



April 10, 2008

The Honorable Barney Frank
Chairman, Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Frank:

Thank you for meeting with us to discuss a recent Mortgage Bankers Association analysis that describes how the passage of H.R. 3609, the "Emergency Home Ownership and Mortgage Equity Protection Act" would result in higher mortgage rates of at least 1.5 percent, holding all else constant. I am pleased to have the opportunity to explain at greater length how we arrived at this specific and conservative number.

The basis of our analysis is the fact that the mortgage market prices for risk. H.R. 3609 introduces significant new risks for lenders, securitizers and servicers of primary residence mortgages. To avoid or offset these risks, these entities will increase interest rates and other compensation, require larger downpayments, tighten credit standards and restrict credit in declining markets. Failing to take such precautions would be unsound business management. The following are our estimates and reasoning on the market costs of passing this bankruptcy legislation. In short, we believe that higher default incidence rates, higher loss severity rates, administrative costs and increased political risk and market uncertainty will combine to increase rates for consumers.

Higher default incidence rates: 70 to 85 basis points

Higher default incidence rates will be driven by two factors. First, the number of defaults will increase by the number of people who previously would default on everything but the mortgage. Should this legislation pass, mortgages will be drawn into the high level of consumer bankruptcy filings. Second, the number of filings will increase due to the non-symmetrical nature of the filings. Giving people the option to write down their mortgages when values are at their lowest points, without the option of recovery when values go up will increase the incidence of filings, particularly if their expectation is to sell the house in a few years. This option of putting back part of the loan without losing the house will drive up the number of defaults. It is difficult to overstate the dramatic increase in default incidence rates.

Higher severity rates: 20 to 25 basis points

Loss severity in the event of default will increase. Since about two thirds of bankruptcy plans fail, lenders will take a loss up front with the write down, and subsequently incur other costs associated with a foreclosure, and those foreclosures may take place in even more severe market conditions than existed at the time of the bankruptcy filing. Given that the borrower will be in the house for a longer period with little incentive to do major and minor maintenance, it is likely that repair costs will be much higher.

Bankruptcy administrative costs: 10 basis points

Lenders already face very high costs in dealing with a foreclosure. In addition to the foreclosure costs, however, the lender would now face the additional costs of protecting its legal interests in the event of a bankruptcy filing. Not the least of these costs would be to order separate appraisals to defend against appraisals ordered by the bankruptcy judge or other claimants. Such costs could run into the thousands of dollars for a particular loan, but would vary as a percentage of the loan amount. Also, this is in addition to foreclosure costs that will probably be incurred anyway and may not be recoverable from private mortgage insurers.

Market uncertainty and increased political risk: 50 to 60 basis points

Market uncertainty over what the new default and severity rates will be will drive up interest rates until the market is reasonably comfortable with the incidence rates associated with the new legal regime. Therefore, mortgage interest rates will likely widen out considerably for several years until investors have some comfort in the new overall loss rates and will then narrow somewhat but still remain above traditional levels. In the short-term, however, the market will likely overprice this risk. At a time when the real estate finance industry and mortgage rates are already under stress, this could be especially devastating. Finally, such a change will further alienate international investors. The U.S. has always been seen as a safe haven for international investment because of the belief that contracts would be honored and are free from political influence. The recognition that Congress is willing to step in to alter financial contracts for short-term benefits would raise the question of what other steps Congress might take and add a risk premium on all U.S. debt.

Using the low end of the range from these factors, we come to 150 basis points. The number is, admittedly, an approximation, as there is no perfect market parallel today for which we can make exact comparisons. Many of our member companies' risk officers, credit specialists, economists and production experts tell us that our number is too conservative. As you know, some believe that our number is far too large. We believe that our estimation is solid, based on today's market and making very supportable assumptions about how the market will respond.

Pricing comparisons

Our analysis was informed by a series of other factors, which we would also like to discuss. As you know, single-family owner-occupied residences are protected from bankruptcy cram down under current law. Bankruptcy cram down is, however, allowed for investor properties, vacation homes and multifamily residences in which the owner occupies a unit. A comparison between loans for properties protected from cram down and loans for properties without this protection is useful.

At the outset, it is important to note that there are differences among these property types beyond vulnerability to cram down. For example, investment properties have a

higher risk of default and foreclosure, especially during economic downturns because investors are quick to divest themselves of bad investments. There is also greater loss severity on each foreclosed investment property due to the increased wear and tear commonly experienced on rental properties. These factors lead to higher interest rates, regardless of the bankruptcy situation.

