Testimony

Of

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Domestic Policy Subcommittee
Oversight and Government Reform Committee
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2154 Rayburn HOB
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"Is Treasury Using Bailout Funds to Increase Prevention as Congress Intended?"

Chairman Kucinich, Ranking Member Issa and Members of the Subcommittee:

Thank you for the invitation to testify before you today.

Housing prices in many areas of the United States have slowed or declined dramatically over the last two years. This decline is partly responsible for the large increase in subprime mortgage delinquencies over the same period. According to the Hope Now Alliance Survey data[1], 14.44% of subprime mortgages are 60 days or more delinquent as of the third quarter of 2008. And while 2.38% of prime mortgages are 60 days or more delinquent over the same period the rate has almost doubled since the third quarter of 2007 (1.26%). From the third quarter of 2007 through the third quarter of 2008, there were 1,000,033 foreclosures sales of which 565,125 were subprime borrowers.

We are in the midst of the subprime meltdown and a second wave of ALT-A (e.g., low documentation mortgages) adjustable rate mortgages (ARMs) are beginning to reset. Therefore, it is of critical importance to find ways to slow down the delinquency and foreclosure waves if economically viable. This urgency is reflected in the announcement by the Federal Housing Finance Agency on Wednesday that Fannie Mae and Freddie Mac announced will be accelerating their loan modification activities.[2] While Secretary Paulson has announced that TARP will not be used to purchase troubled loans from banks, it is still of tantamount importance to stabilize the housing and mortgage markets and loan modifications are one of the best tools available to Treasury even if they decide in the short run not to deploy them. Hopefully, the acceleration of loan modifications by Fannie Mae and Freddie Mac will help stabilize the housing and mortgage market, but it

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[1] See HOPE NOW Alliance Survey, Mortgage Loss Mitigation Statistics, 2008.
[2] Fannie Mae and Freddie Mac will be targeting borrowers that are 90 days late and a 38% mortgage to income ratio. They will be modifying interest rates and, in selected circumstances, principal reductions.

is a dangerous strategy to rely on the banking system to unclog the jammed pipes, particularly with an overwhelmed servicing industry.

The "38% Solution" of Hope Now and the FHFA represents a relatively simple approach to loan modification. It is achieved by stretching the mortgage life from, say, 30 years to 40 years. Certainly, certain borrowers may suddenly have a more "affordable" mortgage and the hope is that this modification will slow down the default waves and stabilize the financial and housing market. But it is important to recognize two problems with simple mortgage extensions. First, mortgage extensions simply substitute one risk for another. While "affordability" increases, the loan balance amortizes more slowly creating greater risk to the lender/investor. Second, it ignores the negative equity problem which is growing quite severe. Hence, I urge Congress and the incoming administration to look beyond expedient solutions and consider other loan modification strategies.

Regarding loan modifications, there are two objectives. The first is home preservation where loan modifications are used to keep borrowers in their home. The second is stemming systemic risk where loan modifications are used to minimize the severe costs of default and foreclosure. These objectives can be compatible if we accept that premise that borrowers must be employed (or a high likelihood of employment in the short run) and have their income verified. This is especially important when dealing with the ALT-A mortgage loans where income verification was not required. But it is clear that home preservation and solving systemic risk problems can be accomplished with a sensible loan modification template if Treasury decides to deploy it.

Loan Modifications and Principal Reductions

There are several loan modifications that are currently being employed by loan servicers. These include loan rate reductions, loan rate "freezes," amortization period extensions and principal reductions. While the first two are the most common, principal reductions have been much less so. In fact, only Ocwen currently has been a major force with approximately 70% of the total principal modifications.[3] According to Credit Suisse, the average balance decline for first-lien principal modifications is approximately 20% and 55% for second-lien principal modifications. As house prices continue to fall and the number of borrowers experiencing negative equity continues rising, the demand for such modifications is growing. Principal modifications serve to reduce the monthly payments and reduce negative equity. Thus, principal modifications should increase the willingness of borrowers to stay in the home.

Principal reductions can be structured in many ways. One is a simple principal reduction with no strings attached. A second is a principal reduction where the homeowner must pay capital gains taxes on the reduction. A third way is to grant a homeowner a principal reduction in exchange for a shared appreciation mortgage (SAM).[4] A fourth way is to

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[3] See "Subprime Loan Modifications Update," Credit Suisse, 01 October 2008.

[4] There is some interesting moral hazard problems associated with SAMs. See Frank Page and Anthony B. Sanders, "On the Pricing of Shared-Appreciation Mortgages," *Housing Finance Review*, Vol. 5, 49-57,

reward borrowers that are “upside down” on their mortgage by reducing their principal with each timely mortgage payment; these principal “draw downs” give an incentive for borrowers to make timely mortgage payments. A fifth way is what can call the “market to market” mortgage where loans are market to market rather than book value; this occurs in “short sales” when lender/servicers acknowledge that the mortgage value is actually the current house price. Going forward, mortgage lenders should consider designs where the mortgage can be refinanced at the current mortgage value rather than the amortized book value.

