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TURMOIL IN U.S. CREDIT MARKETS: EXAMINING PROPOSALS TO MITIGATE FORECLOSURES AND RESTORE LIQUIDITY TO THE MORTGAGE MARKETS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

EXAMINING PROPOSALS TO MITIGATE FORECLOSURES AND RESTORE LIQUIDITY TO THE MORTGAGE MARKETS

THURSDAY, APRIL 10, 2008

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TURMOIL IN U.S. CREDIT MARKETS: EXAMINING PROPOSALS TO MITIGATE FORECLOSURES AND RESTORE LIQUIDITY TO THE MORTGAGE MARKETS

THURSDAY, APRIL 10, 2008

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

Let me thank our witnesses this morning and my colleagues for being here. Let me just say on behalf of Senator Shelby, as you all might well imagine, there are a number of Committee hearings going on this morning, and Senator Shelby is deeply involved in an Appropriations Subcommittee which he is the Ranking Member of, so he will be moving back and forth here but has urged me to go forward and not wait for him to be here this morning.

I am very grateful to all of you for coming out. I am going to make some opening comments, and with the indulgence of Committee members, unless you absolutely feel totally compelled to be heard at the outset, I am going to turn to our witnesses, and particularly the former Secretary of the Treasury, Larry Summers, who is here. And, Dr. Summers, we deeply appreciate your being here, and as well as Mr. Elmendorf.

They are both hosting a conference later this morning, and so I am going to turn to them and urge my colleagues to focus any questions they have to these two witnesses.

I have informed the audience—and our colleagues are aware of this—that at roughly 11 o'clock, we have two or three votes on the floor of the Senate, so we are going to get as much done as we can between now and 11, certainly regarding the two witnesses who have other obligations and have graciously agreed to be here this morning under the time constraints. And then we will come right back again to our other witnesses to complete the hearing this morning. A little complicated, but it allows us to get through here and have a good discussion this morning.

Well, today the Senate Committee on Banking, Housing, and Urban Affairs is meeting to hold a hearing entitled "Turmoil in the

U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Market."

Last week, we had an excellent hearing to look at one result of the turmoil we are experiencing in the capital market: the decision of the Federal Government to commit $29 billion in taxpayer money to rescue Bear Stearns. Today, we are focusing more on the other end of the spectrum: the impact of the crisis on homeowners themselves.

This is the second hearing we are holding on this topic. The first was held in January. Since then, the crisis only seems to have gotten worse. It has spread from housing to other areas, such as student lending and municipal finance. And I expect that the Committee will examine these other areas in the weeks to come.

This hearing could not be more timely. Today, after a week of intensive discussions and negotiations, the Senate later this morning will pass the Foreclosure Prevention Act of 2008. There are a number of important provisions in the legislation. The bill adds $150 million to the counseling budget. It includes an expansion and modernization of the FHA program, which will create a real alternative to the abusive subprime lending so many working families have turned to in the past several years—which has greatly contributed to the crisis, by the way. It adds about $10 billion in increased mortgage revenue bond authority for the States, which will help to provide some lower-cost credit to distressed borrowers. And it includes $4 billion for State and local governments to clean up the mess left by historic foreclosure problems we are experiencing.

There are a number of other provisions in the bill, but those are some of the major ones that will be a part of the bill I hope is adopted later this morning.

It falls far short, I would add, this legislation does, of the lofty title of the bill. We do not do as much as I would like to have seen us do with this legislation. It does not do enough to help families facing foreclosure. Nearly 8,000 foreclosure filings occur every day in the country—almost 8,000 filings every single day—according to RealtyTrac, which follows that information. The most significant challenge we now face is helping people tottering on the edge of foreclosure to keep them in their homes. It is all well and good to provide funds to help pick up the pieces, but we need to do more prevention so we have less need for cleanup after the fact.

To that end, I have been working intensely with colleagues on this Committee, have had numerous conversations with members of both the Democratic and Republican side, listening to their ideas and thoughts about how we could develop such a proposal here to deal with these issues. Hope for Homeowners Act of 2008 is sort of a compilation of those ideas. It is not the final word on it, but it is an opportunity for us to step up and try to move forward as a way of dealing with this issue.

Briefly, the bill would create a new fund at the FHA to insure affordable mortgages for distressed borrowers. These FHA mortgages would refinance the old troubled loans at significant discounts. The new loans would be no larger than the borrowers could afford to pay and no more than 90 percent of the current value of the home. This formula is similar to the one laid out by Federal Reserve Chairman Bernanke in a speech several weeks ago when

he noted that "creating new equity for underwater borrowers may be a more effective way"—and I am quoting him here—"to prevent foreclosures." Now, apparently the administration has also embraced this concept, and I applaud and welcome their participation in this debate and discussion.

Lenders and investors will have to take a serious haircut to participate in the program, but in return, they will receive more than what they would recover through foreclosures, obviously. Borrowers get to keep their homes, but they must share the newly created equity and future appreciation with the FHA program to help offset possible losses. Only owner occupants would be eligible for this new program, and only those who clearly cannot afford their current mortgages. There will be no investors in the program.

In addition to helping homeowners and the communities in which they live, this program will help stabilize capital markets, put a floor under housing prices, and get capital flowing once again. That part of this idea is hardly ever talked about. That may be the most important part of this program. I would argue that keeping them in their homes is, but the fact that we are establishing a floor and that we get capital flowing again is what is critically missing in all that we are talking about, and that is one of the reasons for it.

The big enemy of smoothly functioning capital markets is uncertainty. Today, nobody knows what the subprime mortgages underlying the alphabet soup of complex securities—CDOs, SIVs, RMBs, and the like—are worth. This program would help put a value on those mortgages.

We have another hearing on this proposal next week when we will hear from a number of Government witnesses and others. After that, I want to work with my colleagues to see if we can move this legislation forward.

As you know, Representative Barney Frank is holding hearings as well on this subject matter, and has I think yesterday and today, talking about this issue, and we welcome his involvement.

I understand that some people oppose this kind of program on the grounds that we should not reward people who acted irresponsibly. As we have seen from numerous hearings we have held over the past 15 months, many people facing foreclosure today were victims of abusive and predatory lending practices. Most were trying to act responsibly, but they were led badly astray by unscrupulous mortgage brokers and lenders. They were victims of what Mr. Stern, one of our witnesses this morning, calls "mortgage malpractice," and I urge my colleagues to read his testimony in which he talks about this phenomenon. This is a lender talking about mortgage malpractice that is going on.

In fact, the Wall Street Journal did a study in which it concluded that 61 percent of subprime borrowers it reviewed had high enough credit scores to qualify for prime loans. We know that these brokers portray themselves as trusted advisors to unsuspecting borrowers, while steering these borrowers into higher-cost loans in exchange for higher commissions.

Lenders and brokers gave these borrowers, many on fixed incomes, mortgages with exploding interest rate payments that they knew the borrowers could never, ever afford. These are among the

homeowners that we seek to help with this legislation. We seek to help them because it is the right thing to do. To paraphrase Franklin Roosevelt, when your neighbor's house is burning, you do not charge him for the use of your garden hose. You simply lend it to him. We are not acting for their sakes alone. Today, hundreds of thousands of our neighbors' homes are figuratively burning, and like any fire, the damage threatens to spread. Every home that goes into foreclosure lowers the value of the other homes on that block by at least $5,000. It reduces property tax collections, which leaves local school revenues struggling. It hurts badly the ability of local governments to provide adequate police and fire protection and social services just as the need gets more pressing.

The ripple effects are severe and widespread, so we owe ourselves and our communities, as well as our neighbors, our help in a crisis like this. We must act to put this fire out. That is what I would hope to do with all of you in the coming weeks. I look forward to hearing from our witnesses this morning and from our colleagues about how to draft this legislation that I have circulated a better document, a set of better ideas. We are going to hear from witnesses today, those who favor and oppose this ideas, because we want to have a balanced view of how we are looking at this as well. But my hope is we can put something together here that will accomplish the dual goals of keeping people in their homes as well as unleashing capital which is pent up.

