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TROUBLED ASSET RELIEF PROGRAM

Status of Efforts to Address Defaults and Foreclosures on Home Mortgages

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Highlights of [GAO-09-231T](#), a testimony to Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. Senate

Why GAO Did This Study

A dramatic increase in mortgage loan defaults and foreclosures is one of the key contributing factors to the current downturn in the U.S. financial markets and economy. In response, Congress passed and the President signed in July the Housing and Economic Recovery Act of 2008 and in October the Emergency Economic Stabilization Act of 2008 (EESA), which established the Office of Financial Stability (OFS) within the Department of the Treasury and authorized the Troubled Asset Relief Program (TARP). Both acts establish new authorities to preserve homeownership. In addition, the administration, independent financial regulators, and others have undertaken a number of recent efforts to preserve homeownership. GAO was asked to update its 2007 report on default and foreclosure trends for home mortgages, and describe the OFS's efforts to preserve homeownership.

GAO analyzed quarterly default and foreclosure data from the Mortgage Bankers Association for the period 1979 through the second quarter of 2008 (the most recent quarter for which data were available). GAO also relied on work performed as part of its mandated review of Treasury's implementation of TARP, which included obtaining and reviewing information from Treasury, federal agencies, and other organizations (including selected banks) on home ownership preservation efforts. To access GAO's first oversight report on Treasury's implementation of TARP, click on [GAO-09-161](#).

To view the full product, including the scope and methodology, click on [GAO-09-231T](#). For more information, contact Mathew Scire at (202) 512-8678 or sciremj@gao.gov.

TROUBLED ASSET RELIEF PROGRAM

Status of Efforts to Address Defaults and Foreclosures on Home Mortgages

What GAO Found

Default and foreclosure rates for home mortgages rose sharply from the second quarter of 2005 through the second quarter of 2008, reaching a point at which more than 4 in every 100 mortgages were in the foreclosure process or were 90 or more days past due. These levels are the highest reported in the 29 years since the Mortgage Bankers Association began keeping complete records and are based on its latest available data. The subprime market, which consists of loans to borrowers who generally have blemished credit and that feature higher interest rates and fees, experienced substantially steeper increases in default and foreclosure rates than the prime or government-insured markets, accounting for over half of the overall increase. In the prime and subprime market segments, adjustable-rate mortgages experienced steeper growth in default and foreclosure rates than fixed-rate mortgages. Every state in the nation experienced growth in the rate at which loans entered the foreclosure process from the second quarter of 2005 through the second quarter of 2008. The rate rose at least 10 percent in every state over the 3-year period, but 23 states experienced an increase of 100 percent or more. Several states in the "Sun Belt" region, including Arizona, California, Florida, and Nevada, had among the highest percentage increases.

OFS initially intended to purchase troubled mortgages and mortgage-related assets and use its ownership position to influence loan servicers and to achieve more aggressive mortgage modification standards. However, within two weeks of EESA's passage, Treasury determined it needed to move more quickly to stabilize financial markets and announced it would use \$250 billion of TARP funds to inject capital directly into qualified financial institutions by purchasing equity. In recitals to the standard agreement with Treasury, institutions receiving capital injections state that they will work diligently under existing programs to modify the terms of residential mortgages. It remains unclear, however, how OFS and the banking regulators will monitor how these institutions are using the capital injections to advance the purposes of the act, including preserving homeownership. As part of its first TARP oversight report, GAO recommended that Treasury, among other things, work with the bank regulators to establish a systematic means for determining and reporting on whether financial institutions' activities are generally consistent with program goals. Treasury also established an Office of Homeownership Preservation within OFS that is reviewing various options for helping homeowners, such as insuring troubled mortgage-related assets or adopting programs based on the loan modification efforts of FDIC and others, but it is still working on its strategy for preserving homeownership. While Treasury and others will face a number of challenges in undertaking loan modifications, including making transparent to investors the analysis supporting the value of modification versus foreclosure, rising defaults and foreclosures on home mortgages underscore the importance of ongoing and future efforts to preserve homeownership. GAO will continue to monitor Treasury's efforts as part of its mandated TARP oversight responsibilities.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to provide an update on our 2007 report on default and foreclosure trends for home mortgages and to discuss the Department of Treasury's efforts to preserve homeownership as part of its implementation of the Troubled Asset Relief Program (TARP).¹ My statement is grounded in recent work we did to update our 2007 report and in our ongoing review of Treasury's implementation of TARP as authorized by the Emergency Economic Stabilization Act of 2008, TARP's enabling legislation.²

Today the U.S. financial markets are undergoing stresses not seen in our lifetime. These stresses were brought on by a fall in the price of financial assets associated with housing, in particular mortgage assets based on subprime loans that lost value as the housing boom ended and the market underwent a dramatic correction.³ Defaults and foreclosures have affected not only those losing their homes but also the neighborhoods where houses now stand empty. They have imposed significant costs on borrowers, lenders, and mortgage investors and have contributed to increased volatility in the U.S. and global financial markets.

The Emergency Economic Stabilization Act, which Congress passed and the president signed on October 3, 2008, in response to the turmoil in the financial and housing markets, established the Office of Financial Stability (OFS) within the Department of the Treasury and authorized the Troubled Asset Relief Program (TARP), which gave OFS authority to purchase and insure troubled mortgage-related assets held by financial institutions. One of the stated purposes of the act is to ensure that the authorities and facilities provided by the act are used in a manner that, among other things, preserves homeownership. Additionally, to the extent that troubled mortgage-related assets were acquired under TARP, Treasury was required to implement a plan that sought to "maximize assistance to homeowners" and use the Secretary's authority to encourage the use of the HOPE for Homeowners Program or other available programs to minimize

¹GAO, *Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments*, [GAO-08-78R](#) (Washington D.C.: October 16, 2007).

²Pub. L. 110-343, 122 Stat. 3765 (October 3, 2008).

