INTRODUCTION

In January 2007, March 2007, and August 2007, the Senate Banking Finance & Insurance Committee held informational hearings to investigate the causes of, and discuss potential solutions to, the mortgage market problems that beset California, with increasing severity, during 2007. The January and March hearings focused on lending practices and led to enactment of two bills: Senate Bill 385, which applied federal guidance documents on nontraditional and subprime mortgage lending to state-regulated mortgage lenders and brokers; and Senate Bill 223, which made it a violation of state law to improperly influence or attempt to improperly influence an appraiser in connection with a real estate transaction. This Committee's August 2007 informational hearing focused on homeownership preservation, a topic this Committee revisits with a heightened sense of urgency in January 2008.

On January 16, 2008, the Committee will review the foreclosure avoidance plans announced by Governor Schwarzenegger, President Bush, and Federal Deposit Insurance Corporation (FDIC) Chair Sheila Bair late last year. We will explore the extent to which these plans will help California borrowers at risk of losing their homes and the extent to which significant numbers of California borrowers remain out in the cold, ineligible for the plans, and unable to refinance their unaffordable mortgages in today's credit environment. We will also hear from several housing counselors who are at the center of efforts to help connect borrowers with loan servicers. These counselors will share their opinions about whether the situation for borrowers has improved since last August, when it was, in the words of all of the counselors from which this Committee heard, dismal.

The background paper below describes a number of homeownership preservation initiatives and proposals that have been announced since our Committee's last hearing on the topic. The paper is presented in chronological order, to avoid any suggestion that the order of discussion is intended to rank the different proposals.

Before presenting the proposals, however, it is critical to review three recurring themes this Committee encountered during its 2007 informational hearings. Taken together, the three themes frame the mortgage-related discussions the Committee will have during 2008.

Theme Number 1: Critical underfunding of non-profit housing counselors

Non-profit housing counselors and counseling organizations are playing a significant role in providing foreclosure avoidance counseling, explaining loan terms to borrowers, acting as a communications channel between borrowers and their lenders or loan servicers, and helping borrowers negotiate affordable loan modifications.

Anecdotal stories abound about borrowers who contact their servicers and fail to receive responsive treatment. Yet, when these borrowers seek the assistance of a housing counselor, who calls the servicer on the borrower's behalf, the same servicer becomes much more willing to work constructively with the borrower on a plan to help the borrower avoid foreclosure. Privately, servicers acknowledge that they would prefer to work through a housing counselor, because counselors will evaluate a borrower's financial situation before phoning a servicer.

Once a housing counselor calls a servicer, the servicer knows that the counselor has assembled the necessary financial paperwork and evaluated the borrower's financial situation. The likelihood of a borrower successfully negotiating a loan modification or short sale with his or her servicer increases if a housing counselor is involved.

Many borrowers will also actively avoid talking to their lenders or servicers, but will willingly solicit the assistance of a housing counselor through a toll-free hotline or a neighborhood town hall or mortgage assistance workshop. For these borrowers, a housing counselor is a much less threatening way of seeking help.

Recognizing the value that counselors and counseling organizations bring to foreclosure prevention efforts, policymakers are strongly recommending that borrowers seek out the services of third-party housing counselors and counseling hotlines. Policymakers are scheduling town halls and mortgage assistance workshops at which housing counselors are being asked to participate and issuing public service announcements encouraging borrowers to seek out toll-free housing counseling hotlines or local non-profit, U.S. Department of Housing and Urban Development (HUD)-approved housing counselors.

Housing counselors are also independently scheduling workshops for consumers, with an aim to helping them with mortgage-related problems.

Yet, with all of the emphasis being placed on counselors, no state funding has been allocated for use by HUD-approved housing counselors in their homeownership preservation efforts, and federal funding for counseling efforts has gone down rather than up (California's share of HUD funding decreased from $1.1 million in federal fiscal year (FY) 06-07 to $852,000 in federal fiscal year 07-08).

Although the governor announced plans to redirect slightly over $1 million in federal community development block grant funding to California housing counselors last year, he did not propose to allocate any state funding for counseling efforts. Instead, and somewhat ironically, he allocated $1.2 million in consumer outreach and education funding for public service announcements urging people to seek the assistance of third party counselors.

Very recently, Congress has begun taking steps to help address some of the funding shortfalls, but the impact of Congress' actions on California remains unclear. On December 26, 2007, President Bush signed the FY08 Consolidated Appropriations bill, which allocated $180 million nationwide to NeighborWorks America to administer a national mortgage foreclosure mitigation counseling program. Under the federal legislation, NeighborWorks America will make some money ($27 million of the total) available directly to local NeighborWorks organizations across the country, use up to $5 million to provide foreclosure counseling training courses, and allocate the remainder through grants to housing counseling intermediaries approved by HUD and to qualifying state housing finance agencies. The appropriations bill requires NeighborWorks to allocate $50 million within 60 days of the bill's enactment to states and areas with the greatest need.