With that, I will turn to Senator Bennett, if you want to make any quick opening comments. And I would say to Senator Bunning, Jim, we are trying to—because of time constraints and votes this morning, if we can move right to witnesses. I apologize. I normally like to hear from everybody, but, Bob, any comments you want to make.

Senator BENNETT. Mr. Chairman, I will not presume upon Senator Shelby's prerogatives, and I will wait my turn.

Chairman DODD. I thank you very much.

Witnesses, thank you. Larry, good to have you with us this morning. Welcome back to the Committee. It is an honor to have you here with us this morning.

STATEMENT OF LAWRENCE H. SUMMERS, CHARLES W. ELIOT UNIVERSITY PROFESSOR, HARVARD UNIVERSITY

Mr. SUMMERS. Thank you very much, Mr. Chairman. The honor is mine. Let me do two things very briefly: summarize my view of where the economy stands, and offer four observations on the policy challenges before you.

The economy is very likely currently in recession. If it is not a recession, it will certainly feel like one to the vast majority of our fellow citizens. The likelihood is very high that the downturn will continue for some time, certainly the next two quarters, despite the many constructive steps that have been taken in recent months.

Particularly in housing markets, more distress lies ahead. No one can forecast where house prices are going, but the available evidence from futures markets, the available evidence on the level of inventories of unsold houses suggest that house prices could, on average, fall as much as 15 to 25 percent from current levels.

The declines are likely to be concentrated in lower-priced homes and in the areas of the country where financing with subprime mortgages and low down payments has been especially prevalent.

These declines in house prices are placing and will place unprecedented burdens on the mortgage finance system. It appears, contrary to some of the discussion, that the dominant determinant of how pervasive foreclosures are is the behavior of house prices. When house prices rise, people find ways of refinancing as they rise, even if they are having personal financial difficulties. When house prices fall, foreclosures take off.

The best estimates suggest, as I read them, that we are likely to have as many as 15 million homes with negative equity over the next 2 years, and it is very difficult to gauge the number of foreclosures, but they could on the current path exceed 2 million.

There have been some signs of repair in financial markets since the Bear Stearns events of mid-March, but markets remain quite fragile. In particular, there is, as your initial comments suggested, Mr. Chairman, some reason to believe that as serious as the situation is in the housing markets, because of illiquidity various securities markets are actually pricing in degrees of dislocation that even substantially exceed those associated with a serious recession.

There is, I believe, in the context of these developments, no basis for assuming that the housing market will be self-correcting. Indeed, financial markets sometimes—and at times like the present—do not follow the ordinary law of supply and demand. In economics classes, we teach that when prices fall, demand rises, and that tends to stabilize markets. But in leveraged financial markets, when prices fall, with leverage, people have margin calls or are unable to meet their debts and are forced to sell their assets, and so there is more supply, not more demand. Falling prices leading to reduced demand and increased supply means further falling prices, means vicious cycles, and it is interference with that type of vicious cycle mechanism that provides the important warrant for Government action.

At the same time, it is appropriate to recognize the policies that serve only to delay inevitable adjustments can easily prove counterproductive.

I would urge that policymakers give serious consideration to four areas.

First, and critically, our policies regarding the Government-sponsored enterprises. The GSEs have a potentially critical role at a time of cyclical disturbance. Whatever one thinks about the GSEs as a normal matter, they exist to be in a position to be responsive at a time like the present.

For them simply to expand their balance sheets without increased capital would be to expose the taxpayers and ultimately the entire financial system to very serious risks. The correct course is, therefore, for the Government-sponsored enterprises to raise capital on a very substantial scale for both prudential reasons and to back expanded lending. This may not be the first choice for their shareholders, but it is essential to the national interest. Robust, reasonably capitalized, GSEs taking an active role is probably the single most important step that the Government can take in bringing more regularity to the housing markets.

Second, there is a strong case for Federal support for the writing down of mortgages in selected cases along the lines that you, Mr. Chairman, and Congressman Frank have suggested. Carefully designed measures to reduce the tremendous externalities associated with foreclosures can provide an important contribution in the current context.

In considering such measures, it will be essential to ponder design issues, including the treatment of second liens, assuring integrity in the appraisals on which the program will inevitably be based, possibly adverse selection effects on mortgages offered by servicers, and eliminating incentives for opportunistic behavior by homeowners. There are also desirable changes in legal rules.

Third, I support carefully designed bankruptcy reform as a vehicle for encouraging the writing down of mortgages where that is appropriate.

Finally, and respectfully, Mr. Chairman, I would raise serious concerns with respect to the tax measures contained in the legislation the Senate is likely to pass this morning as I understand them. Providing tax credits conditioned on initiation of the foreclosure process is likely to have perverse effects in two respects: foreclosures may be encouraged in order to make the underlying sale consistent with the tax credit; and in any event, the benefits will flow not to families, but to the financial institutions that have taken over the foreclosed property.

I would also suggest that experience and economic logic suggest that tax benefits targeted to corporations with net operating losses are unlikely to have major stimulative effects. To the extent that stimulus and responding to economic distress are key objectives, tax measures targeted at those who suffer foreclosure or at the conversion of foreclosed homes into rental housing would represent a substantially more effective public choice.

I stand ready to respond to your questions.

Chairman DODD. Thank you very much, Larry. I appreciate your testimony immensely, and thank you once again for being here on short notice.

I would say to my colleagues, I called the former Secretary and asked if he could be with us today, just in the last few days, and I am very grateful to him for making that happen. So I thank you for being with us.

Good morning, Mr. Baker. How are you? Nice to have you with us. Are you ready to testify?

STATEMENT OF DEAN BAKER, CO-DIRECTOR, CENTER FOR ECONOMIC AND POLICY RESEARCH

Mr. BAKER. Thank you very much for inviting me here. What I wanted to say is that I would like to recognize first that we have a very diverse housing market, and what may be good for some portions of the country may not be for other portions. In particular, what I am going to do is talk about the loan guarantee program and raise three—outline three basic objections to it.

First, it will lead to many homeowners paying much more in housing cost than they would if they were rent a comparable unit.

Second, we will end up with a situation where many homeowners are unlikely to accumulate any equity in their homes and, in fact,

we are very likely to end up putting considerable tax dollars at risk.

And, third, I think the effort to stabilize prices in bubble-inflated areas will prove unsuccessful and, furthermore, I would argue it is undesirable, even if it were successful. And I will very briefly comment on what I would argue is a better alternative to a loan guarantee program, what I call "own to rent," a temporary change in foreclosure rules on moderate-income housing that would guarantee people the option to remain in their house as long-term renters. I think that is a solution that would not cost any taxpayer dollars or require any bureaucracy and potentially lead to much better outcomes for homeowners.

The first point, in talking about the diverse market, it is important to recognize we had an unprecedented housing bubble in the United States over the last decade, which led to an overvaluation of house prices on average of about 70 percent. We have had house prices falling very rapidly in the last year and a half, so the bubble is partially deflated, and in large parts of the country I would say prices are no longer out of line with fundamentals. Places like Cleveland, Detroit, Atlanta, large parts of the Midwest and South, prices are pretty much in line with fundamentals.

On the other hand, in the bubble-inflated areas—primarily areas along the coasts, you still have house prices that remain 30, 40 percent above their underlying values. That means that if we were to intervene at this point and try and stabilize prices, it would be similar to intervening in the collapse of the Nasdaq when it had fallen from 5,000 to about 3,500 on its eventual way down to 1,200. It is simply not viable and would not be good policy.

OK. To go through the details, if we look at what we are doing for moderate-income homeowners in these bubble areas, we still have a situation where the ratio of house price to annual rent is far above 20:1. If you do the arithmetic on this, you would find that the annual ownership costs in such situations, even getting these people good mortgages, a 6-percent mortgage, the annual ownership cost, adding in the mortgage cost, insurance, property tax, maintenance costs, that will typically run as high as 10 percent, perhaps even higher, as a share of the ownership price.