³Subprime loans are loans generally made to borrowers with blemished credit that feature higher interest rates and fees than prime loans.

foreclosures. The HOPE for Homeowners program was created by Congress under the Housing and Economic Recovery Act of 2008 (HERA). The program, which was put in place in October 2008, is administered by the Federal Housing Administration within the Department of Housing and Urban Development. It is designed to help those at risk of default and foreclosure refinance into more affordable, sustainable loans. HERA also made a number of other significant changes to the housing finance system, including creating a single regulator for the government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—and giving Treasury authority to purchase obligations and securities of the GSEs.

To update information contained in our 2007 report on default and foreclosure trends, we analyzed data from the Mortgage Bankers Association's quarterly National Delinquency Survey, which covers about 80 percent of the mortgage market. The survey provides information dating back to 1979 on first-lien purchase and refinance mortgages on one- to four-family residential properties.⁴

For the period 1979 through the second quarter of 2008 (the most recent quarter for which data were available for the dataset we were using), we examined national and state-level trends in the numbers and percentage of loans that were in default, starting the foreclosure process, and in the foreclosure inventory each quarter. For the second quarter of 2005 through the second quarter of 2008, we disaggregated the data by market segment and loan type, calculated absolute and percentage increases in default and foreclosure measures, compared and contrasted trends for each state, and compared default and foreclosure start rates at the end of this period to historical highs. In our previous report, we assessed the reliability of the NDS data by reviewing existing information about the quality of the data, performing electronic testing to detect errors in completeness and reasonableness, and interviewing MBA officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of the report. To describe Treasury's efforts to develop a homeownership preservation program as part of its TARP implementation efforts, we relied on the work that we performed as part of our mandated review of

⁴The National Delinquency Survey presents default and foreclosure rates (i.e., the number of loans in default or foreclosure divided by the number of loans being serviced).

Treasury's implementation of TARP.⁵ Specifically, we obtained and reviewed available information, including public statements by Treasury officials, terms for participation in the Capital Purchase Program (CPP), data on loan modification program efforts of other agencies and organizations, and OFS organization charts. Additionally, we interviewed Treasury officials to obtain information on actions taken to date and to discuss their planned actions and priorities regarding homeownership preservation. We also held discussions with the first 8 financial institutions that received TARP funds under its CPP.

The work on which this testimony is based was performed in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Summary

Default and foreclosure rates for home mortgages rose sharply from the second quarter of 2005 through the second quarter of 2008, reaching a point at which more than 4 in every 100 mortgages were in the foreclosure process or were 90 or more days past due.⁶ These levels are the highest that have been reported in the 29 years since the Mortgage Bankers Association began keeping complete records. The subprime market experienced substantially steeper increases in default and foreclosure rates than the prime or government-insured markets, accounting for over half of the overall increase in the number of loans in default or foreclosure during this time frame. In both the prime and subprime market segments, adjustable-rate mortgages experienced relatively steeper growth in default and foreclosure rates compared with fixed-rate mortgages, which had more modest increases. Every state in the nation experienced growth in the rate at which foreclosures started from the second quarter of 2005 through the second quarter of 2008. By the end of that period, foreclosure

⁵GAO, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*, [GAO-09-161](#) (Washington, D.C.: December 2, 2008).

⁶Although definitions vary, a mortgage loan is commonly considered in default when the borrower has missed three or more consecutive monthly payments (i.e., is 90 or more days delinquent).

start rates were at their 29-year maximums in 17 states. The foreclosure start rate rose at least 10 percent in every state over the 3-year period, but 23 states experienced an increase of 100 percent or more. Several states in the “Sun Belt” region, such as Arizona, California, Florida, and Nevada, had among the highest percentage increases in foreclosure start rates.

In light of its initial decision not to conduct large-scale purchases of troubled mortgage-related assets held by financial institutions, Treasury’s OFS has been considering different approaches to preserving homeownership. OFS had initially intended to purchase troubled mortgage-related assets and use its ownership position to influence loan servicers and achieve more aggressive mortgage modification standards, which would help meet the purposes of the act. Instead, OFS chose to use \$250 billion of TARP funds to inject capital directly into qualified financial institutions through the purchase of equity. According to OFS, this shift in strategy was intended to have an immediate impact on the health of the U.S. financial and housing markets by ensuring that lenders had sufficient funding and encouraging them to provide credit to businesses and consumers, including credit for housing. Treasury also has indicated that it intends to use its CPP to encourage financial institutions to work to modify the terms of existing residential mortgages. However, Treasury has not yet determined if it will impose reporting requirements on the participating financial institutions, which would enable Treasury to monitor, to some extent, whether the capital infusions are achieving the intended goals. As a result, we recommended in our first TARP oversight report that Treasury work with the bank regulators to establish a systematic means for reviewing and reporting on whether financial institutions’ activities are consistent with the purposes of CPP.⁷ Treasury is taking additional steps toward the act’s goal of preserving homeownership. It has established an Office of the Chief of Homeownership Preservation within OFS that is considering various options, such as insuring troubled mortgage-related assets or adopting programs based on the loan modification efforts of FDIC and others. These include recent efforts announced by the GSEs and their regulator to streamline loan modifications. While loan modification presents a number of challenges, rising defaults and foreclosures on home mortgages underscore the importance of ongoing and future efforts to preserve homeownership. We will continue to monitor Treasury’s efforts to preserve home ownership as part of our TARP oversight responsibilities.

⁷GAO-09-161

Background

As of June 2008, there were approximately 58 million first-lien home mortgages outstanding in the United States. According to a Federal Reserve estimate, outstanding home mortgages represented over \$10 trillion in mortgage debt. The primary mortgage market has several segments and offers a range of loan products:

- The prime market segment serves borrowers with strong credit histories and provides the most competitive interest rates and mortgage terms.
- The subprime market segment generally serves borrowers with blemished credit and features higher interest rates and fees than the prime market.
- The Alternative-A (Alt-A) market segment generally serves borrowers whose credit histories are close to prime, but the loans often have one or more higher-risk features, such as limited documentation of income or assets.
- The government-insured or -guaranteed market segment primarily serves borrowers who may have difficulty qualifying for prime mortgages but features interest rates competitive with prime loans in return for payment of insurance premiums or guarantee fees.

Across all of these market segments, two types of loans are common: fixed-rate mortgages, which have interest rates that do not change over the life of the loans, and adjustable-rate mortgages (ARM), which have interest rates that change periodically based on changes in a specified index.