It is unknown how much of the $180 million California will receive, nor how our funding will be split between the money that will be available within 60 days and the remainder, which will be distributed over the course of the year. The California Business, Transportation, and Housing Agency is spearheading the state's effort to bring the maximum amount of funding to California. More information on how the $180 million will be allocated is contained in Appendix A.

Conclusion: At the same time state and federal policymakers are recommending that borrowers in trouble seek out housing counselors, and at the same time we are increasingly learning that housing counselors are much better able to arrange successful workouts with servicers than are borrowers acting alone, there is insufficient money available to counselors to handle their significantly increased workload.

<u>Theme Number 2: Lack of market liquidity</u>

Much has been written, and both federal and international action has been taken, to "improve market liquidity," but many individuals fail to understand the importance of market liquidity to California's ability to grow its way out of our current mortgage crisis.

Generally speaking, liquidity relates to the availability of money. In a highly liquid lending environment like the one that characterized California's mortgage boom years, credit is both easy and inexpensive to obtain. Increasingly during 2007, as financial institutions recognized billions of dollars in losses on mortgage loans in their own portfolios, they tightened their lending standards. Investors, some of whom were losing money on mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) in their portfolios, and some of whom were looking at the losses of others, became unwilling to purchase any more MBSs or CDOs. Furthermore, because many of these securities were sold all over the globe, there was increasing uncertainty within the financial world about which investors were left holding the riskiest securities. Taken together, these market responses restricted the amount of money available to fund mortgage lending.

Financial institutions also helped fuel the credit crunch through their increasing hesitance to lend to one another. Bank-to-bank lending is ordinarily quite common, because all banks must maintain a certain level of cash reserves at all times, and day-to-day ebbs and flows of funds cause some banks to have excess reserves on some days, and other banks to be short on reserves during some days. Normally, banks lend to one another at relatively low rates called overnight rates to reflect their short-term nature. Now, however, many banks are hoarding their cash out of concerns over the direction of the markets, further restricting the free flow of funds. Not only are banks more hesitant to lend to each other, they are also more hesitant to lend to their business customers. The recent decisions of some companies to issue new stock is a reflection of their inability to raise sufficient cash from their banks. The recent actions of the Federal Reserve Board to auction off funds are an indication of its desire to provide ample short-term cash to lending institutions, in hopes of improving liquidity. Recent declines in the stock market have reflected overall investor uncertainty about the state of the U.S. economy

The combination of all of the above has dried up the availability of funds for borrowers wishing to refinance out of unaffordable mortgages. Declining housing prices have increased borrowers' loan-to-value ratios and/or debt-to-income ratios to levels above those that lenders are willing to carry, making it impossible for many borrowers to refinance based on the values of their homes. This factor has been complicated by lenders' decisions to tighten their underwriting standards, relative to 2005 and 2006. Many lenders are simply unwilling to make the same loan that they may have made two years ago, when the borrower first obtained his or her hybrid ARM.

Another complicating factor is that lenders lack the cash with which to make many loans. Secondary market interest in most U.S. MBS' has dried up, forcing lenders to hold increasing numbers of loans in their portfolios. Every loan a lender holds in its portfolio requires the lender to reserve a certain amount of money, to guard against the loan going bad. A consequence is that lenders are running up against reserve caps; they own all the loans they can or wish to hold, and before they can make new loans, the loans in their portfolios must either pay off or be sold.

California's high housing prices have made it more difficult to refinance here than in many other areas of the country. The conforming loan limit (i.e., the limit on loans that Fannie Mae and Freddie Mac are allowed to purchase or guarantee) is $417,000. Many loans in California far exceed that number. Fannie and Freddie have been able to prop up the secondary market for conforming loans to a certain extent, but are unable to do the same for jumbo loans (i.e., loans that exceed the conforming loan limit). Many borrowers in California with jumbo loans are essentially out of luck, unless they have stellar credit and a significant amount of equity.

Conclusion: The relative inability of many borrowers to refinance leaves only four options for many borrowers in unaffordable mortgages – a loan modification, forbearance plan, short sale, or a foreclosure. In better economic times, California would have been able to grow itself out of its mortgage woes, because California borrowers would have been able to refinance out of unaffordable mortgages. That is no longer possible in today's credit environment.

<u>Theme Number 3: The tension among loan servicers, borrowers, investors, housing counselors, and lawmakers over modification of securitized loans</u>

During this Committee's August 2007 hearing, the Committee heard from several experts knowledgeable about the securitization of mortgage loans. Witnesses testified that mortgage loans held in portfolio by their lenders were much more easily modified than securitized loans; the same witnesses also testified that securitized loans could be modified by their servicers, if certain contractual conditions were met. (Readers interested in a more complete discussion of the constraints that can hamper the modification of securitized loans are directed to the background paper developed for this Committee's August 2007 hearing. That background paper is available from the Committee office or on this Committee's website at http://www.senate.ca.gov/ftp/sen/committee/standing/banking/info_hearings/backgrounds/8-21-07_preserving_the_dream.doc).