So just to take a numerical example, if we are looking at a home that would sell for $200,000, this home in this situation might rent for $10,000; we would be having a family that stays there as an owner paying $20,000 a year in ownership costs. That difference of $10,000 a year is a considerable amount of money for a moderate-income family that might be making $40,000, $50,000, $60,000 a year. This is money that is not available for child care expenses, health care expenses, other necessary expenses for that family. That simply does not seem to me good policy to be having moderate-income families pay way more than necessary by way of housing costs.

The second point is, in terms of equity, if prices are falling, if they are going to fall 30, 40 percent—as I am quite confident they will in many of these bubble-inflated areas—people are not going to be accumulating equity even if they get a loan with a substantial writedown. Most people, moderate-income homeowners, only stay in their home about 4 years. These people are not going to accumu-

late equity. They are still likely to be underwater at the time they leave their home, which means either a loss to them or to taxpayers or to both. So it simply does not seem to me like good policy.

The third point, in terms of the price support program, I sort of think that when we talk about a housing price support program, we should think about it the same way we would an agricultural price support program, except that instead of talking about a commodity with a market of, say, $20 billion a year, we are talking about a commodity—housing—with a value of $20 trillion. It is not going to work. We are not going to be able to sustain bubble-markets.

On the other hand, even if we could do it, it again strikes me as rather perverse policy. Why do we want to keep artificially high house prices? Do we want to make it impossible for young families to be able to afford to buy homes or people moving into an area to be able to afford to buy homes? That simply does not seem to me like good policy.

A last point I will just say on that is that we should also keep in mind the considerable costs associated with this program in terms of implementing—creating new mortgage instruments. Very conservatively we would have to imagine it is 1 percent of the cost; it might well be 2 percent. If we are talking about a $300 billion loan guarantee program, that is $3 to $6 billion in costs that will either be borne by the taxpayers or the homeowners. Again, to my mind, that is not a good expenditure.

In terms of the alternative, the own-to-rent alternative, I think this is a very simple proposal. It requires no taxpayer money, no bureaucracy. We simply have a temporary change in the foreclosure rules that gives moderate-income homeowners facing foreclosure the option to remain in their house as renters for a significant period of time, say 10 years or so. This provides homeowners with some security. They know that if they like the home, they like the schools, they like the neighborhood, they are not going to be thrown out on the street. Perhaps more importantly, it gives the mortgage holders a very real incentive to sit down and renegotiate terms that will allow the homeowners to remain in their home as homeowners since it is a safe bet that banks are not anxious to end up as landlords. I would urge Congress to consider this or other alternatives that, you know, perhaps put less taxpayer money at risk than some of the guarantee proposals, at least for the bubble-inflated markets.

In conclusion, I would just say that, to my mind, the big policy mistake that we are trying to deal with here is that we allowed for a financial bubble, a bubble in the housing market, to grow to very dangerous proportions. That was what created the situation that led to the crash that led to the recession that Secretary Summers was referring to. And I think it is unfortunate that that happened. Now that we have seen the crash, I have to say I find it somewhat striking that with so many economists that were unable to recognize the inflated prices during the bubble, they are so anxious to tell us that now prices are undervalued.

Thank you.

Chairman DODD. Thank you very much.

Ellen, thank you very much. Ellen Harnick, the Center for Responsible Lending. Thank you for joining us.

STATEMENT OF ELLEN HARNICK, SENIOR POLICY COUNSEL, CENTER FOR RESPONSIBLE LENDING

Ms. HARNICK. Thank you very much for having me here.

I think I just want to pick up on the point about the extent of the financial crisis we face and just to focus us on the details of what this really means.

Mr. Summers said that 2 million families may end up losing their homes in foreclosure. This is consistent with numbers that we have seen from a variety of sources. What this means is 2 million families will be put out of their homes. Some proportion of those families will find themselves homeless. Most of those families will suffer financial devastation from which they will never fully recover over the course of their working lives.

We have talked about the declines in values that their neighbors will face, and we should be clear what we are talking about are not simply the declines that flow from home prices declining or the deflating of the housing bubble. What we are talking about are additional home price declines that will follow from the foreclosures themselves. And in many communities where the number of foreclosures in a particular neighborhood hit a tipping point, what families living in those neighborhoods will face is not merely a loss in their wealth and financial stability, but an actual significant decline in their quality of life.

We all know what boarded-up homes on a block can do, and what we will start to see and some parts of the country have already started to see are middle-class neighborhoods that are now being overrun with criminal activity that makes it uncomfortable for families to have their children walk to and from school for the first time in their lives living in those communities.

I think it is extremely important to take these things into account in deciding what can be done. Congress can avoid a substantial number of these foreclosures. I am not talking about the foreclosures that we will face from families who simply cannot afford a sustainable loan. I think that is off the table. But what I am talking about are foreclosures that are needless in the sense that rational economic decisions could prevent the homes from being lost. I think that the proposal that you, Mr. Chairman, have made for the FHA program is an excellent example of very significant work that can be done to avoid needless foreclosures.

I want to pause for a minute on the moral hazard question. It has not been raised, but it sometimes is in other contexts. People say, well, we should not help these reckless borrowers, we should not support irresponsible lending. And I think—Mr. Chairman, you alluded to this in your opening remarks, and I think it is really important to stress that the mortgage malpractice or lending malpractice is an excellent point, and for those who doubt it, you do not have to know anything more about the particular borrowers at issue other than to know that all of these 228 hybrid ARMs, with which I know the Committee is familiar, these are extremely risky loans. They are not like your normal adjustable rate mortgages. And every single person who received these loans received them in

preference to a sustainable 30-year fixed-rate loan, which even in the subprime market could have been obtained at a very small increase over the introductory rate on the loan they got. And as Mr. Chairman said, many of these borrowers qualified for prime loans.

The second point on the moral hazard question has to do with a point that I think Secretary Paulson made very eloquently immediately following the rescue of Bear Stearns, which was, yes, we worry about moral hazard, of course we worry about moral hazard; but we worry more, our primary focus at the moment is on stabilizing the market. And I do not think it is too fine a point to note that the investment banks and Wall Street have a share of the responsibility for supporting and encouraging the kind of loans that led to this crisis. I think helping them should preclude any real anxiety about helping the homeowners that we are talking about.

It is now widely said—Chairman Bernanke said this a few weeks ago—that the key is reducing some of these principal balances and setting economically rational interest rates. We are not talking about propping up home prices unduly. We are talking about putting a floor under the decline.

I have basically three recommendations to make with respect to the Hope for Homeowners Act.

The first is the 13-percent haircut—the 10-percent reduction over current loan value, plus the 3 percent to go to the insurance pool—this is essential. It is essential for two reasons: one, to ensure the sustainability of the program so that taxpayers are not unduly at risk; and, second, from our point of view, it is extremely important that while we are going to help put a floor under the problem, we are not going to save investors and lenders from the full consequences of their investing decisions. These were sophisticated actors, and it is important that we not take away some of the incentives to behave more responsibly in the future.

The reason I raise this is that as I read the bill, it leaves open the possibility that this requirement could be waived by future administrations of the program, and I think that that would be a mistake.

The second recommendation is the appreciation sharing so that the homeowner is sharing with the FHA some of the benefit of the program. We think it is extremely important and appropriate that the homeowner should be helping to finance this program. We think that extending the appreciation sharing indefinitely, as the bill currently does, is not appropriate and also will be unworkable. Most homeowners do not stay in their homes more than 5 years. But for those who do and who make improvements, for example, in the homes, having indefinite appreciation sharing would require very complicated calculations about what part of the appreciation is a function of the original home and what is a function of subsequent improvements. I think capping it at 5 years with a 3-percent payment thereafter, as Mr. Frank's bill does, is a very good approach.