Delinquency, default and foreclosure rates are common measures of loan performance. Delinquency is the failure of a borrower to meet one or more scheduled monthly payments. Default generally occurs when a borrower is 90 or more days delinquent. At this point, foreclosure proceedings against the borrower become a strong possibility. Foreclosure is a legal (and often lengthy) process with several possible outcomes, including that the borrower sells the property or the lender repossesses the home. Two measures of foreclosure are foreclosure starts (loans that enter the foreclosure process during a particular time period) and foreclosure inventory (loans that are in, but have not exited, the foreclosure process during a particular time period).

One of the main sources of information on the status of mortgage loans is the Mortgage Bankers Association's quarterly National Delinquency Survey. The survey provides national and state-level information on mortgage delinquencies, defaults, and foreclosures back to 1979 for first-lien purchase and refinance mortgages on one-to-four family residential

units.⁸ The data are disaggregated by market segment and loan type—fixed-rate versus adjustable-rate—but do not contain information on other loan or borrower characteristics.

In response to problems in the housing and financial markets, the Housing and Economic Recovery Act of 2008 was enacted to strengthen and modernize the regulation of the government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—and expand their mission of promoting homeownership.⁹ The act established a new, independent regulator for the GSEs called the Federal Housing Finance Agency, which has broad new authority, generally equivalent to the authority of other federal financial regulators, to ensure the safe and sound operations of the GSEs. The new legislation also enhances the affordable housing component of the GSEs' mission and expands the number of families Fannie Mae and Freddie Mac can serve by raising the loan limits in high-cost areas, where median house prices are higher than the regular conforming loan limit, to 150 percent of that limit. The act requires new affordable housing goals for Federal Home Loan Bank mortgage purchase programs, similar to those already in place for Fannie Mae and Freddie Mac.

The act also established the HOPE for Homeowners program, which the Federal Housing Administration (FHA) will administer within the Department of Housing and Urban Development (HUD), to provide federally insured mortgages to distressed borrowers. The new mortgages are intended to refinance distressed loans at a significant discount for owner-occupants at risk of losing their homes to foreclosure. In exchange, homeowners share any equity created by the discounted restructured loan as well as future appreciation with FHA, which is authorized to insure up to \$300 billion in new loans under this program. Additionally, the borrower cannot take out a second mortgage for the first five years of the loan, except under certain circumstances for emergency repairs. The program became effective October 1, 2008, and will conclude on September 30, 2011. To participate in the HOPE for Homeowners program, borrowers must also meet specific eligibility criteria as follows:

⁸NDS data do not separately identify Alt-A loans but include them among loans in the prime and subprime categories. State-level breakouts are based on the address of the property associated with each loan. The NDS presents default and foreclosure rates (i.e., the number of loans in default or foreclosure divided by the number of loans being serviced).

⁹Pub. L. 110-289, 122 Stat. 2654 (July 30, 2008).

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- Their mortgage must have originated on or before January 1, 2008.
 - They must have made a minimum of six full payments on their existing first mortgage and must not have intentionally missed mortgage payments.
 - They must not own a second home.
 - Their mortgage debt-to-income ratio for their existing mortgage must be greater than 31 percent.
 - They must not knowingly or willfully have provided false information to obtain the existing mortgage and must not have been convicted of fraud in the last 10 years.

The Emergency Economic Stabilization Act, passed by Congress and signed by the President on October 3, 2008, created TARP, which outlines a troubled asset purchase and insurance program, among other things.¹⁰ The total size of the program cannot exceed \$700 billion at any given time. Authority to purchase or insure \$250 billion was effective on the date of enactment, with an additional \$100 billion in authority available upon submission of a certification by the President. A final \$350 billion is available under the act but is subject to Congressional review. The legislation required that financial institutions that sell troubled assets to Treasury also provide a warrant giving Treasury the right to receive shares of stock (common or preferred) in the institution or a senior debt instrument from the institution. The terms and conditions of the warrant or debt instrument must be designed to (1) provide Treasury with reasonable participation in equity appreciation or with a reasonable interest rate premium, and (2) provide additional protection for the taxpayer against losses from the sale of assets by Treasury and the administrative expenses of TARP. To the extent that Treasury acquires troubled mortgage-related assets, the act also directs Treasury to encourage servicers of the underlying loans to take advantage of the HOPE for Homeowners Program. Treasury is also required to consent, where appropriate, to reasonable requests for loan modifications from homeowners whose loans are acquired by the government. The act also requires the Federal Housing Finance Agency, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve Board to implement a plan to maximize assistance to homeowners, that may

¹⁰Pub. L. 110-343.

include reducing interest rates and principal on residential mortgages or mortgage-backed securities owned or managed by these institutions.

The regulators have also taken steps to support the mortgage finance system. On November 25, 2008, the Federal Reserve announced that it would purchase up to \$100 billion in direct obligations of the GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), and up to \$500 billion in mortgage-backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae. It undertook the action to reduce the cost and increase the availability of credit for home purchases, thereby supporting housing markets and improving conditions in financial markets more generally. Also, on November 12, 2008, the four financial institution regulators issued a joint statement underscoring their expectation that all banking organizations fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers, and that banking organizations work with existing mortgage borrowers to avoid preventable foreclosures. The regulators further stated that banking organizations need to ensure that their mortgage servicing operations are sufficiently funded and staffed to work with borrowers while implementing effective risk-mitigation measures. Finally, on November 11, 2008, the Federal Housing Finance Agency (FHFA) announced a streamlined loan modification program for home mortgages controlled by the GSEs.

Most mortgages are bundled into securities called residential mortgage-backed securities that are bought and sold by investors. These securities may be issued by GSEs and private companies. Privately issued mortgage-backed securities, known as private label securities, are typically backed by mortgage loans that do not conform to GSE purchase requirements because they are too large or do not meet GSE underwriting criteria. Investment banks bundle most subprime and Alt-A loans into private label residential mortgage-backed securities. The originator/lender of a pool of securitized assets usually continues to service the securitized portfolio. Servicing includes customer service and payment processing for the borrowers in the securitized pool and collection actions in accordance with the pooling and servicing agreement. The decision to modify loans held in a mortgage-backed security typically resides with the servicer. According to some industry experts, the servicer may be limited by the pooling and servicing agreement with respect to performing any large-scale modification of the mortgages that the security is based upon. However, others have stated that the vast majority of servicing agreements do not preclude or routinely require investor approval for loan

modifications. We have not assessed how many potentially troubled loans face restrictions on modification.