Pooling and servicing agreements (PSAs) or servicing agreements (SAs) establish the contractual obligations of servicers to the investors who hold securitized loans. The Committee learned last August that the PSAs and SAs for most subprime securitizations authorize the servicer to modify loans that are either in default or for which default is either imminent or reasonably foreseeable.

According to the American Securitization Forum (ASF), the terms “imminent” and “reasonably foreseeable” are interpreted synonymously by most market participants.

Once a servicer determines that a securitized loan is in default or is likely to default using the imminent or reasonably foreseeable standard, that servicer must determine what action on that loan is in the best interest of the security holders (i.e., the servicer must determine what action will maximize the net present value of the security to the securityholders).

Some borrowers with ARMs that are about to reset or that have recently reset to levels the borrowers cannot afford will be able to refinance into more affordable loans. Despite the liquidity crisis described above, borrowers who have improved their credit scores since they obtained their subprime loans (or borrowers who had relatively good credit scores when they obtained their loans and have retained or improved these scores) should be able to refinance in today’s credit environment, as long as they still have some equity in their home and have not taken on significant amounts of new debt since they obtained the loan they now hold. Servicers have an incentive to see a borrower refinance out of an unaffordable loan product into an affordable loan product, because a borrower who refinances, and in doing so pays off his or her original mortgage, fully reimburses the principal owed to the securitization trust. Investors do not receive the interest payments they might otherwise have received, but they are guaranteed a return of principal, something they would not receive in today’s housing market if the loan went to short sale or foreclosure.

When a servicer encounters a borrower who is unable to refinance out of an unaffordable ARM, the servicer must determine whether a loan modification, forbearance plan, short sale, or foreclosure will result in the greatest return to investors. If the servicer determines that a modification is in order, the servicer must also determine what modification terms will provide the greatest return to the investors. In order to do this, the servicer is obligated to determine the maximum payment a borrower can afford under the terms of a modification.

Some borrowers will only be able to afford their initial, introductory interest rates, and no more. However, some borrowers may not be able to afford their rate reset, but could afford, in the long-term, an interest rate higher than their current, introductory interest rates; in these cases, the servicer is contractually obligated (to the investors) to charge the borrower the highest rate the borrower can afford in the long-term.

This need to establish the maximum amount each borrower is able to afford causes many servicers to undertake a very careful review of each borrower’s financial situation before offering a loan modification, a practice that can be extremely time-consuming. Most servicers have had trouble hiring enough qualified staff to perform these reviews, which has resulted in extremely high workloads among the staff who do this type of work.

The inability of servicers to fast-track decisions on loan modifications has led to great frustration among borrowers, lawmakers, consumer advocates, and housing counselors, who view servicers’ actions to date as unresponsive and irresponsible. Those with the borrowers’ interests foremost in their minds have called on servicers to initiate streamlined, standardized modifications of certain types of loans and to offer loan modifications that provide long-term affordability and homeownership preservation. These calls for servicer action stress the widespread dangers of allowing large numbers of loans to enter default and foreclosure, not only to the borrowers who lose their homes to foreclosure and see their credit tarnished, but to the neighbors whose housing values are depressed, and to the local and state economies that rely on a healthy housing market.

Those who express frustration and anger at servicers cite data such as the following:

- In December 2007, Moody's Investors Service estimated that only 3.5% of all subprime loans outstanding as of September 30th had been modified by servicers during the time period studied, a slight improvement over the 1% number issued by Moody's in September;

- Recent RealtyTrac figures identify California as ground zero for the nation's foreclosures. During the third quarter of 2007, one quarter of the nation's foreclosure filings – nearly 150,000 homes -- were in California. Seven of the top sixteen metropolitan areas with the highest rates of foreclosure nationwide are in California, in the Stockton, Riverside/San Bernardino, Sacramento, Bakersfield, Oakland, Fresno, and San Diego metropolitan areas.

- Recent Mortgage Bankers Association figures show national delinquency rates at their highest level in 21 years. The rate of foreclosure starts and the percentage of loans in the process of foreclosure were at their highest levels ever during the third quarter of 2007.

If servicers do not uphold their contractual obligations to investors, they risk being sued by the investors who hold the loans. Thus, servicers face a dilemma: either undertake the time-consuming process of evaluating every borrower's financial situation on a loan-by-loan basis and withstand the wrath of those upset at the slow pace of your actions or streamline the modification of certain loans in your servicing portfolio and risk being sued by investors with concerns that the streamlining process hampered your ability to maximize the net present value of those loans to the securitization trust. It is not an exaggeration to say that the threat of investor lawsuits is crippling many servicers in their attempts to modify loans rapidly enough to satisfy their critics.

Conclusion: This unresolved tension between servicers' contractual obligations and what many believe are the servicers' moral obligations to act swiftly to preserve homeownership for many borrowers is perhaps the most significant issue facing this Committee and this state in 2008.