Finally, we need a mechanism for dealing with the problem that in many cases loan servicers will be unable to take advantage of this program, just as they are unable to voluntarily modify the loans, even where each of those options is far better for investors than foreclosure. And the clearest example of where that will arise

is in the case of the loans that carry piggyback second mortgages. Without the consent of the second-lien holder, there is no—you cannot modify the loan and save the home. And consent of the second-lien holder has not been forthcoming. The only proposal that I am aware of that would address this problem is a mechanism for allowing courts to supervise a modification of those loans so that the second-lien holder's consent is not required.

Thank you very much.

Chairman DODD. Thank you very, very much. I appreciate it, and I appreciate your testimony.

Mr. Scott Stern, we thank you very much for being here this morning.

STATEMENT OF SCOTT STERN, CHIEF EXECUTIVE OFFICER, LENDERS ONE, INCORPORATED

Mr. STERN. Thank you, Chairman Dodd. My name is Scott Stern, and I am the CEO of Lenders One Mortgage Cooperative in St. Louis, Missouri. Since this is our first appearance before the Committee, I would like to say a few words about the unique role that Lenders One plays in the mortgage industry.

As the country's largest mortgage cooperative, Lenders One represents the Nation's "Main Street" lenders, like William Raevis Mortgage in Shelton, Connecticut, and probably lenders in the great States that you all represent. Our 110 shareholder mortgage companies have originated over 1 million home loans, almost exclusively prime loans, in the past 5 years, and we make homeownership possible in communities across the United States.

This Committee, this Congress, and the administration have taken important steps to address today's mortgage crisis. However, the mortgage storm is far from over, and the Federal Government's work is not done. More needs to be done to address the root of the problem: looming foreclosures caused by defective subprime loans. These loans represent a toxin in the mortgage system that has spread far beyond the subprime sector to infect liquidity in the prime mortgage market, accelerate home price depreciation, and cause ripple effects throughout the Nation's economy.

As FDIC Chairman Sheila Bair testified recently, negative housing trends are likely to continue at least through this year. The bulk of subprime hybrid ARM resets are still ahead of us. Over 1 million such loans valued in the hundreds of billions of dollars will reset in 2008. A similar volume of payment option ARMS and interest-only loans are also on the horizon. Many of these loans are foreclosures waiting to happen.

I would also like to add that, in my expert opinion, these loans would not be foreclosure candidates had they been FHA loans in the first place.

Loan modification efforts to date have fallen short of the scale necessary to make a significant reduction in foreclosures. The main Federal effort, FHASecure, while well intentioned, is simply not serving enough borrowers. Credit Suisse has estimated that only 44,000 delinquent borrowers would be eligible for a refinance under the program. And the latest numbers directly from HUD indicate that since the inception of the program in September 2007, just 1,500 FHASecure conversions have been made.

We believe that an enhanced federally assisted effort to cleanse the market of distressed subprime loans will contribute to stabilizing the mortgage finance system. Chairman Dodd's bill, the Hope for Homeownership Act, is carefully drawn to achieve that goal. The concept is simple: lenders and investors would take a loss by marking down the loan to market value. Borrowers would refinance at a higher yet stable rate than their initial teaser rate. No one gets a free ride.

In my remaining time, I would like to address the three fundamental objections to Government action.

No. 1, restructuring a troubled loan is not fair to other homeowners who are not in troubled loans. We are not unsympathetic to that view. However, the fact is that foreclosures create home equity losses, tighter credit, and a strained tax base for all homeowners, not just the family losing their home. By reducing foreclosures, all homeowners will see the benefits of market stability.

No. 2, borrowers who take out risky loans deserve what they get. As a mortgage practitioner who has personally originated over $300 million in home loans, I respectfully disagree. Disclosures were often less than adequate, and faced with a bewildering array of loan terms, borrowers tended to trust their banker or broker, who in turn broke that trust. I liken the situation to that of a doctor and patient dealing with a medical procedure. The patient bears some reasonable risk. But they do not bear the risk of malpractice by the doctor. In our industry, we have frankly seen too much mortgage malpractice.

And third, that this creates a burden on the taxpayer. Again, I respectfully disagree. The new loans would have positive equity; they would be fixed-rate stable mortgages; and the new borrowers would qualify under terms that made them safe loans.

"Curing" a loan that had a high risk of failure creates no moral hazard. Just the opposite. Modifying a loan which probably should not have been made in the first place is the kind of action that can help restore integrity in the market.

Finally, while we support the overall approach for the Hope for Homeowners Act, we do have some suggestions for improving the proposed legislation which can be found in our written testimony.

Once again I would like to thank the Committee for today's opportunity to share the views of the Nation's independent mortgage bankers, and we look forward to continuing to work with this Committee to ensure stability and fairness in the mortgage market.

Chairman DODD. Mr. Stern, thank you. That was excellent testimony. I appreciate immensely your comments.

Mr. Elmendorf, welcome. Mr. Elmendorf is a Senior Fellow at Brookings, and we appreciate your being back with the Committee.

STATEMENT OF DOUGLAS W. ELMENDORF, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. ELMENDORF. Thank you, Chairman Dodd and Members of the Committee. I appreciate the opportunity to appear before you today.

The American economy, as we all know, now faces serious challenges. The economy is very likely in recession. Neither housing construction nor house prices show any sign of reaching bottom.

The financial system is reeling, and lending to households and businesses is impeded. In the absence of further policy action, several million families will default on their mortgages in the next few years and lose their homes to foreclosure.

Congress, the administration, and the Federal Reserve have responded to the broader problems, with forcible fiscal and monopoly actions. But less has been done to tackle the housing and mortgage mess directly. It is neither feasible nor appropriate for the Government to ensure that all families, regardless of their mortgages or their overall financial situations, can remain in their homes. However, it is both feasible and appropriate for the Government to reduce the number of families that will lose their homes in the next few years. Moreover, policy actions in this direction will have favorable effects on the broader economic problems that we confront.

The first part of my remarks presents the case for greater Government involvement, and the second part turns to specific policies.

Some have argued that mortgage borrowers and lenders should be left to work out their problems themselves. With the sharp deterioration in underwriting standards over the past several years, many families have indeed ended up in mortgages that are unsustainably large. In addition, the argument goes, it is unfair to help homeowners facing foreclosure while not helping people who chose to remain renters or who are stretching to meet their mortgage payments. And helping borrowers and lenders will create a moral hazard of excessive risk taking in the future.

These arguments contain some truth, in my view, but they are not the whole truth. Despite these reasonable concerns, the Government has a crucial part to play.

First, the Government has long had an active role in housing finance. With large mortgage lenders suffering massive losses, and many mortgage-backed securities viewed especially negatively in financial markets, the private supply of mortgage credit is now severely hampered.

Second, Government policy never does, nor should, follow free market principles absolutely. We are always balancing the need for people to bear responsibility for their decisions with the goal of protecting the vulnerable members of our society.

Third, mortgage problems have consequences that go well beyond the families and institutions directly involved. Foreclosures lower property values. Gyrations in financial markets pose risks to everyone's savings. And the weakening of the overall economy hurts many, many people.

Fourth, the legal complexities and coordination challenges created by mortgage securitization imply that fewer loans will be modified than would be in the interests of even the lenders.

The compromise housing bill being debated in the Senate this week includes several valuable provisions, as the Chairman has noted, including the appropriation of additional funds for mortgage counseling and the augmenting of funds for State and local governments. However, the bill falls short of what is needed, in my view. The further proposals of Chairman Dodd and Chairman Frank in the House to expand eligibility for FHA guaranteed loans would be an appropriate and important step forward for several reasons.

First, the FHA's traditional mandate is to assist individuals underserved by the traditional mortgage market. Given the pullback in private mortgage lending and securitization, it is natural to increase the FHA's presence as a counterweight.

Second, the proposals on the table are appropriately selective in the families they help. The proposals recognize the hard truth that not every family can afford to stay in its current home, so eligibility is limited to owner-occupiers who satisfy underwriting standards and represent good credit risks at the new mortgage levels.