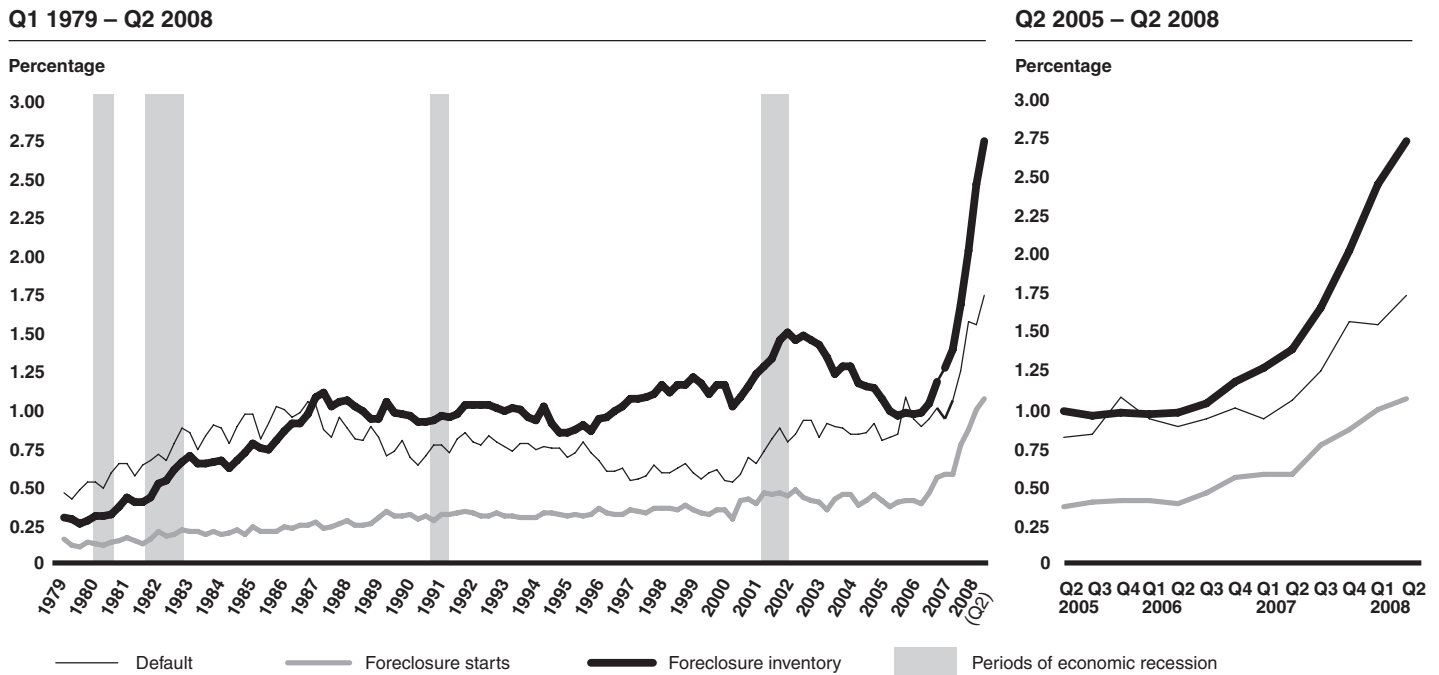
Default and Foreclosure Rates Have Reached Historical Highs and Are Expected to Increase Further

National default and foreclosure rates rose sharply during the 3-year period from the second quarter of 2005 through the second quarter of 2008 to the highest level in 29 years (fig.1).¹¹ More specifically, default rates more than doubled over the 3-year period, growing from 0.8 percent to 1.8 percent. Similarly, foreclosure start rates—representing the percentage of loans that entered the foreclosure process each quarter—grew almost three-fold, from 0.4 percent to 1 percent. Put another way, nearly half a million mortgages entered the foreclosure process in the second quarter of 2008, compared with about 150,000 in the second quarter of 2005.¹² Finally, foreclosure inventory rates rose 175 percent over the 3-year period, increasing from 1.0 percent to 2.8 percent, with most of that growth occurring since the second quarter of 2007. As a result, almost 1.25 million loans were in the foreclosure inventory as of the second quarter of 2008.

¹¹In the second quarter of 2005, foreclosure rates began to rise after remaining relatively stable for about 2 years.

¹²We calculated the number of foreclosure starts and the foreclosure inventory by multiplying foreclosure rates by the number of loans that the National Delinquency Survey showed as being serviced and rounding to the nearest thousand. Because the survey does not cover all loans being serviced, the actual number of foreclosures is probably higher than the amounts we calculated.

Figure 1: National Default and Foreclosure Trends, 1979 – Second Quarter 2008



Source: GAO analysis of MBA data, National Bureau of Economic Research.