CHRONOLOGY OF KEY FORECLOSURE-AVOIDANCE ACTIONS TAKEN SINCE THIS COMMITTEE'S LAST INFORMATIONAL HEARING

The pages below summarize key actions taken by government agencies, mortgage industry participants, and consumer advocates since this Committee's last informational hearing on homeownership preservation. They are presented in chronological order.

CREATION OF THE FHA SECURE PROGRAM

On August 31, 2007, President Bush, HUD Secretary Alphonso Jackson, and Department of the Treasury Secretary Henry Paulson announced the creation of a new program within the Federal Housing Administration (FHA) called FHASecure. FHASecure is intended to allow certain homeowners having trouble making their mortgage payments to refinance into more affordable loans. Introduced at a time when very few mortgage lenders were willing to refinance borrowers who were in trouble, the program was intended to help increase market liquidity.

FHA, which is part of HUD, does not issue mortgages; instead, it insures them. Like other types of mortgage insurance, FHA mortgage insurance protects lenders against loss if the homeowner defaults on his or her mortgage loan. However, unlike conventional loans, FHA-insured loans require small down payments (usually no more than 3%). FHA loans also allow lower household incomes and higher debt-to-income ratios than conventional loans.

FHASecure is targeted to homeowners in non-FHA insured, adjustable rate mortgages (ARMs) who have a history of on-time mortgage payments under their loans' initial starter interest rates, but who become delinquent on their loans after their interest rates reset. FHASecure allows these homeowners to refinance into FHA-insured loans issued by a range of FHA-approved lenders. The program is also open to borrowers with Option ARMs who became delinquent after their loans were recast to fully amortizing loans by the lender. Homeowners who are current on their ARMs, but who expect to become delinquent on those mortgages after their interest rates reset, or after the loans recast to fully amortizing loans, are also being encouraged by FHA to apply.

Under FHA Secure, there is no limit to how far behind a borrower may be on his or her mortgage, nor on how many payments he or she may have missed. However, the amount a borrower is able to refinance depends on the value of the property, the amount still owed on the mortgage, and whether the lender is willing to take back a second mortgage to help bridge the gap between what a borrower owes and what the home is worth. Of special significance in a high-cost state like California, the size of an FHA-insured loan cannot exceed FHA's loan limits, which are geographically based. A listing of FHA loan limits in all of California's counties is included in Appendix B. The maximum FHA loan limit in California is $362,790; limits in some of our counties are as low as $200,160.

When the program was announced, HUD estimated that up to 300,000 borrowers nationwide could be eligible to refinance through FHASecure by the end of 2008. To date, approximately 50,000 borrowers have refinanced their loans through FHASecure. It is unknown how many of those borrowers are located in California.

Legislation that would modernize FHA and increase FHA's loan limits is currently pending in Congress. FHA modernization bills that would, among other things, increase FHA's loan limits to the conforming loan limit (currently $417,000), decrease the required down payment from 3% to 1.5%, and change the rules by which FHA calculates mortgage insurance premiums, have passed both the House and the Senate. The bills are currently awaiting a House-Senate conference, expected by many to be convened as early as January 2008.

CREATION OF THE HOPE OWNERSHIP PRESERVATION INITIATIVE

In August 2007, in recognition of the significant funding shortfall faced by many housing counselors, the California Reinvestment Coalition (CRC) launched the California Home Ownership Preservation Initiative (CHOPI). CHOPI is a two-year, $10 million statewide grant initiative designed to increase the capacity of California nonprofit organizations that offer mortgage counseling to low- and moderate-income homeowners. The $10 million program is intended to fund 100 counselors, an amount that CRC believes is the minimum number necessary to make a significant difference in the housing crisis. CRC estimates that 100 counselors can reach out to 150,000 borrowers and help 40,000 of these borrowers avoid foreclosure. To date, CRC has raised approximately $4.6 million for its initiative and will continue to solicit funds until it reaches its $10 million goal. Among the contributors to the fund to date: Merrill Lynch, HSBC, Wachovia, Comerica, Countrywide, Citigroup, Wells Fargo, and Bank of America. All of the funds available for the initiative will be dispersed by the San Francisco Foundation or the California Community Foundation to mortgage counselors. CRC will begin distributing requests for proposal on January 14th, 2008. It expects the average grant to be $100,000 over two years, to support counseling for foreclosure avoidance.

SHEILA BAIR'S RATE-FREEZE PROPOSAL

On October 4, 2007, while speaking before an investor conference in New York, Federal Deposit Insurance Corporation (FDIC) Chairman Sheila Bair suggested that servicers freeze the starting (introductory) interest rates on subprime hybrid ARMs and convert the loans to fixed rate mortgages. "Keep it at the starter rate. Convert it into a fixed rate. Make it permanent. And get on with it. These subprime starter rates are above market already. If investors had looked at the underwriting criteria that has been applied to these mortgages, I don't think anybody would have had a reasonable expectation that they were going to be making payments at the reset rate."