In a limited public source survey of lenders, MBA examined the difference in interest rates between primary residences and non-owner-occupied properties. At the time of our examination in the 4th Quarter of 2007, we found that the interest rate on investment properties ranged from 37.5 to 100 basis points higher than the rate on residential properties. In addition to interest rate, lenders required that points¹ be paid at closing in the range of 50-150 basis points. Down payment requirements were also higher. There is evidence that these rates have gone up more recently, with spreads between owner and non-owner occupied housing increasing to 200-250 basis points with LTV of 70 – 80 percent. It is rare today to find a lender willing to provide greater than 80 percent LTV financing on an investment property.

Down payment requirements will increase as lenders attempt to limit their risk of losing part of their security by loaning only in amounts below the perceived risk of cram down. Given that lenders will do what they can to bring new borrowers into the market, we believe that down payments will be higher than they are in today's market, but not high enough to account for all of the risk. The balance of that risk will be accounted for in higher rates.

Lost Credit Enhancements

Comparing loans for different property types alone fails to quantify the price impact of the loss of credit enhancements for home loans. Cramming down a mortgage, or lien stripping, renders ineffective certain portions of government mortgage insurance and private mortgage insurance that currently protect lenders and servicers against foreclosure losses. As a result, lenders and servicers will be taking on significant additional credit risk on new and existing loans and will have to price for that risk.

Some studies that analyze the impact of mortgage cram down on home mortgage credit have failed to recognize the tremendous impact that this loss of creditor protection will have. Claiming that lenders experience the same loss from a lien strip as they do from a foreclosure ignores the critical role of mortgage insurance, whether public or private, in preserving affordable credit or fails to understand its basic operation.

The extinction of credit enhancements has a particularly significant impact on mortgage companies that service Federal Housing Administration (FHA) and Department of Veterans Affairs Home Loan Guaranty Program (VA). Servicers and investors are also at risk of losing much of the benefits of private mortgage insurance.

¹ Points are prepaid interest that reduces the note rate.

When Congress created the FHA and VA loan programs, there was no risk of cram down on home mortgages. As a result, authorizing statutes and regulations of the government programs fail to deal appropriately with the risk created by H.R. 3609. Statutes were developed to deal with foreclosures, not bankruptcy modifications and strip downs. Accordingly, combining H.R. 3609 with existing investor accounting and claim policies will create perverse results, including the loss of government insurance.

By law, servicers cannot receive FHA insurance or a VA guarantee for the amount of any lien strip. Nevertheless, servicers are still required by contract to remit scheduled payments of principal and interest (“P&I”) to Ginnie Mae. Reduced collections without reduced P&I payments to investors increase servicer’s advancing costs.

Making matters worse, once the borrower successfully completes the Chapter 13 repayment plan, the loan would have to be purchased out of the Ginnie Mae pool based on the scheduled amortization amount, not the crammed down balance. In effect, the servicer would have to advance the amount that was stripped down to Ginnie Mae security holders and absorb the principal loss. This is a substantial shift in liability that servicers certainly did not contemplate when they agreed to service Ginnie Mae securities. Servicers rarely take principal losses today. The severity of losses to which servicers would now be exposed would be comparable to what FHA and VA lose with each foreclosure – more than \$30,000 per property. Yet, if those loans went to foreclosure sale, FHA insurance and VA guarantees would kick in to protect the servicer against principal loss.

Adding to the servicers’ cost is the uncertainty about the eligibility of these loans for re-securitization into GNMA II pools. Wall Street has little appetite for bankrupt debtors. If bankruptcy modifications cannot be re-securitized, servicers will have to place these assets on their books, hold capital and loan loss reserves against them in addition to taking the risk of principal loss, which they do not typically do today. The servicer would also continue to pay the debt service on the commercial loan used to originally buy the loan out of the pool. Expanding bankruptcy cram-down will dramatically increase the number of Chapter 13 modifications and cause such a substantial increase in costs to the servicing industry that servicer safety and soundness would be threatened.

While some might argue that lenders will convince these entities to merely change their policies, it is not so simple. FHA, for example, is not permitted by statute to pay an insurance claim for the strip down amount. It is simply not contemplated under the statute. The benefit of the FHA program is that the lender is insured against losses from borrowers who choose –for whatever reason—to take advantage of the program. This legislation would mean that the FHA insurance would not cover the risk of loss that would result from bankruptcy.

Private mortgage insurance may be extinguished in the event of a lien strip. Private mortgage insurance was created to pay claims against losses suffered from foreclosure, not court ordered write-downs, which were clearly prohibited when the insurance contracts were written. It is unclear whether private mortgage insurance companies would extend their contracts to lien strips. If the private mortgage insurance industry does agree to pay on these unanticipated lien strips, that industry will incur significant costs that may trigger substantial hardships and corporate failures.