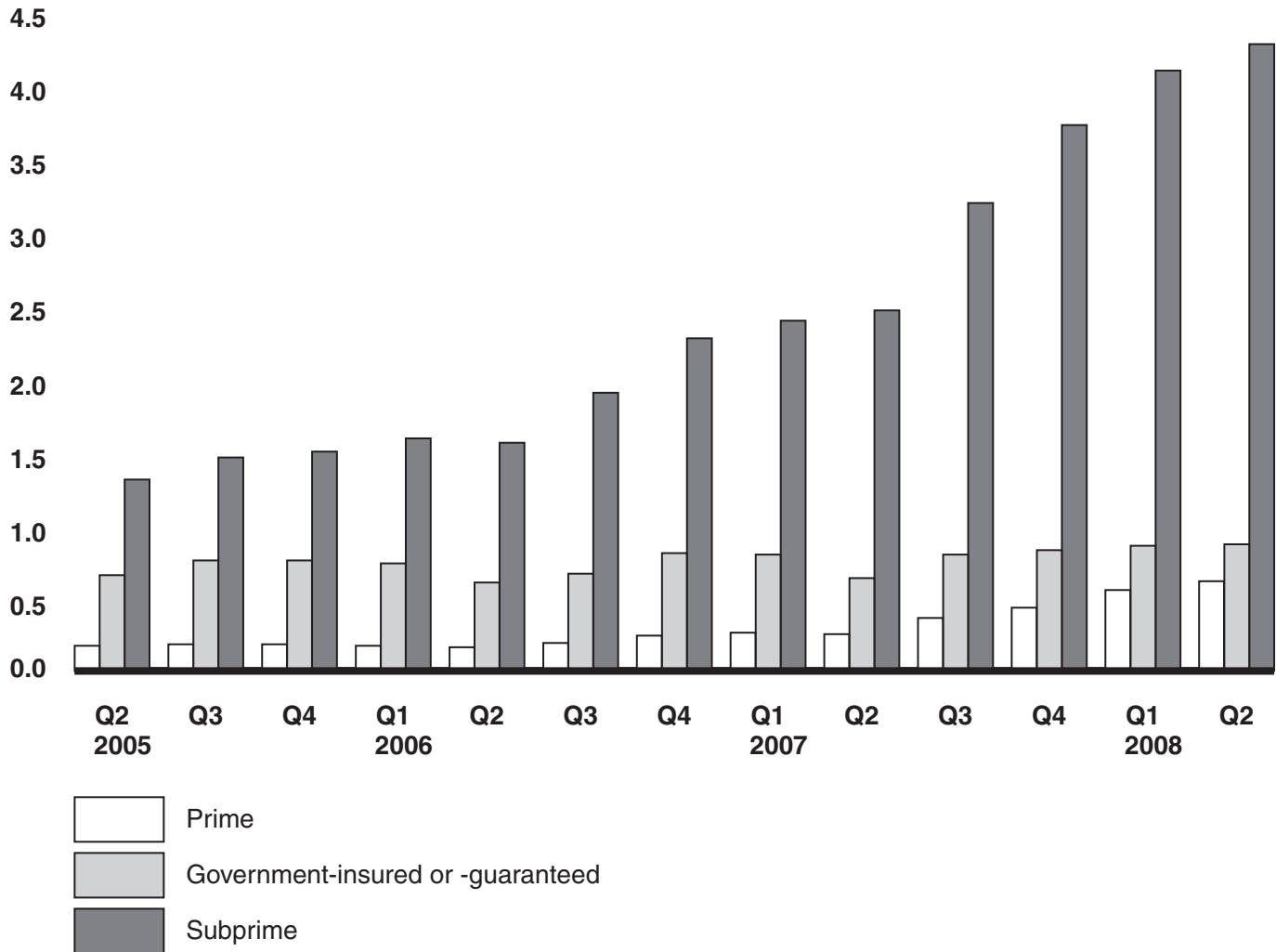
Default and foreclosure rates varied by market segment and product type, with subprime and adjustable-rate loans experiencing the largest increases during the 3-year period we examined. More specifically:

- In the prime market segment, which accounted for more than three-quarters of the mortgages being serviced, 2.4 percent of loans were in default or foreclosure by the second quarter of 2008, up from 0.7 percent 3 years earlier. Foreclosure start rates for prime loans began the period at relatively low levels (0.2 percent) but rose sharply on a percentage basis, reaching 0.6 percent in the second quarter of 2008.
- In the subprime market segment, about 18 percent of loans were in default or foreclosure by the second quarter of 2008, compared with 5.8 percent 3 years earlier. Subprime mortgages accounted for less than 15 percent of the loans being serviced, but over half of the overall increase in the number of mortgages in default and foreclosure over the period. Additionally, foreclosure start rates for subprime loans more than tripled, rising from 1.3 percent to 4.3 percent (see fig. 2).

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- In the government-insured or -guaranteed market segment, which represented about 10 percent of the mortgages being serviced, 4.8 percent of the loans were in default or foreclosure in the second quarter of 2008, up from 4.5 percent 3 years earlier. Additionally, foreclosure start rates in this segment increased modestly, from 0.7 to 0.9 percent.
 - ARMs accounted for a disproportionate share of the increase in the number of loans in default and foreclosure in the prime and subprime market segments over the 3-year period. In both the prime and subprime market segments, ARMs experienced relatively steeper increases in default and foreclosure rates, compared with more modest growth for fixed rate mortgages. In particular, foreclosure start rates for subprime ARMs more than quadrupled over the 3-year period, increasing from 1.5 percent to 6.6 percent.

Figure 2: Foreclosure Start Rates by Market Segment, Second Quarter 2005 through Second Quarter 2008