Loan Modifications and Foreclosures

Loan modifications may help keep borrowers in their homes and increase the probability that they will be able to cure their delinquency. Foreclosure involves multiple transaction costs, including legal filings and selling expenses that can reach almost 50% loss severity on subprime loans.[5] During the current housing and mortgage crisis, the capacity of loan servicers to process additional foreclosures has been limited, resulting in an increase their effective cost to cure delinquencies and a reduction in the number of households that have been able to obtain a modification.

Loan modifications are especially appropriate when borrowers are facing a short-term financial crisis, such as a temporary illness. Such borrowers may be willing to pay their mortgage, but need some time-limited relief in order to resume payments. However, even in the case of a permanent reduction in ability to pay, modifications may still be beneficial to both borrower and lender.

But there are cases where the lender can implement a modification even when the financial crisis is not short-term. Suppose the lender is certain that the borrower will be able to meet their obligations immediately, as long as payments are reduced. Also, suppose the borrower will hold the loan for the full remaining term. Substantial reductions in principal would be of greater financial benefit to the lender, as they avoid all of the transaction costs. While this is still a substantial loss to the lender, it is nonetheless much preferable to foreclosure.

Pursuing foreclosure is most beneficial only when cure is unlikely, even with modification. If borrowers are simply unwilling to pay their mortgage on a property, or are unable to pay a reasonable amount, then modifications simply delay the inevitable. There are several disadvantages to such delays in the foreclosure process. Delinquent owners tend to not maintain their properties, so the longer the property remains in the hand of a delinquent owner, the more the underlying collateral tends to lose value. Such properties can also become a source of blight for their neighborhoods.

1986 and Anthony B. Sanders and Carlos Slawson, "Shared Appreciation Mortgages: The UK Experience," *Journal of Housing Economics*, Vol. 14, 178-193, 2005.

Identifying borrowers that have a high likelihood of cure is mandatory for TARP loan modifications to work. A recent study states that 40% of homeowners seeking counseling claimed that the reason they have defaulted on their mortgage was due to a reduction in or loss of income.[6] An excellent example of a statistical model that helps predict a delinquent borrower's likelihood of cure is Freddie Mac's Early Indicator. Servicers use Early Indicator as a tool for quickly identifying and contacting borrowers that are likely to become seriously delinquent and to determine appropriate loss mitigation strategy when necessary.

NPV Tests for Loan Modifications

Loan servicers can employ a series of net present value (NPV) test to ascertain if a loan modification makes economic sense. First, the loan servicer determines if the net present value of the liquidation proceeds from sale of the property if the servicer were to foreclose on the loan. Second, the servicer determines if the NPV of the cash flows expected from a loan modification that under the assumption that it works. Third, the servicer determines if the borrower can afford to make the monthly payments according to the recommended loan modifications. This straightforward approach to loan modifications allows for greater volume if servicers can agree on a unified methodology for its implementation. However, there still must be employment and income verification, or the strong possibility of employment in the short-run.

Current Loans or Troubled Loans Only

Typically, servicers wait until a borrower has gone 60 days or more delinquent before engaging in the loan modification decision. However, there are a considerable number of borrowers that are "upside down" on their mortgage loans (meaning that the house value is less than the outstanding loan balance). While these borrowers may be making timely mortgage payments, some percentage of these borrowers may simply walk away from their loans if housing values continue to fall. This is especially true in states like Arizona and California where there is limited or no deficiency judgments (where a decline in a borrower's credit score is virtually the only penalty to default). At a minimum, borrowers in areas such as Arizona that purchased or refinanced their homes after 2006 should be placed on a "watch list" since they are more likely to move to default than borrowers in stable housing markets. But we are in unchartered territory to the extent that there has never been a period in our history where homeowners could be as much as 50% upside down on the mortgage. This housing crash and corresponding spike in delinquencies and default were not anticipated by the banks, investment banks and MBS and ABS investors.[7]

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[6] National Foreclosure Mitigation Counseling Program, Congressional Update, Activity through September 15, 2008

[7] See Anthony B. Sanders, "The Sub Prime Crisis and its Role in the Financial Crisis," *Journal of Housing Economics*, 2008 (forthcoming) for a discussion of the dramatic change in late 2006 between house prices and subprime mortgage delinquencies and defaults.

The downside of a principal reduction policy is that borrowers with the ability to pay their mortgage payments would have a financial incentive to become delinquent on their loans. In effect, they would trade a decrease in their credit score for the reduction in their payment. Consequently, it is vital for lenders to distinguish borrowers who are genuinely unable to repay their original mortgage from those that are simply 'modification shopping.' Failing to make this distinction could inspire a flood of delinquencies.

In summary, preventive principal reductions can actually serve to stave off defaults and help stabilize the housing and mortgage market. Waiting until the borrower goes 60 to 90 days delinquent is dangerous since the longer a servicer waits to modify a loan, the more likely the loan is to go to default generating enormous costs for the lender/investor.[8] Thus, loan modifications are not a bailout of borrowers; rather, it is an attempt to reduce costs to lenders/investors while at the same time preserving homeownership and reducing systemic risk in the economy.

Thank you for your willingness to let me share my thoughts with you.

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[8] See "Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs" by Amy Crews Cutts and William A. Merrill, March 2008, Freddie Mac Working Paper #08-01