If private mortgage insurance companies do not pay these unanticipated claims, the servicer or noteholder must absorb the principal losses making the private mortgage insurance worthless. As you know, private mortgage insurance has historically been a key driver in helping first time homebuyers overcome the hurdle of a required high downpayment. If this protection evaporates, downpayments will increase. We estimate lenders will require 20-30 percent down as a general rule. If lenders are willing to make loans with less than 20 percent down, rates will increase to balance the risk.

Impact on the Servicing Industry

The risk of uninsured losses and repurchase risk created by H.R. 3609 will cause existing servicing portfolios to decline in value, requiring accounting write-downs of servicing assets. The velocity at which loans would enter bankruptcy could cause capital and liquidity problems for servicers. This disruption could also cause significant problems with voluntary workouts as bankruptcy cram downs would consume the servicer's financial and personnel resources. The stated objective of encouraging more voluntary workouts through H.R. 3609 could simply not materialize.

Going forward, servicers would bid less for servicing assets, which will drive up mortgage rates and costs for borrowers. Also, because servicers do not currently bear the primary risk of principal loss, servicers will shun high LTV loans and require significantly greater compensation. All of these options have a direct impact on the availability and cost of credit.

Impact on Investors

Securitization increases the flow of capital and therefore lowers mortgage rates. Securitization of mortgages is based on the underlying value of those mortgage contracts. Granting bankruptcy judges the authority to retroactively modify a mortgage in Chapter 13 proceedings would have a materially adverse impact on the mortgage contract. The resulting uncertainty would mean that securitizers or investors could not assess prices or calculate the risk of how many mortgages could be modified. Such uncertainty would likely drive investment away from mortgage-backed securities (MBS) or result in overcompensating for risk through pricing. Existing MBS values could also decline as losses mount, resulting in additional downgrades of securities.

Removing of Key Creditor Protections

H.R. 3609 makes bankruptcy more attractive than it is today without including significant protections that currently keep bankruptcy filings to a minimum. The legislation creates a moral hazard and will increase the severity and frequency of loss.

Currently, the Bankruptcy Code provides that the secured portion of any crammed down loan must be entirely paid off within the three-to-five-year duration of the Chapter 13 plan². For example, if a loan –mortgage or otherwise– of \$150,000 is stripped down to \$100,000, the debtor must still pay the entire \$100,000 within three-to-five years in equal monthly installments. This control limits unbridled runs on bankruptcy courts whenever asset values or rates decline. This control is, however, absent from H.R. 3609 which gives the bankruptcy judge full discretion to extend the repayment term. Under this legislation, the only loan whose term could be extended beyond the term of the Chapter 13 repayment plan would be the primary residence mortgage. In effect, mortgage loans would actually be disadvantaged relative to all other lending.

Most importantly, vacation homes and investment properties seldom get to the point of cram down because they are likely to be a burden on the estate and, unlike a principal residence, not essential to the borrower's survival. A judge, in assessing the debtor's needs, has the ability to compel a debtor to sell off assets that are not necessary to the borrower. Vacation homes and investment properties are not necessary for a consumer to live, as a principal residence. Accordingly, there is generally little reason to cram down these loans³, they are simply sold off or the lender obtains termination of the automatic stay and the property is foreclosed upon.

Conversely, a principal residence is essential to the reorganization of the borrower and, thus, if H.R. 3609 is enacted, courts will not release these assets from the stay and judges will be required to impose cram downs. Notably, H.R. 3609 removes any judicial discretion in applying the lien strip or cram down--it is simply required even if not merited or needed to make the loan affordable for the borrower.

Lost Hazard and Flood Insurance Protection

The bankruptcy reform bill extinguishes lenders' legal interests in hazard and flood insurance claims resulting from property damage. Although home mortgage servicers have not experienced this phenomenon, there is substantial case law regarding automobile financing that indicates that lenders are at significant risk of losing their

² 11 USC 1322(d)(2007). See also *In re Enewally*, 368 F.3d 1165 (9th Cir., 2004). The unsecured portion of the claim that gets crammed down gets an apportioned payment to the extent there is additional income or cash that can support those payments. If there are no funds remaining to pay unsecured creditors after paying secured and priority claims, the unsecured creditors receive nothing and the unsecured debt is discharged upon termination of the plan.

³ Investment properties with no equity but with a positive cash flow are still subject to repayment during the three to five-year term of the plan. Since the property is actually contributing funds to the debtor's estate, there is no reason for the judge to cram down the debt.

interests in hazard and flood insurance claims for the amount of the cram down. Because the fair market value of properties decline when damaged by a natural disaster or borrower waste, cram downs could extinguish all or a substantial part of the debt and also extinguish the lender's recovery through hazard insurance claims.