Foreclosure start rate

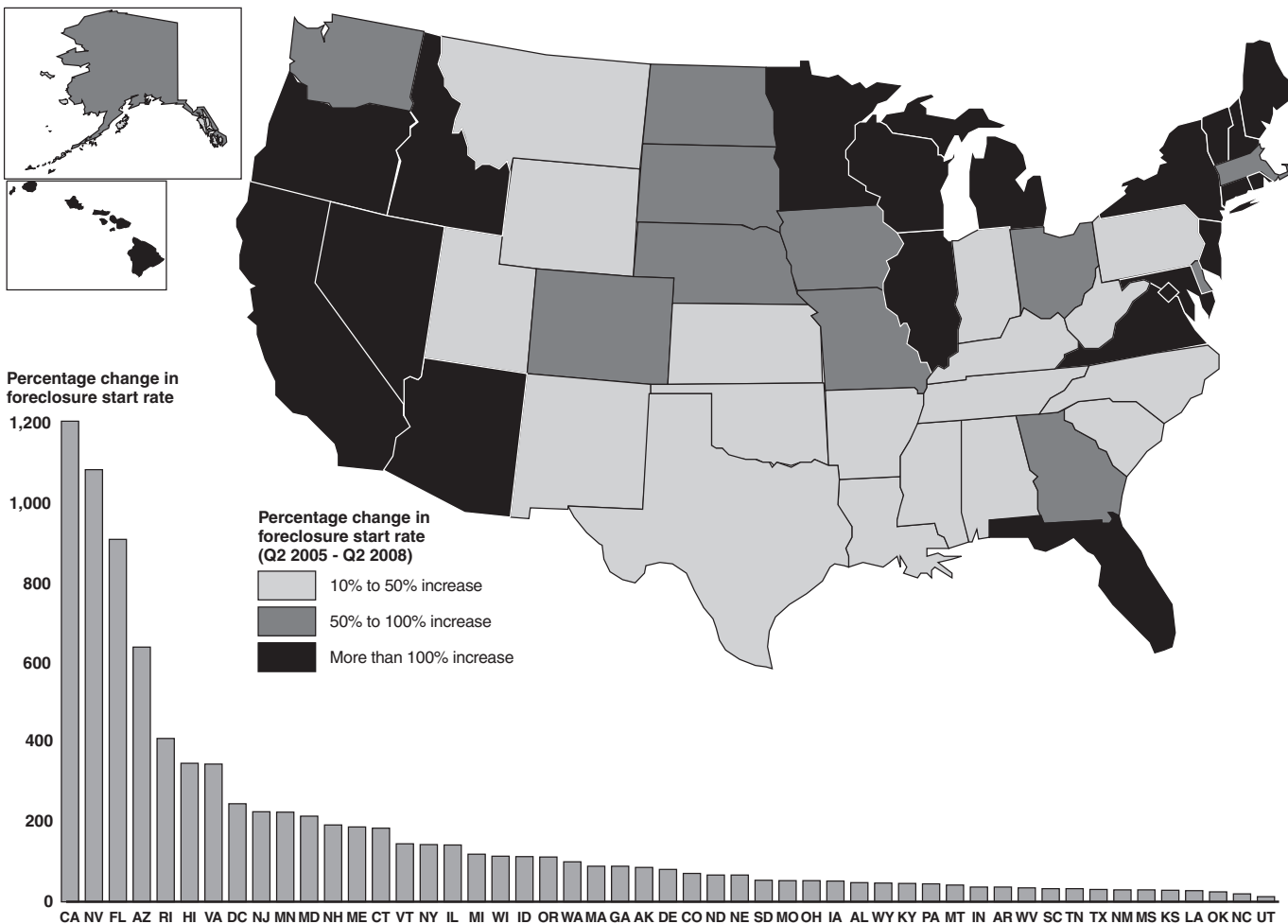


Source: GAO analysis of MBA data.

Default and foreclosure rates also varied significantly among states. For example, as of the second quarter of 2008, the percentage of mortgages in default or foreclosure ranged from 1.1 percent in Wyoming to 8.4 percent in Florida. Other states that had particularly high combined rates of default and foreclosure included California (6.0 percent), Michigan (6.2 percent), Nevada (7.6 percent), and Ohio (6.0 percent). Every state in the nation experienced growth in their foreclosure start rates from the second quarter of 2005 through the second quarter of 2008. By the end of that

period, foreclosure start rates were at their 29-year maximums in 17 states. As shown in figure 3, percentage increases in foreclosure start rates differed dramatically by state. The foreclosure start rate rose at least 10 percent in every state over the 3-year period, but 23 states experienced an increase of 100 percent or more. Several states in the “Sun Belt” region, such as Arizona, California, Florida, and Nevada, had among the highest percentage increases in foreclosure start rates. In contrast, 7 states experienced increases of 30 percent or less, including North Carolina, Oklahoma, and Utah.

Figure 3: Percentage Change in Foreclosure Start Rates by State, Second Quarter 2005 through Second Quarter 2008.



Sources: GAO analysis of MBA data; Art Explosion (map).

Some mortgage market analysts predict that default and foreclosure rates will continue to rise for the remainder of this year and into next year. The factors likely to drive these trends include expected declines in home prices and increases in the unemployment rate. The Alt-A market, in particular, may contribute to increases in defaults and foreclosures in the foreseeable future. According to a report published by the Office of the Comptroller of the Currency and the Office of Thrift Supervision, Alt-A mortgages represented 10 percent of the total number of mortgages at the end of June 2008, but constituted over 20 percent of total foreclosures in process.¹³ The seriously delinquent rate for Alt-A mortgages was more than four times the rate for prime mortgages and nearly twice the rate for all outstanding mortgages in the portfolio. Also, Alt-A loans that were originated in 2005 and 2006 showed the highest rates of serious delinquency compared with Alt-A loans originated prior to 2005 or since 2007, according to an August 2008 Freddie Mac financial report.¹⁴ This trend may be attributed, in part, to Alt-A loans with adjustable-rate mortgages whose interest rates have started to reset, which may translate into higher monthly payments for the borrower.

Treasury is Examining Options for Homeownership Preservation In Light of Recent Changes in the Use of TARP Funds

Treasury is currently examining strategies for homeownership preservation, including maximizing loan modifications, in light of a refocus in its use of TARP funds. Treasury's initial focus in implementing TARP was to stabilize the financial markets and stimulate lending to businesses and consumers by purchasing troubled mortgage-related assets—securities and whole loans—from financial institutions. Treasury planned to use its leverage as a major purchaser of troubled mortgages to work with servicers and achieve more aggressive mortgage modification standards. However, Treasury subsequently concluded that purchasing troubled assets would take time to implement and would not be sufficient given the severity of the problem. Instead, Treasury determined that the most timely, effective way to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks.

¹³U.S. Department of the Treasury, Comptroller of the Currency and Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report, Disclosure of National Bank and Federal Thrift Mortgage Loan Data*, January-June 2008.

¹⁴Freddie Mac, *Freddie Mac's Second Quarter 2008 Financial Results*, August 6, 2008.