Third, the plans do not simply throw open taxpayers' wallets. Instead, they keep any cost to taxpayers quite low, again, by limiting eligibility to cases where existing principal amounts are written down, also by collecting insurance premiums, and by recapturing future appreciation.

Fourth, these proposals encourage servicers to modify existing mortgages by providing a safe harbor against legal liability for doing so and by facilitating the issuance of new mortgages so that the old mortgagors do not need to remain in the market if they would prefer to leave it. As other panelists have noted, finding ways for the Government to help resubordinate second liens would be a valuable further step.

In conclusion, I would emphasize that all of the policy options available to the Congress at this time are unsatisfying in many ways, but the cost of inaction is also very high. I urge this Committee and the Congress to go beyond the compromise Senate bill by expanding the role of the FHA. Addressing the mortgage mess can help families and reduce the scale of our broader economic problems, and it can do so with limited effects on future mortgage lending and future risk taking, and at fairly low cost to taxpayers.

Thank you very much. I would be happy to answer any questions you may have.

Chairman DODD. Well, thank you very much, Mr. Elmendorf. I think you may be hearing the buzzers going off here, so we will be running in and out voting. So let me address, if I can, to both you and to Secretary Summers, a question, if I may. And I think, Larry, you sort of alluded to this in talking about the negative cycle of foreclosures. I think others have called it the "negative feedback loop," and maybe other economists make reference to that. Would you expand on that a little bit, because I think it goes to the heart of why there is a justification for some intervention here. If you get this constant domino effect which drives this problem even further and deeper, creating additional problems, it may provide some light as to why this particular fact situation warrants something like the suggestion we are making.

Mr. SUMMERS. You have two different possible vicious cycle mechanisms going on. One, which is abundantly clear, is with respect to mortgage-backed securities where, as you put it in your opening statement, Mr. Chairman, there was an issue of finding—there was an issue of finding a floor and reducing uncertainty. And you have the problem that there are leveraged holders of those securities. As those securities decline in value, they get a margin call; they have to put up more money. They are either unable or unwilling to put up more money, as a consequence of which they sell them, as a consequence of which they go further down in value.

And I think it is quite clear that that mechanism is present and is pervasively present with respect to mortgages, and anything that involves purchasing mortgage-backed securities, as your proposal would, or as the involvement of the GSEs does, serves to limit that.

Second, there is the similar mechanism operative in the market for houses. The more house prices fall, the more people walk away; the more they walk away, the more house prices fall; and then more people walk away, and you have the same kind of vicious cycle. There is also a desirability of containing a vicious cycle of that kind.

With respect to the second mechanism, though, I would caution that while I do not think I would go quite as far as he did, the point that Dean Baker made I thought was right, that one has to be very careful in stabilizing markets and preventing overreactions. But at the same time, one needs to be very careful of not trying to prop up markets at artificially inflated values. And I do not think we can say at this point that there are large parts of the country where house prices have fallen significantly below fundamentals, and, therefore, by reducing the effective supply of housing, we are making the adjustment process better.

So while as you know, I am very sympathetic to the broad structures that you have put forward in your legislation, my enthusiasm derives from two sources, and quite explicitly does not derive from a third. It derives from the sense that this would be constructive with respect to the mortgage market in providing stability in that financial market. It derives from the sense that it would bring about more efficient outcomes that the person who is living in many of these houses is the right person to continue to live in that house, but needs to be living in that house with the value of the house written down. And I believe your legislation will support that taking place more efficiently and effectively than it otherwise would.

But I become uncomfortable when—and I also believe related to that that in certain neighborhoods preventing an epidemic of foreclosures would avoid a disaster. But I think it is very important to be clear that it is not and should not be the objective of public policy to prevent house price deflation as a macro phenomenon. Moreover, in some sense, one of our concerns is that what we have to want is that both housing markets and financial markets find a level where it is attractive to be a buyer. And the longer the Government—if the Government were to become a dragging anchor, slowing the process of adjustment, you would delay the day when it was attractive to be a genuine buyer, and in some ways repeat the mistakes of what the Japanese did.

So, yes, but the case is based on the micro of the housing market and the macro of the mortgage financial market, and not based on a desire to artificially prop up housing prices. And I think it is—I am glad you asked the question because I think it is important to be clear about, at least for me, where the case lies.

Chairman DODD. Well, I think that is a very good point, and I—other members can speak, obviously, for themselves here. I agree with your conclusion; hence, while we are trying to do this carefully, understanding there are hazards in how we craft something like this, there is a hazard in not crafting anything at all. And so

how you try and manage this intelligently—one of the objectives, obviously, is to have a limited timeframe we are talking about for exactly the last point you are making, so that this is a very—we are talking about a brief period with a sunset provision in a sense, so it is not an ongoing program, not setting up a separate bureaucracy, utilizing the platforms that presently exist with FHA, for instance. There is a tendency in this town, obviously, if you establish something, it does not go away, and the danger of what that could do to your macro point.

Mr. SUMMERS. I think a danger—If I might?

Chairman DODD. Yes.

Mr. SUMMERS. I think a danger which you will need to be attentive to—and I believe it can be addressed—that actually Dean Baker's comments highlighted for me is the following: You are going to do one of your transactions where you buy the mortgage and then the FHA gives a 90-percent mortgage, and you are going to do it hypothetically in some community where there has not been a lot of turnover in the housing market, where there are 15 months of normal demand for houses being supplied. And some appraiser is going to come along and say what the value of the house is, and then you are going to write a mortgage for 90 percent of that, and that is what the guy holding the mortgage is going to have.

Well, in an illiquid market with a very large inventory, doing that appraisal is not an easy thing to do accurately, and everyone that appraiser is going to meet is going to tend to have an interest in a higher appraisal. And the people who are going to bear the burden if there are misappraisals are going to be the taxpayers when the appraisal turns out to be wrong and 2 years from now, gosh, the house is worth 20 percent less than it was appraised and we are seeing this movie again.

And so I would urge that there be very considerable attention given to the incentives in the appraisal process as this takes place, and to what I might think of as forward-looking appraisals. It is very easy in down markets to do—I mean, I have been misled myself in this on a number of unfortunate occasions, where you are told what your house is worth on the basis of somebody who did comparables when houses like yours were sold 6 months before, and that becomes the basis for the appraisal, and that is not realistic in the context where the market is falling.

I think one of the things that you will need to give careful thought to is the incentives governing the appraisals as this process goes down.

Chairman DODD. Thank you very much.

Mr. Elmendorf, do you want to comment on this as well? I know you have time constraints.

Mr. ELMENDORF. I agree with much of what Larry said about not trying to prevent an aggregate correction in house prices. I do not think your proposed legislation would or could do that. I think our goal is to try to avoid an overshooting, and particularly in those cases where house prices rose very dramatically and are now coming back down very dramatically. And in those areas, particularly those where subprime lending was very prevalent, I think there is a risk of an overshooting in a way that would be very damaging

to the people in those areas, those in the subprime mortgage houses and those in all other houses or rental housing as their neighborhoods and communities are hurt. And I think trying to avoid that overshooting is a legitimate goal and one that your legislation would help to achieve by providing a way to help people get into new mortgages.

Chairman DODD. Thank you very much.

Let me turn to Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Welcome all, good testifiers and experts in this field. We have a major problem, as you well know, and there are many solutions, one of them being on the floor today. I happen to think it is inadequate. But we have an awful lot of other people who are proposing changes like Chairman Frank, Chairman Dodd, and others.

Can anybody answer this question: How many people who are in trouble today took second mortgages or refinanced to tap their home equity?

Mr. STERN. I will be happy to answer this question.

Senator BUNNING. Go ahead, Scott.

Mr. STERN. Thank you for the question. Our experience is that where there were second loans, they were originated as part of a single transaction, perhaps an 80-percent first and a 20-percent second, not——

Senator BUNNING. To get the whole house covered?