In interviews with the press the day after announcing her proposal, Ms. Bair stated that her comments before the investor conference reflected a newfound sense of urgency she felt after reading a September 2007 Moody's Investors Service Inc. report. In that report, Moody's found that servicers had modified only about 1% of loans that reset in January, April, and July. Ms. Bair felt that the survey was a wake-up call, and that decisive action by industry was necessary to forestall measures likely to have more deleterious effects on industry than her proposal. "If the industry doesn't do it themselves, either Congress is going to do it for them, or a bankruptcy judge is going to do it for them," she said, referring to federal proposals that would allow bankruptcy courts to modify mortgages. "I'm trying to make one suggestion at least for a certain category of loans where I perceive these to be more sympathetic borrowers and show policymakers that the industry is working to find a solution."

Since she made her remarks, Ms. Bair's "rate freeze proposal" has been widely referenced by many players in the mortgage arena. Many newspaper editorial boards, policymakers, and consumer advocates have come out in support of Ms. Bair's idea. Some servicers have also expressed support in concept, but at the same time expressed their concerns over being challenged by investors for making too many "automatic" modifications. To date, no servicers have committed to following Ms. Bair's rate freeze proposal on their entire pool of securitized, subprime hybrid ARMs.

COUNTRYWIDE'S $16 BILLION HOME PRESERVATION PLAN

On October 23, 2007, Countrywide Financial Corporation announced a plan to help many of its borrowers keep their homes by reaching out to borrowers at risk of default. This plan is summarized in this background paper, because it is the largest of its type announced by any servicer operating in California, and because Countrywide is believed to service more Californians' loans than any other servicer.

The premise of Countrywide's initiative was characterized as follows by David Sambol, Countrywide's President and Chief Operating Officer: "Countrywide believes that none of our subprime borrowers that have demonstrated the ability to make payments should lose their home to foreclosure solely as a result of a rate reset."

Beginning in October, Countrywide launched an outbound calling initiative targeted at customers who are current on their loans and are approaching a rate reset on an adjustable rate loan. The plan is for Countrywide to refinance or modify up to $16 billion in loans for borrowers facing interest rate resets between now and the end of 2008.

The program has three components:

1) $10 billion in mortgages will be refinanced into prime or FHA loans. Countrywide estimates that approximately 52,000 of its borrowers who are currently in subprime loans, but who have strong payment histories, will be eligible to refinance their loans. Countrywide plans to contact all 52,000 borrowers to offer refinance options.

2) $4 billion in loans held by 20,000 borrowers will be modified. Countrywide will work to identify and contact both prime and subprime borrowers who are current on their mortgages but unable to qualify for a refinance and unlikely to be able to afford their upcoming rate resets. The outreach effort will include both an early notification letter prior to reset, followed up with a call no later than three months prior to the reset to evaluate borrowers' financial circumstances and work with them to develop affordable solutions.

3) $2.2 billion in loans held by 10,000 additional borrowers will receive pre-approved rate reductions. For borrowers who are currently delinquent on their loans and experiencing financial difficulties as a result of a recent interest rate reset, Countrywide will be offering a simplified loan modification process. Each borrower who qualifies for this program will receive a letter offering a pre-determined, pre-approved rate reduction.

In its press release describing the plan, Countrywide listed a toll-free number for its home retention team and encouraged its customers who are facing an increase in their mortgage payment or who fear falling behind on their mortgages to call. That number is 1-800-669-6650.

On December 21, 2007, Countrywide announced the results of its loss mitigation efforts. Through the first eleven months of 2007, the company helped 69,000 of its customers retain their homes through solutions such as loan modifications, long-term repayment plans, special forbearance plans, and other options. The vast majority of these borrowers (45,735) received loan modifications. Countrywide helped an additional 8,000 borrowers avoid foreclosure through short sales or deeds-in-lieu. Countrywide did not release information on how many of its borrowers lost their homes to foreclosure during the same time period. However, using a different information release obtained from the company's web site, staff determined that as of November 2007, less than 1% (0.94%) of Countrywide's approximately 9 million outstanding loans were in foreclosure. (Running the calculations, a total of 84,798 loans were in foreclosure as of November). According to Countrywide representatives, approximately ten percent of Countrywide's 9 million loans are subprime. It is not known how many of the loans in foreclosure represent subprime ARMs.

GOVERNOR SCHWARZENEGGER'S SUBPRIME MORTGAGE AGREEMENT

On November 20, 2007, Governor Schwarzenegger announced that he had reached an agreement (referred to herein as the Schwarzenegger Agreement) with four state-regulated financial institutions, who together service one quarter of all subprime loans held by Californians. The four institutions include Countrywide, GMAC, Litton, and HomeEq. Since the initial announcement, three more servicers have signed onto the agreement, including Wilshire Credit Corporation, Home Loan Services (which services loans for First Franklin Bank), and Carrington Mortgage Services (which purchased the servicing arm of New Century from a bankruptcy court in mid-2007). Together, these seven servicers service over one third of subprime loans held by Californians.