The standard agreement between Treasury and the participating institutions in the CPP includes a number of provisions, some in the “recitals” section at the beginning of the agreement and other detailed terms in the body of the agreement. The recitals refer to the participating institutions’ future actions in general terms—for example, “the Company agrees to work diligently, under existing programs to modify the terms of residential mortgages as appropriate to strengthen the health of the U.S. housing market.” Treasury and the regulators have publicly stated that they expect these institutions to use the funds in a manner consistent with the goals of the program, which include both the expansion of the flow of credit and the modification of the terms of residential mortgages. But, to date it remains unclear how OFS and the regulators will monitor how participating institutions are using the capital injections to advance the purposes of the act. The standard agreement between Treasury and the participating institutions does not require that these institutions track or report how they use or plan to use their capital investments. In our first 60-day report to Congress on TARP, mandated by the Emergency Economic Stabilization Act, we recommended that Treasury, among other things, work with the bank regulators to establish a systematic means for determining and reporting on whether financial institutions’ activities are generally consistent with the purposes of CPP.¹⁵

Without purchasing troubled mortgage assets as an avenue for preserving homeownership, Treasury is considering other ways to meet this objective. Treasury has established and appointed an interim chief for the Office of the Chief of Homeownership Preservation under OFS. According to Treasury officials, the office is currently staffed with federal government detailees and is in the process of hiring individuals with expertise in housing policy, community development and economic research. Treasury has stated that it is working with other federal agencies, including FDIC, HUD, and FHFA to explore options to help homeowners under TARP. According to the Office of Homeownership Preservation interim chief, Treasury is considering a number of factors in its review of possible loan modification options, including the cost of the program, the extent to which the program minimizes recidivism among borrowers helped out of default, and the number of homeowners the program has helped or is projected to help remain in their homes. However, to date the Treasury has not completed its strategy for preserving homeownership.

¹⁵ [GAO-09-161](#).

Among the strategies for loan modification that Treasury is considering is a proposal by FDIC that is based on its experiences with loans held by a bank that was recently put in FDIC conservatorship. The former IndyMac Bank, F.S.B., was closed July 11, 2008, and FDIC was appointed the conservator for the new institution, IndyMac Federal Bank, F.S.B. As a result, FDIC inherited responsibility for servicing a pool of approximately 653,000 first-lien mortgage loans, including more than 60,000 mortgage loans that were more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying. On August 20, 2008, the FDIC announced a program to systematically modify troubled residential loans for borrowers with mortgages owned or serviced by IndyMac Federal. According to FDIC, the program modifies eligible delinquent mortgages to achieve affordable and sustainable payments using interest rate reductions, extended amortization, and where necessary, deferring a portion of the principal. FDIC has stated that by modifying the loans to an affordable debt-to-income ratio (38 percent at the time) and using a menu of options to lower borrowers' payments for the life of their loan, the program improves the value of the troubled mortgages while achieving economies of scale for servicers and stability for borrowers. According to FDIC, as of November 21, 2008, IndyMac Federal has mailed more than 23,000 loan modification proposals to borrowers and over 5,000 borrowers have accepted the offers and are making payments on modified mortgages. FDIC states that monthly payments on these modified mortgages are, on average, 23 percent or approximately \$380 lower than the borrower's previous monthly payment of principal and interest. According to FDIC, a federal loss sharing guarantee on re-defaults of modified mortgages under TARP could prevent as many as 1.5 million avoidable foreclosures by the end of 2009. FDIC estimated that such a program, including a lower debt-to-income ratio of 31 percent and a sharing of losses in the event of a re-default, would cost about \$24.4 billion on an estimated \$444 billion of modified loans, based on an assumed re-default rate of 33 percent. We have not had an opportunity to independently analyze these estimates and assumptions.

Other similar programs under review, according to Treasury, include strategies to guarantee loan modifications by private lenders, such as the HOPE for Homeowners program. Under this new FHA program, lenders can have loans in their portfolio refinanced into FHA-insured loans with fixed interest rates. HERA had limited the new insured mortgages to no more than 90 percent of the property's current appraised value. However, on November 19, 2008, after action by the congressionally created Board of Directors of the HOPE for Homeowners program, HUD announced that the program had been revised to, among other things, increase the

maximum amount of the new insured mortgages in certain circumstances.¹⁶ Specifically, the new insured mortgages cannot exceed 96.5 percent of the current appraised value for borrowers whose mortgage payments represent no more than 31 percent of their monthly gross income and monthly household debt payments no more than 43 percent of monthly gross income. Alternatively, the new mortgage may be set at 90 percent of the current appraised value for borrowers with monthly mortgage and household debt-to-income ratios as high as 38 and 50 percent, respectively. These loan-to-value ratio maximums mean that in many circumstances the amount of the restructured loan would be less than the original loan amount and, therefore, would require lenders to write down the existing mortgage amounts. According to FHA, lenders benefit by turning failing mortgages into performing loans. Borrowers must also share a portion of the equity resulting from the new mortgage and the value of future appreciation. This program first became available October 1, 2008. FHA has listed on the program's Web site over 200 lenders that, as of November 25, 2008, have indicated to FHA an interest in refinancing loans under the HOPE for Homeowners program. See the appendix to this statement for examples of federal government and private sector residential mortgage loan modification programs.

Treasury is also considering policy actions that might be taken under CPP to encourage participating institutions to modify mortgages at risk of default, according to an OFS official. While not technically part of CPP, Treasury announced on November 23, 2008, that it will invest an additional \$20 billion in Citigroup from TARP in exchange for preferred stock with an 8 percent dividend to the Treasury. In addition, Treasury and FDIC will provide protection against unusually large losses on a pool of loans and securities on the books of Citigroup. The Federal Reserve will backstop residual risk in the asset pool through a non-recourse loan. The agreement requires Citigroup to absorb the first \$29 billion in losses. Subsequent losses are shared between the government (90 percent) and Citigroup (10 percent). As part of the agreement, Citigroup will be required to use FDIC loan modification procedures to manage guaranteed assets unless otherwise agreed.

Although any program for modifying loans faces a number of challenges, particularly when the loans or the cash flows related to them have been bundled into securities that are sold to investors, foreclosures not only

¹⁶See <http://www.hud.gov/news/release.cfm?content=pr08-178.cfm>.

affect those losing their homes but also their neighborhoods and have contributed to increased volatility in the financial markets. Some of the challenges that loan modification programs face include making transparent to investors the analysis supporting the value of modification over foreclosure, designing the program to limit the likelihood of re-default, and ensuring that the program does not encourage borrowers who otherwise would not default to fall behind on their mortgage payments. Additionally, there are a number of potential obstacles that may need to be addressed in performing large-scale modification of loans supporting a mortgage-backed security. As noted previously, the pooling and servicing agreements may preclude the servicer from making any modifications of the underlying mortgages without approval by the investors. In addition, many homeowners may have second liens on their homes that may be controlled by a different loan servicer, potentially complicating loan modification efforts.