Properties damaged by Hurricane Katrina illustrate this concern. As you may know, many impacted borrowers have been offered over two years of forbearance and/or loan modifications at significant cost to the servicer and investor. Some properties have zero or low value due to the damage. H.R. 3609 would allow those borrowers to wipe out all or significant portions of the debt in Chapter 13 bankruptcy and take insurance money that would otherwise be escrowed by the lender to ensure repairs to the property. By wiping out the portions of the debt, the lien strip also reduces the lender's insurable interest. The noteholder and servicer could thus lose valuable rights to insurance proceeds leaving creditors with no recourse to recover the value of the debts. H.R. 3609 places lenders, servicers and investors in an inappropriate role of property insurers of last resort and/or guarantors of property values. Mortgage lenders and servicers are not in a position to evaluate these risks. The only way lenders can account for uncertainty is to charge higher prices to offset the risk.

Consensus is Growing That Cram Down Will Increase Costs

The vast majority of economists and mortgage experts agree that bankruptcy cram down will have an adverse impact on interest rates and credit availability. Professor Joseph Mason of Drexel University testified before the Senate Judiciary Committee that it is straightforward to conclude that cram downs will increase the cost of mortgage credit. Allowing bankruptcy judges to unilaterally change the terms of a mortgage to those less favorable to the lender will impose unexpected and un-forecastable costs upon lenders and therefore raise the cost of providing funds to borrowers that can qualify for such treatment.

Professor Mark Scarberry of Pepperdine Law School testified that permitting home mortgage cramdown would cause difficulties in the secondary mortgage market and would cause unjustified harm to the holders of home mortgage-related securities with a negative effect on investors of modest means by denying investors the benefit of the upturn in the real estate market that ordinarily follows a downturn. Professor Scarberry testified that allowing strip downs would substantially change the risk characteristics of home mortgages.

Conclusion

Passage of the Emergency Home Ownership and Mortgage Equity Protection Act will significantly impact mortgage interest rates and mortgage terms. It will introduce new risks into the system for which lenders will have to price. Our analysis is that this change would increase mortgage rates by at least 150 basis points, holding all else constant. Given the uncertainty this law will introduce into the mortgage market, there is no question that it will result in increased costs.

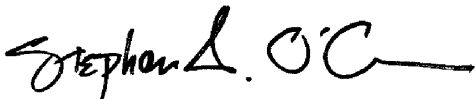
When a mortgage exceeds the value of the home, most commonly this is the result of a decline in the home's price. Cramming down mortgages to the current fair market value effectively uses lenders to insure home owners for home price declines. This result is true even when the lender acted prudently in making the mortgage loan. Accordingly, requiring lenders to insure against home price declines via bankruptcy cram down will most dramatically limit credit in areas that have experienced or will experience home price declines.

Home ownership remains the best way to build, maintain and grow wealth for American families. At the same time, more federal attention needs to be placed on quality affordable rental housing for all Americans. But we do not believe that wise public policy should eliminate the preference the Bankruptcy Code currently gives to home ownership. We believe even more strongly that Congress should not take action that would actually make the Bankruptcy Code treat primary residences worse than all other assets in a reorganization.

The Committee on Financial Services and the House of Representatives have acted in reasonable and effective ways to address the current mortgage market. Recently Congress passed legislation injecting liquidity into the market by raising the loan limits for the GSEs and FHA. Provisions making mortgage insurance deductible (lessening the need for "piggyback" loans that were often ARMs) and eliminating forgiven debt from gross income for tax purposes have become law. The House has passed FHA reform, GSE regulatory reform and broad mortgage regulatory reform. The Federal Reserve has aggressively lowered interest rates, which is contributing to lower rates for new mortgages, and is impacting the indices on which many subprime ARM resets are based. Congress and the Administration have pushed the industry to work more effectively and efficiently to help borrowers who are struggling. You have also worked on several efforts to improve the stock of rental housing, shifting federal housing policy's focus from home ownership to a more rational goal of ensuring quality affordable housing at all levels of the income scale.

Thank you again for your willingness to discuss this issue with us. We appreciate the opportunity to engage with you on this and other issues and look forward to continuing our work together to respond to the current challenges in the mortgage market.

Sincerely,

A handwritten signature in black ink that reads "Stephen A. O'Connor". The signature is written in a cursive, flowing style with a long horizontal line extending from the end of the name.

Stephen A. O'Connor
Senior Vice President of Government Affairs