The Schwarzenegger Agreement, which is directed towards subprime borrowers with hybrid ARMs, includes three basic principles. Lenders who sign onto the Agreement agree to:

1) Reach out proactively to borrowers well before their loans reset;

2) Streamline the processes by which they determine whether borrowers may reasonably be expected to be able to make their reset payments; and,

3) Fix loans at their starter rate for a sustainable period of time for borrowers who are in their homes, currently making timely payments at their loan's starter rate, but who will be unable to afford their reset payments.

In a press release touting the Agreement, the Governor noted that his Agreement built off of Sheila Bair's rate freeze proposal. The Governor estimated that 500,000 Californians have subprime loans that will reset to higher rates during the next two years and will potentially be helped by the Agreement (Committee staff notes that this estimate compares to nationwide estimates of 2 to 2.5 million borrowers nationwide with ARMs scheduled to reset by the end of 2008).

In announcing his Agreement with servicers, the Governor also announced his decision to reallocate $1.2 million in existing state funding for consumer education efforts to a statewide outreach campaign targeted at troubled borrowers. During the campaign, the state will run public service announcements and will partner with local leaders and other organizations like churches and community groups to get out the following message: Borrowers have several alternatives to foreclosure, but must reach out to their lenders and/or seek out the assistance of nonprofit housing counselors if they are having trouble making their mortgage payments and would like to avoid foreclosure.

DEPARTMENT OF CORPORATIONS' ROLE IN FORECLOSURE PREVENTION

The Schwarzenegger Agreement was an outgrowth of discussions that California Department of Corporations (DOC) Commissioner Preston DuFauchard began having with California-regulated servicers in September 2007. Shortly after this Committee's August 2007 informational hearing, and in direct response to Chairman Machado's demand for more action on the part of California's regulators to facilitate foreclosure prevention actions by state licensees, Commissioner DuFauchard surveyed all of DOC's mortgage-related licensees for information about their servicing and foreclosure prevention efforts through September 30th of this year. Results of this survey, together with an analysis of survey data by the Commissioner, are included in Appendix C.

During the process of developing the survey, Commissioner DuFauchard held conversations with executives of all of the servicing firms regulated by DOC and with many federally-regulated servicers. The Commissioner's goal in having these conversations was to develop a survey form that collected information which would be useful to policymakers. Going into these conversations, the Commissioner knew that different servicers have different definitions for the same activity. For example, some servicers define a loan modification as one that lasts for a period of at least three years; other servicers use a definition of five years or longer. His goal in making personal contact with the servicers was to learn enough about the servicing vernacular to craft a survey form that would generate answers from different servicers which could be compared with one another.

In addition to developing a robust survey form, the Commissioner forged relationships with several of these servicers. It was those relationships that set the groundwork for the Governor's invitation to sign onto his Agreement.

FORMATION OF THE HOPE NOW ALLIANCE

On October 10, 2007, Secretary of the Treasury Paulson and HUD Secretary Jackson announced the formation of the HOPE NOW alliance. HOPE NOW is a collaboration of credit and homeownership counselors, mortgage servicers, and mortgage market participants, formed at the request of Secretaries Paulson and Jackson to achieve three goals:

1) Explore a variety of methods to reach out to at-risk homeowners, including a direct-mail campaign to encourage at-risk borrowers to call their mortgage servicer or a credit

counselor;

2) Work to improve communications between servicers and non-profit counselors, to speed outreach and develop and explain options for at-risk borrowers; and

3) Develop standards with investors to enable counseling sessions for homeowners to be funded by servicing contracts.

HOPE NOW's mission is "to maximize the preservation of homeownership while minimizing foreclosures, and assist borrowers who have the willingness and wherewithal to remain in their homes but need some help to do it. The goal is to keep people in their homes and, when that is not possible, prevent foreclosure."

HOPE NOW's first mass mailing of letters encouraging at-risk homeowners to contact their mortgage servicer or a credit counselor was sent beginning on November 19th and was intended to target over 200,000 mortgage holders with past-due accounts. A second round of letters to at-risk borrowers was sent beginning on December 19th to an unspecified number of at-risk borrowers. Copies of these letters are included in Appendix D.

Members of the HOPE NOW Alliance include the American Financial Services Association, American Securitization Forum, Assurant, Inc, Bank of America, CCCS Atlanta, Inc., Citigroup, Inc., Consumer Bankers Association, Consumer Mortgage Coalition, Countrywide Financial Corporation, Fannie Mae, the Financial Services Roundtable, First Horizon National Corporation, Freddie Mac, GMAC ResCap, Homeownership Preservation Foundation, Housing Partnership Network, The Housing Policy Council, HSBC Finance, JP Morgan Chase & Co., National City, NeighborWorks America, Mortgage Bankers Association, Option One Mortgage, PMI Mortgage Insurance Co., Securities Industry and Financial Markets Association, State Farm Insurance Companies, Sun Trust Mortgage, Inc., Washington Mutual, Inc., and Wells Fargo & Company. HOPE NOW participants include servicers who cover 85% of currently outstanding subprime mortgages.