Treasury also points to challenges in financing any new proposal. The Secretary of the Treasury, for example, noted that it was important to distinguish between the type of assistance, which could involve direct spending, from the type of investments that are intended to promote financial stability, protect the taxpayer, and be recovered under the TARP legislation. However, he recently reaffirmed that maximizing loan modifications was a key part of working through the housing correction and maintaining the quality of communities across the nation. However, Treasury has not specified how it intends to meet its commitment to loan modification. We will continue to monitor Treasury's efforts as part of our ongoing TARP oversight responsibilities.

Going forward, the federal government faces significant challenges in effectively deploying its resources and using its tools to bring greater stability to financial markets and preserving homeownership and protecting home values for millions of Americans.

Mr. Chairman, this concludes my statement. I would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

Appendix I: Examples of Federal Government and Private Sector Residential Mortgage Loan Modification Programs

Institution	Program or Effort	Selected Program Characteristics
Federal Government Sponsored Programs		
Federal Deposit Insurance Corporation (FDIC)	IndyMac Loan Modification Program	<ul style="list-style-type: none"> Eligible borrowers are those with loans owned or serviced by IndyMac Federal Bank Affordable mortgage payment achieved for the seriously delinquent or in default borrower through interest rate reduction, amortization term extension, and/or principal forbearance Payment must be no more than 38 percent of the borrower's monthly gross income Losses to investor minimized through a net present value test that confirms that the modification will cost the investor less than foreclosure
Federal Housing Administration (FHA)	Hope for Homeowners	<ul style="list-style-type: none"> Borrowers can refinance into an affordable loan insured by FHA Eligible borrowers are those who, among other factors, as of March 2008, had total monthly mortgage payments due of more than 31 percent of their gross monthly income New insured mortgages cannot exceed 96.5 percent of the current loan-to-value ratio (LTV) for borrowers whose mortgage payments do not exceed 31 percent of their monthly gross income and total household debt not to exceed 43 percent; alternatively, the program allows for a 90 percent LTV for borrowers with debt-to-income ratios as high as 38 (mortgage payment) and 50 percent (total household debt) Requires lenders to write down the existing mortgage amounts to either of the two LTV options mentioned above
Federal Housing Finance Agency (FHFA)	Streamlined Loan Modification Program ¹	<ul style="list-style-type: none"> Eligible borrowers are those who, among other factors, have missed three payments or more Servicers can modify existing loans into a Freddie Mae or Fannie Mac loan, or a portfolio loan with a participating investor An affordable mortgage payment, of no more than 38 percent of the borrower's monthly gross income, is achieved for the borrower through a mix of reducing the mortgage interest rate, extending the life of the loan or deferring payment on part of the principal
Private Sector Programs		
Bank of America	National Homeownership Retention Program	<ul style="list-style-type: none"> Eligible borrowers are those with subprime or pay option adjustable rate mortgages serviced by Countrywide and originated by Countrywide prior to December 31, 2007 Options for modification include refinance under the FHA HOPE for Homeowners program, interest rate reductions, and principal reduction for pay option adjustable rate mortgages First-year payments mortgage payments will be targeted at 34 percent of the borrower's income, but may go as high as 42 percent Annual principal and interest payments will increase at limited step-rate adjustments
JPMorgan Chase & Co.	General loan modification options	<ul style="list-style-type: none"> Affordable mortgage payment achieved for the borrower at risk of default through interest rate reduction and/or principal forbearance Modification may also include modifying pay-option ARMs to 30-year, fixed-rate loans or interest-only payments for 10 years Modification includes flexible eligibility criteria on origination dates, loan-to-value ratios, rate floors and step-up adjustment features

¹This program was created in consultation with Fannie Mae, Freddie Mac, HOPE NOW and its twenty-seven servicer partners, the Department of the Treasury, FHA and FHFA.

Institution	Program or Effort	Selected Program Characteristics
JPMorgan Chase & Co. (Continued)	Blanket loan modification program	<ul style="list-style-type: none"> Eligible borrowers are those with short-term hybrid adjustable rate mortgages owned by Chase Chase locks in the initial interest rate for the life of the loan on all short-term adjustable rate mortgages with interest rates that will reset in the coming quarter
	American Securitization Forum Fast Track	<ul style="list-style-type: none"> Eligible borrowers are those with non-prime short term hybrid adjustable rate mortgages serviced by Chase Under the program developed by the American Securitization Forum Chase freezes the current interest rate for five years
Citi	Homeowner Assistance program	<ul style="list-style-type: none"> Eligible borrowers are those not currently behind on Citi held mortgages but that may require help to remain current Citi will offer loan workout measures on mortgages in geographic areas of projected economic distress including falling home prices and rising unemployment rates to avoid foreclosures
	Loan Modification Program	<ul style="list-style-type: none"> Affordable mortgage payment achieved for the delinquent borrower through interest rate reduction, amortization term extension, and/or principal forbearance According to Citi, program is similar to the FDIC IndyMac Loan Modification Program
HOPE NOW Alliance	Foreclosure prevention assistance programs	<ul style="list-style-type: none"> HOPE NOW is an alliance between Department of Housing and Urban Development (HUD) certified counseling agents, servicers, investors and other mortgage market participants that provides free foreclosure prevention assistance Forms of assistance include hotline services to provide information on foreclosure prevention, which according to HOPE NOW receives an average of more than 6,000 calls per day; and access to HUD approved housing counselors for debt management, credit, and overall foreclosure counseling Coordinates a nationwide outreach campaign to at-risk risk borrowers and states that it has sent nearly 2 million outreach letters Since March 2008, has hosted workshops in 27 cities involving homeowners, lenders, and HUD certified counselors

Source: Publicly available information from agencies and organizations listed above.

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