—including forbearance, repayment plans, extension of loan terms, lower interest rate—have also grown to a lesser extent. Notably, the servicing industry increased its performance of reset modifications after Treasury issued a Rev. Proc. 2007-72, creating a safe harbor from loss of the REMIC tax status for performance of reset modifications.

Principal reductions are seen by experts as solving both a borrower's inability to make mortgage payments and unwillingness to make mortgage payments when the loan greatly exceeds the value of the house. Providing for a solution to this latter problem is extremely significant, especially in large portions of the nation where housing prices inflated fastest and longest. As Professor Sanders testified, "[W]e are in unchartered territory to the extent that there has never been a period in our history where homeowners could be as much as 50% upside down on the mortgage."

However, the mortgage servicing industry has not moved toward making large numbers of principal modifications. In fact, all but a few servicers avoid performing principal modifications. Only one company, Ocwen, accounted for 70 percent of all principal modifications found by

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[2] Credit Suisse, *Subprime Loan Modifications Update,* (October 1, 2008).

[3] *Id.*, at Exhibit 3.

Credit Suisse.[4] In spite of Rev. Proc. 2008-28, which created a safe harbor for principal modifications,[5] they remain a rarely exercised option by mortgage servicers.[6]

Thus, principal reduction must be at the centerpiece of a program of loan modifications, and the role of the Federal government should be to facilitate massive numbers of them. Clearly, the private market is unable or unwilling to perform principal modifications in sufficient numbers, and the Treasury Department's rulemaking is not an adequate stimulus on its own. In addition, the federal government should learn lessons from mortgage servicers that have distinguished themselves for aggressively performing principal modifications. Mr. Larry Litton, Chairman, Litton Loan Servicing LP, and one of the nation's leading performers of principal modifications, testified that while principal modifications are necessary, they are not sufficient if they do not go far enough to make the loan affordable to the borrower. In an effort to curb redefault rates among loans receiving principal modifications, his company is now aiming toward reducing enough principal to result in a debt-to-income ratio of 31%, down from 39%. Many others also believe that modified loan-to-value ratio should not exceed 100% to 110%.

Options for the TARP to Prevent Foreclosures

Witnesses at the Subcommittee's hearing testified to a number of ways to use TARP to facilitate a massive program of principal modifications. For example, Professor Michael Barr's written testimony outlined a mechanism where the Treasury Department would use TARP to purchase whole troubled mortgages out of securitized trusts. While there are a number of technical challenges to doing this, testimony at my hearing made clear that the industry believes they can be overcome. Indeed, Mr. Tom Deutsch of the American Securitization Forum, a trade association representing all parties to asset-backed securitizations, testified that the barriers are surmountable and investors would be willing to sell troubled assets to the government at a discount from face value. TARP funds could be used to guarantee home mortgages meeting Treasury Department guidelines, similar to a recent proposal by FDIC. This idea was effectively disqualified by the Treasury Department for violating the fictitious "investment" rule. Professor

[4] *Id.*, at 7.

[5] Rev. Proc. 2008-28 allows principal write-downs for residential mortgage loans on dwellings of less than 5 units. Treasury imposes a relatively loose standard allowing servicers considerable latitude: the servicer "reasonably" believes that the loan faces a "significant risk of foreclosure," and "reasonably" believes his loan modification is less risky than the terms of the original loan. Treasury goes on to explain that "[t]his reasonable belief may be based on guidelines developed as part of a foreclosure prevention program similar to that described in … this revenue procedure or may be based on any other credible systematic determination." Rev. Proc. 2008-28's effective duration is until December 2010.

[6] Three month rolling average of principal modifications, as a percent of total modifications, has risen from 1.4% in September 2007, to 3.9% in August 2008. Source: Staff calculations from Credit Suisse data.

Barr also recommended that TARP could find a way to pay servicers to restructure loans according to Treasury Department guidelines.

Conclusion

It is also possible that a new Treasury Department and Congress will want to consider further rulemakings and legislation. Barring some acute financial breakdown, I believe Congress should withhold the second installment of $350 billion for the TARP, and that we should inform the President before his administration requests it. In fact, every expert that testified in front of my

Subcommittee last Friday agreed that it would be prudent of Congress to preserve these resources pending the new Administration. Withholding the second installment would preserve the ability of the incoming administration to reconsider Secretary Paulson's policy reversal, and allow Congress to legislate further, while preserving a significant portion of the funds Congress has already made available for the purpose of preventing foreclosures.

If you have any questions, please contact Jaron Bourke, Staff Director, at (202) 225-6427.

Sincerely,

Dennis J. Kucinich

Dennis J. Kucinich
Chairman
Domestic Policy Subcommittee

cc: Darrell Issa
Ranking Minority Member

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Witness Information Sheet

The following is a summary of some of the pertinent rules and procedures applicable to witnesses testifying before the **Domestic Policy Subcommittee**, Committee on Oversight and Government Reform:

- Each witness should provide his or her written statement in electronic format to Jean Gosa, Clerk, at jean.gosa@mail.house.gov, no later than 10:00 a.m. two business days prior to the hearing. In a separate email to jean.gosa@mail.house.gov and by the same deadline, each witness should also provide a one-paragraph biographical statement, highlighting the witness's experience that is relevant to the subject of his or her testimony. Finally, each witness should bring 100 copies of his or her statement to the hearing room at the time of the hearing or to Room B-349B Rayburn House Office Building prior to the hearing.

- At the hearing, each witness will be asked to summarize his or her written testimony in five minutes in order to maximize the time available for discussion and questions.

- The Committee does not provide financial reimbursement for witness travel or accommodations. Witnesses with extenuating circumstances, however, may submit a written request for such reimbursements to Robin Butler, Financial Administrator, Committee on Oversight and Government Reform, 2157 Rayburn House Office Building, at least one week prior to the hearing. Reimbursements will not be made without prior approval.

- Witnesses with disabilities should contact Committee staff to arrange any necessary accommodations.

- The Committee on Oversight and Government Reform is the principal oversight committee in the U.S. House of Representatives. The jurisdiction of the Committee is set forth in House Rule X clauses 1(m), 2, 3(i), and 4(c).

- Committee Rules governing this hearing are online at http://oversight.house.gov/rules/.

For inquiries regarding these rules and procedures, please contact the **Domestic Policy Subcommittee** at (202) 225-6427.