STATEMENT ON REIMBURSING COUNSELING EXPENSES FROM SECURITIZATION CASHFLOWS

Also on October 10, 2007, ASF published a Statement on Reimbursement of Counseling Expenses in Residential Mortgage-Backed Securitizations. A copy of this document is included as an appendix to the document reproduced in this report in Appendix E.

In its October 2007 document, ASF gave a boost to housing counselors by concluding that the work of housing counselors in foreclosure mitigation can help servicers preserve the net present value of investors' holdings in certain circumstances. In making this finding, ASF laid groundwork allowing servicers to reimburse housing counselors for their loss mitigation efforts. Specifically, ASF concluded that borrower counseling expenses are reimbursable from securitization trust cashflows for loans in default or where default is reasonably foreseeable, and where the servicer concludes, in its reasonable judgment, that the related counseling service had or is likely to have the effect of mitigating losses and maximizing recoveries on the particular loan.

The securitization trust cashflows to which ASF referred are the cashflows from loans that are not in default (i.e., servicers may use cash on hand from mortgages that continue to pay in order to reimburse housing counselors for their efforts to help negotiate workable solutions for borrowers who are in trouble on their loans; the rationale is that the trust and its investors own both the current and the troubled loans, so using money from current loans to help maximize the net present value of the troubled loans is in the best interest of the investors in the aggregate). In its October 2007 statement, ASF notes that counseling can help bridge gaps between servicers and borrowers by educating borrowers about their options and mediating potentially adversarial situations. The ASF specifically issued its October 2007 guidance in order to further facilitate the wider and more effective use of loan modifications and other loss mitigation tools.

THE BUSH/PAULSON/HOPE NOW ALLIANCE FORECLOSURE AVOIDANCE PLAN

On December 6, 2007, President Bush announced that representatives of the HOPE NOW alliance had developed a plan under which up to 1.2 million homeowners could be eligible for some form of mortgage relief. The plan is aimed at subprime borrowers with hybrid ARMs, who can afford the starter rate on their mortgages, but will not be able to afford their payments once their interest rates reset. Details of the plan are contained in a document prepared by ASF titled, "Streamlined Foreclosures and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans," a copy of which is included in Appendix E. A question and answer document issued on December 17, 2007 by ASF to help people better understand the HOPE NOW plan is also included in Appendix E. In the discussion below, the HOPE NOW plan will be referred to as the "streamlined framework," because that is the name used by ASF throughout its explanatory document.

The streamlined framework applies to all first lien subprime residential ARMs that have an initial fixed rate period of 36 months or less and that meet all of the following criteria:

1) Originated between January 1, 2005 and July 31, 2007;

2) Included in securitized pools;

3) Have an initial interest rate reset between January 1, 2008 and July 31, 2010.

Generally speaking, the framework applies to subprime hybrid ARMs known colloquially as 2/28s and 3/27s.

Servicers using the streamlined framework are directed to divide borrowers with these types of loans into three segments, as described below. The streamlined framework is based on the assumption that borrowers who have Segment 1 loans will either be able to afford their interest rate resets or will be able to refinance these loans into other, more affordable products; borrowers who have Segment 2 loans may be candidates for a streamlined modification if the borrowers meet additional criteria discussed below; and borrowers who have Segment 3 loans require additional scrutiny by a servicer before appropriate action by the servicer can be determined.

The loan segmentation criteria is described below:

Segment 1 includes current loans where the borrower is likely to be able to refinance into any available mortgage product, including an FHA loan, FHA Secure loan, or another readily available mortgage industry product. If a borrower also has a second lien on the property, as is true of many California borrowers, the streamlined framework assumes that the borrower is able to refinance the first lien only, on a "no cash out" basis. For this reason, in order for a loan to meet the criteria to be included in Segment 1, the borrower's second lien holder must agree to subordinate its interest to the refinanced first lien.

Segment 2 includes current loans where the borrower is unlikely to be able to refinance into any readily available mortgage industry product. Criteria used by HOPE NOW participants to include a loan in this segment are as follows:

1) The loan must not be more than 30 days delinquent and must not have been more than 60 days delinquent during the last 12 months. More than one 60 day delinquency during the last 12 months disqualifies the loan from inclusion in Segment 2;

2) The loan must have a loan-to-value ratio greater than 97%, based on the first lien only (i.e., a borrower with an 80% first lien and a wraparound second lien would be ineligible for inclusion in Segment 2 unless the value of his or her home had fallen so low that the 80% first lien had grown to 97% of the value of the property);

3) The loan must not be eligible for FHA Secure (see FHA Secure discussion above).

Segment 3 includes loans where the borrower is not current and is having trouble meeting his or her initial introductory rate payment obligations.