Mr. STERN. To get to 100-percent loan-to-value, most likely on the suggestion of a lender. I do not know a lot of mortgage lenders who walk into a lender and say, "I would like an 80:20 piggyback loan." These are often at the suggestion of the lender.

Your question is perhaps to question were these irresponsible lenders who just borrowed too much. I would respectfully say I do not think so. The majority of the time where these were second loans, I think they were part of an overall single transaction of a first and second mortgage combined on the recommendation of lenders.

Senator BUNNING. Would that be because of the total overall cost not being able to be afforded by a single mortgage so they could borrow enough to cover the entire mortgage with a second loan?

Mr. STERN. Over the past 5 to 7 years, the mortgage industry has done a variety of things to expand homeownership opportunities, most of them well intentioned. Some of these involved minimizing documentation, some of them involved lowering credit standards, and some of them involved reducing down payment of any borrowers who borrowed 100 percent of their home's value did so because they needed to. Many of the borrowers did so because they had to. But at the end of the day, there were also competent underwriters, typically seasoned underwriters, who looked at these transactions and erroneously concluded that the overall risk of the loan was accurate.

What we now know is that there was a significant layering of risk that is resulting in the challenges that they have today. They do not have enough money. They cannot afford the ARM resets. But now, of course, the big challenge is they cannot refinance, even if they want to, because their home has negative equity.

But in answer to your question, I do think there are cases where borrowers put little down because they needed to, but now it is the result of the negative equity in their home that is causing the challenges, not the fact that they put no money down to begin with.

Mr. BAKER. If I could just throw in one more thing.

Senator BUNNING. Sure.

Mr. BAKER. A lot of the people that took out additional equity when they refinanced, in many cases these were people who wanted to refinance to take advantage of lower interest rates where they were subject to resets in 2005–06, and there had been appreciation in the interim, and they were actually encouraged in many cases by lenders to take out some of the additional equity to meet needs, whatever. So it was very often at the urging of the lenders that they would have refinanced for more than the original value of their mortgage.

Senator BUNNING. Can any of you see what incentives there would be for second mortgage holders to release their mortgage so borrowers can refinance?

Mr. BAKER. In many of these cases, they have—I mean, as things stand now, their second mortgage is going to be almost worthless, you know, because the home is underwater. They already——

Senator BUNNING. Well, I understand that, but to actually have a chance for the first mortgage to get changed, you have got to get a release from the second mortgage. So——

Mr. BAKER. That is right. You are absolutely right, Senator. I am sorry. But, I mean, at this point they essentially are giving up nothing except their right to obstruct.

Mr. ELMENDORF. Can I amend that a bit? I think the problem is they are not quite worth nothing because in some cases house prices may rise, people may stay in the homes. Second-lien holders may get something. It is not very much. It is probably pennies on the dollar of what the mortgage—of what they hoped to get in an ideal world. But it is not quite zero, and I think that is the complication. It is not just they will not sign the form. They want to get a little something out of this, and I think that is the reason why coordination in the refinancing is important and why the second-lien holders may need—do need to be brought into this process, and they may need to get something out of the deal—not very much, I think, but perhaps something.

Senator BUNNING. Maybe anyone—go ahead, Larry.

Mr. SUMMERS. I wish I had a clear way forward for you on this issue. I think it is a very difficult one. There is what I would call a long and undistinguished tradition of hold-up artists in financial life. And just as the guy who figures out that somebody wants to build a mall in a certain area and he figures out to own half an acre, half an acre is not really worth very much to him, but he feels himself to have an asset of considerable importance because of his blocking right, that is the nature of the problem that one has with these second mortgages.

On the other hand, as I suspect those on your side of the aisle will point out, rightly, one does need to be rather careful about being cavalier about what, after all, are legal rights that people acquire.

Senator BUNNING. Well, especially if we throw it into a bankruptcy court, or something like that.

Mr. SUMMERS. I personally am of the view—and I know this is controversial—that carefully structured bankruptcy reform that does it in the context of bankruptcy would be constructive. There are others who would go further—and I would not—in allowing as part of a comprehensive solution some broad-gauged writing down of second mortgages with somebody's discretion outside of the bankruptcy context. I find that to be somewhat—I find that to be a problematic approach. But I think the question of how one works through the second mortgages is a crucial one.

I would just add one other thing. I would, if I could be so presumptuous, commend to Committee staff the recent work that has been done by the Boston Fed where they have followed every mortgage and every home in Massachusetts over the last 20 years. And one finds a variety of quite interesting patterns. Much more common than I would have imagined, for example, is the pattern where somebody takes out a prime mortgage and subsequently refinances as a subprime mortgage in order to get more out in appreciation. And we think of these mortgages that are being restructured all as the mortgage that the person used in order to buy the home. And it is that in many cases, and most cases probably particularly the egregious 2006 and 2007 subprime cases. But there are a variety of other phenomena here involving refinancing, and I think there is really a great deal of experience that is calibrated in that data that could usefully inform the design of this legislation.

Senator BUNNING. Thank you.

Chairman DODD. Thank you, Senator.

Senator Reed.

Senator REED. Thank you, Mr. Chairman. Thank you for your excellent testimony.

Secretary Summers, one of the assumptions that everyone is operating under, and I know I am, is that if you adjust the price of the property down to a realistic value, then the homeowner will be able to carry on. But the question then is the continued viability of homeowners given declining wages in some places, stagnant wages, unemployment going up, commodity prices going up, and family budgets. This is not the best time to try to work out a real estate crisis.

So any thoughts on the other side of the equation, that if this continued, price increases in commodities and unemployment growth, classic recession, where are we?

Mr. SUMMERS. I think it is a serious concern, Senator Reed. I am inclined to think that the further decline in house prices risk that I described is, if anything, slightly greater than the risks you describe, but I do not minimize the risks that you describe.

The HOLC program in the Depression that the Chairman has referenced in designing his legislation has an approximately 20-percent foreclosure rate, even though the program was put in at the bottom of the Depression, things were getting better, and equity levels were rather higher than what we contemplate today.

So I think we need to be realistic in recognizing that whatever we do with the FHA, there is going to be a significant re-foreclosure rate. On the other hand, there are going to be a very large

number of families who are going to have been benefited and who are going to have been enabled to stay in their homes.

Now, some suggest, as Dean Baker did, that, one, cut past all that problem by turning the potential victims of foreclosure into long-term renters. And I see a merit of that approach in the sense that you would avoid some of these problems—not all of these problems. They might not be able at a certain point to afford the rent.

For me, at the present time, the problematic aspect of that is the almost entirely involuntary character of what is happening vis-a-vis the contract that underlay the mortgage and vis-a-vis the bank.

So I do not support that and would oppose it fairly vigorously, but going in that direction is the direction one goes if the problem one is most focused on is the ability of people to continue to stay in their homes indefinitely.

Senator REED. Dean Baker, do you have a comment?

Mr. BAKER. Yes, just a couple of things. I think any sort of program like the Hope Act would be most successful if we are very careful about the prices for reasons Secretary Summers had said and I had said earlier. And I think one way in which we could do that is if you try to anchor the guarantee price in rents, because rents are ongoing in the market, they have not fluctuated in as radical a pattern as sale prices. So if we were to set a guarantee price of, say, some multiple, 15:1 or something like, of rent, we would do two things. One, we would ensure ourselves that we are not setting ourselves up, setting up the taxpayers for large losses; and, second, we would minimize the subsequent foreclosure because that would be a situation where you would not anticipate large subsequent declines in the house price.

So I would suggest that, you know, when we are looking to appraisals, again, as Secretary Summers said, it is very hard to find a reliable appraisal in a very irregular market. We could get a reliable rental appraisal because there is a large amount of rents in the market, and that could be a very good anchor. And, again, insofar as we are using money, using some of this guarantee to guarantee overpriced homes in bubble areas, that is money that is not going to stabilize markets where it could have a beneficial effect.