Once a servicer identifies loans that meet the criteria for inclusion in Segment 2, the streamlined framework directs the servicer to evaluate the borrower before determining whether a streamlined loan modification can be performed pursuant to the framework. A borrower whose loan meets the criteria for inclusion in Segment 2 must meet the following three criteria in order to qualify for a streamlined modification:

1) The borrower must occupy the property as his or her primary residence. If a loan falls into Segment 2, but the borrower does not live in the property that secures the loan, streamlined modification is not indicated.

2) The borrower must have a FICO score below 660, and must not have improved his or her FICO score by more than 10% since obtaining the loan.

3) The borrower's monthly payment must increase by more than 10% after his or her first interest rate reset.

Borrowers with Segment 2 loans who meet the three aforementioned criteria are eligible to have their loans modified in a streamlined manner. Modified loans will retain the low, introductory interest rate for five years. Servicers are encouraged to use an alternate analysis to determine whether borrowers who fail the FICO score criterion above might still be eligible for a loan modification using alternate criteria, such as a debt-to-income review or other form of borrower-specific analysis.

The ASF document states that no servicer following the streamlined framework should take any action that is prohibited by the PSA or other applicable securitization governing documents, or that would violate applicable laws, regulations, or accounting standards. It also notes that servicers are not obligated to provide a fast-track loan modification to all borrowers who are eligible for one.

ASF observes that servicers may not be able to make contact with all borrowers who meet the criteria for a fast-track modification. In this case, ASF is of the view that servicers may deem a borrower to have consented to the terms of a fast-track modification if the servicer sends prior notice of the modification to the borrower and if the borrower makes two monthly payments under the modified loan after receiving notice of the modified loan terms.

The ASF document also contains a series of findings intended to provide cover among investors for servicers who opt to make streamlined modifications pursuant to the framework (see, in particular, pages 4 and 8-10 of the document reproduced in Appendix E).

As noted above, Secretary Paulson estimated that up to 1.2 million borrowers would be eligible for either a loan refinance or a streamlined loan modification under the streamlined framework (i.e., 1.2 million of the estimated 1.8 million borrowers with outstanding subprime ARMs set to reset by the end of 2009 would fall into Segments 1 or 2). In the time since the streamlined framework was issued, however, analysts have estimated that far fewer borrowers may be helped by the plan. One of the more comprehensive analyses of the streamlined framework was issued on December 7, 2007 by Deutsche Bank Securities, Inc. (Paulson Delivers Loan Mod Details, but "Not a Silver Bullet," by Karen Weaver, Katie Reeves, and Ying Shen, Deutsche Bank Securities, Inc.). According to the Deutsche Bank analysis, only about 90,000 loans, or 5.5% of the outstanding subprime hybrids eligible for the streamlined framework, are likely to meet the criteria for Segment 2. Deutsche Bank further estimates that 16% of the outstanding subprime hybrids meet the criteria for Segment 3. While the streamlined framework assumes that any loan which is not in Segment 2 or 3 is refinance-able, Deutsche Bank believes this is an unrealistic assumption. Other analysts who have studied the Paulson plan reach similar conclusions.

LOAN MODIFICATION REPORTING BY SERVICERS

In Appendix C of the December 2007 streamlined framework (i.e., in Appendix C of the document contained in Appendix E of this report), the ASF included reporting standards intended to apply to monthly reporting of loan modification activity for securitizations of residential mortgage loans. Specifically, ASF listed 28 items that should be reported by servicers for all of the loans they modify and suggested that servicers track data separately for the three segments of loans set forth in the guidance. While ASF's stated reasons for encouraging servicers to report monthly data relate to the needs of investors who hold the securities backed by the modified mortgages, many other interested parties, including policymakers, regulators, and consumer advocates, have looked to ASF's call for monthly reporting as a way in which to gauge the effectiveness of foreclosure prevention efforts.

To date, however, no servicers have begun issuing monthly reports using ASF's reporting standards. Participation in the HOPE NOW plan is voluntary, as is data reporting. Furthermore, according to a December 12th article in American Banker (A Murky Path to Loan-Mod Transparency, by Cheyenne Hopkins) the data collection efforts will be led by the HOPE NOW Alliance, rather then the Department of the Treasury, and the data collected will not be made available to the general public. The article also noted one of the challenges faced by Commissioner DuFauchard in his data-collection efforts, namely that securitizers and investors define loan modifications differently. Their definitions would need to be coordinated in order to allow for any meaningful analysis of the results.

It should also be noted that servicers bear some risk in reporting their loan modification data. A separate article in American Banker (Loan Modifications' Subordinate Problem: How to Account, by Harry Terris, December 6, 2007), cited a June 2007 Fitch, Inc. report on the complexity of the reporting problem and the potential ripple effects it could cause. According to the article, "extensive use of modifications, coupled with the reporting of modified loans as contractually current, could effectively upend the way mortgage-backed investors were paid by redirecting funds to junior investors in a way that hurt more senior claimants. That is because the modifications would keep loans current past designated 'trigger' dates, and so create a risk of inappropriate release." It is therefore possible that a servicer's data could be used by an investor to sue for what the investor believed was an inappropriate redirection of funds within the securitization trust.