Senator REED. We all make reference back to the experience of the 1930s and the Depression, but there seems to be some—there are differences, obviously, and one is that—and maybe this is more folklore than reality, but it seems to have some currency. It is that back then most of the mortgages were owned by a financial institution that could go in and make this deal pretty directly. The securitization process, which is very sophisticated, how will that complicate or what should we be particularly looking at in terms of the obstacles to getting anything done given these very sophisticated securitization products that have been cut up in tranches and defy some people's understanding? Secretary Summers.

Mr. SUMMERS. I apologize for having lost sight of precisely where the legislation Senator Carper has discussed in the past currently is. But the proposals to give legal liability—to give relief of legal liability from servicers for renegotiate strike me as being close to the lowest hanging fruit in this whole area.

I think there is room for debate as to just how much of the problem they will solve. I think there is no room for—I think there is

almost no room for rational debate that they represent a constructive step in the right direction.

Senator REED. Any other comments? Yes, Ellen. Ms. Harnick.

Ms. HARNICK. I would add that one other difference that flows from the fact that these loans are securitized is that different incentives are at play, so that back in the 1930s, the lender was the holder of the note and was the person negotiating. Today, when you have the servicer negotiating on behalf of different tranches of investors, sometimes the servicer's own incentives are quite different from what is good for the note holder. So that, for example, there has been a lot written about this, but servicers actually earn more themselves from foreclosing than they do from some of these cost-intensive alternatives like modification. And I assume that that would be in play with the FHA proposal as well. They will incur costs in going through the process for which they will not be reimbursed under their pooling and servicing agreement; whereas, if they foreclose, all their costs would be covered.

So this is a problem that would have to be worked through. There would need to be a way to make the rational outcome—realize the rational outcome even where the servicer's incentive might run to the contrary.

Senator REED. Do you have a proposal?

Ms. HARNICK. Well, the best proposal I am aware of is the one that allows a court to supervise the process and ensure that the rational solution is imposed where the servicer cannot or will not agree, and that is the bankruptcy conversation that has been raised in other quarters.

Mr. STERN. If I——

Senator REED. Yes, please.

Mr. STERN. I am happy to just add very, very quickly that the No. 1 thing we hear from Wall Street and from securitizers is they do not know where the bottom is. And I assure you that when they say we do not know where the bottom is, they are not talking about credit quality. They are talking about value.

On a recent call I was on, we discussed the fact that this is the best quality of loans—the applications of March of 2008 are the best quality of loans many of us have ever seen. They are high credit, they are low loan to value, and yet we cannot make the loans because simply the properties are not appraising out.

If we had a bottom of the appraisal market, of the valuation market, these loans could be refinanced. Many of these borrowers need to refinance. Their ARMs are resetting. They come to us. We cannot help them because the simple reason is their loans are underwater. Securitizers need a bottom.

Senator REED. Thank you very much, Mr. Chairman.

Bob, I think you are next.

Senator BENNETT. Senator Dodd as he left said he was going to have to recess the headquarters because of the votes, and since I am the only one who has voted, he said, "You recess the hearing." [Laughter.]

So I am prepared to do my presentation now—Senator Bayh.

Senator BAYH. Mr. Chairman, if I could just briefly apologize to our panelists for the votes intruding upon this panel. We are all grateful for your time. Secretary Summers, it is particularly good

to see you, and I could not help but think about the echoes to some of the challenges that you dealt with very ably in the 1990s currency crises in East Asia or in Mexico, and the countervailing risks of contagion and moral hazard. And it seems to me that there are some analogies to this situation where we need to deal with the systemic risk of the day, but then look very carefully at how we got into this mess and put into place mechanisms to make sure—you mentioned the incentives that are misaligned in some cases—to make sure we do not get into it again to deal with the moral hazard potentially down the road.

So I would not help but be struck by that, and, again, thank you all. I apologize for having to run, but it is one of the few things as Senators, you know, they actually pay us to do here is to vote. So thank you all very much.

Thank you.

Senator BENNETT. Thank you.

I want to combine some of the things I would have said in an opening statement with my questioning period, and I have found this panel to be very, very helpful, not necessarily in terms of the solutions you proposed—that might disappoint you—but in terms of the problems you have exposed that are helpful to us.

Secretary Summers, I applaud you and your final statement where you say, "It is essential to recognize that policies that serve only to delay inevitable adjustments can easily prove counterproductive." And in our effort to be seen as doing something, the Congress inevitably moves in that direction, and I appreciate that warning.

I want to show you a chart—I should have had it blown up, but I think it is big enough you can at least see the divergence between the two lines, and let me tell you what they are. The blue line is estimated price change since January 2006, according to Case-Shiller, and it goes from the baseline point, a peak here in price appreciation occurring in July of 2006, and then down 10.8 percent now.

The red line is cumulative estimated price change since January 2006 according to OFHEO's Monthly Purchase Price Index USA. They are dramatically different. OFHEO shows a one-tenth of 1 percent increase in housing prices over that period, with the peak occurring in May 2007. And in May 2007, Case-Shiller had it already underwater.

And as I have talked to Mr. Lockhart at OFHEO and asked him why the discrepancy, the answer is: We went to different places to gather data. Case-Shiller gathered the data in the 20 largest cities in the United States, and OFHEO tried to gather data over a much broader scale. Point one for you, Dr. Baker, that there is a difference between prices in one place and prices in another, which makes it more difficult for us to come up with a nationwide system, and if we try to do our nationwide system based on the blue line, we may very well do damage to people who are living in cities that contribute to the red line, because the differential is fairly strong.

My own observation is that in addition to the differential that you talk about, Dr. Baker, where some cities have reached equilibrium and others are in bubble condition, even within the same market there are differences, depending on the price band. In my

own city of Salt Lake City, I know there is a glut of $400,000 homes, because my daughter has one that she has been trying to sell for over a year and can't. There is a shortage of homes under $200,000. And the law of supply and demand says that we should be building homes in that area. Why is there a shortage in that price band? Because homeowners in the period when the peak occurred, regardless of where you put it on the chart, could make more money building $400,000 homes and so they did not build homes in an area where there would be a greater demand because they could sell homes in the higher area, because people were buying them with the kinds of practices that you have been talking about. And also—let's not rule this out or turn our backs to it—people were buying homes for the purpose of selling them. And the homeowners were meeting that demand, and the market was there for it. And when that collapsed, everybody involved in it got hurt, and I frankly think most of them who were involved in the speculation deserved to get hurt.

These are not struggling working families who got schnookered into something by an improper mortgage activity, Mr. Stern. I fully agree that that went on. There is no question that what you have described is accurate. But it was not accurate for the whole market, and this is my point. Depending on which city you go to, depending upon which price band you go to, depending on what kind of buyers you go to, you get an entirely different kind of dynamic and an entirely different motive for getting into this, and solving it with a single Federal program is extremely difficult.

Now, Mr. Stern, you said the solution—I wrote down the phrase—is you "mark to market value." Who determine what is market value? You have described loans that are good loans that fully meet all the needs of the lender, but the market value is not there because the appraisal is not there. Is the appraisal—market value, the economists tell you, is when a willing buyer and a willing seller sit down and come to a price. And at many parts of the there, again, at the lower end, a willing buyer and a willing seller could very easily come to a price because there is a shortage. And to arbitrarily have some Government agency or someone backed by a Government agency try to determine market value is going to be very, very difficult. And if all public policy flows from that kind of determination, we run the risk of doing what Secretary Summers warned us against of delaying an inevitable shake-out here.

One final comment—well, no, two. This chart is harder for you to see at that distance. There is a bottom line that looks flat on both charts. It is in dark blue. It is not flat. It is loans in foreclosure, all mortgages. And in 2001, it was at 1 percent, and by 2008, it is at 2 percent. So it is not flat. It has doubled in that time period.

Now, the swooping red line is subprime adjustable rates in foreclosure. And in 2001, it was at 8 percent. It fell to 3.5 percent in 2006, and then skyrocketed to 14 percent, and it is still going up.

The somewhat more complicated chart above it has a third line on it in dark maroon. It is between the two. Very interestingly, it in 2008 is below where it was in 2001. It is foreclosures of subprime fixed-rate mortgages. Subprime fixed-rate mortgages hit

their peak in foreclosures in 2002 and have been coming down ever since.

Further underscoring the point that hits me out of all of this testimony is that this is not a monolithic market. And most of the conversation, both by you and by the reporters who have chased me as I have walked up and down the halls, is, "What are you going to do about 'the' housing crisis?" As if it were a single, monolithic problem.

We have differences in—repeat, differences in location, we have differences in price band, we have differences in style of mortgages. We have all kinds of differences that we are trying to solve by a single Federal law.

My final point, you talk about the resets. I have a mortgage that just got reset. It went from 6.25 percent to 5.25 percent. I just got the notice yesterday. I ripped it open as I came home from the day in the Senate, and I said, "This is great. I love reset in this market." It just cut one full percentage point, 100 basis points off of the amount that I am paying here. We cannot automatically assume that reset means disaster.

Now, I have gone on too long. That is my opening statement, and I am going to have to leave in 2 minutes. But, Secretary Summers, you wanted to respond.

Mr. SUMMERS. Senator, I take your point about heterogeneity, but I think is exactly right, but I would qualify—I would at least make three points.

First, I think if you look at the study carefully, the difference between the OFHEO index and the Case-Shiller index, you will discover that different places is part of the story, but another very large part of the story is that the OFHEO index covers homes that are supported by conforming mortgages, not the homes that are supported by the nonconforming mortgages of various kinds, including subprime, where much of the problem lies.

Second, there is, as you say, heterogeneity, and at least as I understand it, that is why voluntarism is at the center of Senator Dodd's proposal and proposals like it. Homeowners like you and mortgage owners of your mortgage will have no motivation whatsoever because of the circumstances—the part of the country you live in, the nature of your creditworthiness, and so forth—to bring their mortgage forward. The available evidence suggests that foreclosures are vastly disproportionately concentrated in categories of homes that have fallen way off in price.

And so if you make available a universal foreclosure program, the people who will take it up will be those who are facing the problems of falling house prices and securitization.

It is an unfair observation, but it is not a completely unfair observation, to suggest that if a proposal were made to help the victims of heart disease that an argument that that was an unwise proposal because there was enormous heterogeneity in health and many people did not have heart disease and had other diseases would probably not be a very strong argument. And while this situation is not—the analogy is not really right, and so what I just said is a bit of——

Senator BENNETT. I will agree with you that the analogy is not——

Mr. SUMMERS. As a bit of a cheap shot, it does capture something which I think is important to recognize, which is the place where these national programs will have their impact will be in the segments that are caught by the kinds of distress that we have been discussing.

Senator BENNETT. I vastly apologize, but Harry Reid keeps the time rule vigorously, and if I do not leave, I will not get there in time for the vote. Respond if you want to in writing, anything you want to send to my office. And, again, it has been a very valuable panel, and I have learned a great deal from it.

The Committee is adjourned.

Let me correct that. The Committee is in recess.

[Recess.]

Chairman DODD. The Committee will come back to order. My apologies. You are very patient. We will have to get you a very good mortgage someplace.

[Laughter.]

You cannot plan these things. You set up a hearing, and then everything happens at once. Last evening, we spent all day trying to resolve some 16, 18 different amendments as a managers' amendment as part of the housing proposal we just voted on. And I had also agreed and accepted a wonderful invitation several weeks ago to speak to the midshipmen at the Naval Academy last evening. And I wonder who was working against me that all of a sudden the final vote on the housing package was going to occur on the very night that I was going to address the corps of midshipmen in Annapolis, and then this morning holding this hearing and having the votes occur at the same time.

So to the three of you here, I appreciate immensely your willingness to stay around a little bit and respond more to some Members' questions and some thoughts, and your testimony has been excellent this morning. So I thank you for that as well.

Given the short time we have, let me turn to Senator Carper. I have had a chance already to raise some questions, and he has not, and then what we will probably do is leave the record open and allow Members to submit additional questions as well for you.

Senator Carper.

Senator CARPER. Thank you, Mr. Chairman. Let me just congratulate you and Senator Shelby on the work that culminated with the vote on the floor. Do you recall what the final vote was?

Chairman DODD. 84 to 12.

Senator CARPER. 84 to 12. It is pretty hard around here to get—I could introduce a resolution that says today is Thursday, and I would be lucky to get 84 votes for it. So that is pretty impressive.

[Laughter.]

I would echo the Chairman's thoughts. Thank you so much for your patience, for waiting for us, and for your testimony and responses.

One of the things that Secretary Summers mentioned before we started our series of votes, he talked a little bit about the safe harbor legislation, and he sort of complimented me on my safe harbor legislation, which actually is going to be introduced by Delaware's Congressman, Mike Castle, also a Banking Committee member and, like me, a former Governor. People confuse us all the time, in-

cluding in Delaware. But it is an issue that I have some real interest in, and I think the notion is if we are going to have this voluntary program where we get borrowers, lenders, servicers, mortgage servicers to agree to take a haircut, a financial haircut, then there may have to be some protection against lawsuits against the servicer.

And what I think Secretary Summers was saying is he agrees with that notion, and I just want to ask each of you to comment on the value of that proposal by my colleague from Delaware, Congressman Castle, the safe harbor proposal.

Mr. STERN. I am happy to start. On my way over here today, when we were pondering whether Government action was necessary, and we were thinking about medical malpractice, we said, well, when something happens to you in the hospital, you sue your doctor. You do not ask the Government for help. And why is this situation different? And I said, you know what? If I had been the victim of a bad loan, I would go sue my lender. And it is very relevant, I think, because I think if I am a servicer, a large servicer, and several of these companies have hundreds of billions, if not trillions, of dollars of loans, I think they have to be concerned about consumer lawsuits—not investor lawsuits, but from the very borrowers to whom they made the loans.

I do think it is an outstanding trade-off or compromise to say that in exchange for writing down the loan we will provide a safe harbor from a private right of action, because I do think if you are a servicer right now, you have to be concerned about lawsuits on behalf of borrowers who ended up with loans with the very features that are causing the financial pressure. I think it is an excellent outcome.

Senator CARPER. All right. Thank you.

Others, please.

Ms. HARNICK. Well, the safe harbor that I think is a really terrific idea and that I think Dr. Summers was supporting is the idea of protecting servicers from lawsuits by investors, because I believe that that fear is, in fact, one of the significant barriers both to voluntary loan modifications and I would imagine it would be a barrier to accepting a short refinancing under the FHA proposal. So I think that that would be really essential. And it is essential in part because it would address—there is nothing unfair about it, I think, from the point of view of investors, because what it is attempting to do is address the very significant problem that servicers are in a position where they often cannot make the economically rational choice. If the economically rational choice is accept a short refinance or modify the loan and thereby recover more for the mortgage holder than the inevitable consequence of foreclosure, that is a very good choice. And if servicers—to the extent that servicers are—and I have heard repeatedly that they are—hampered by the fear that some investors will say, well, the way you modified the loan or the way you structured the new refinancing disadvantaged me, even though it was better for the collective. So I do think it is an excellent idea.

I have to say I would not be supportive of the idea of providing a safe harbor from consumer lawsuits, and I do not know if that is something that needs to be discussed further. I could expand on

it if necessary, but for investor lawsuits, I think it is an excellent idea.

Senator CARPER. Mr. Stern, in your comments were you referring to investor lawsuits?

Mr. STERN. I am suggesting that if a consumer receives a short payoff from a servicer, one of the things they should offer in exchange is, yes, to not sue the servicer who provided them the short payoff.

Senator CARPER. OK. Fair enough. Thank you.

Dr. Baker.

Mr. BAKER. I do not have too much to add on that. I would agree very strongly that I think it is a step in the right direction because, you know, you sort of have this asymmetry that, you know, again, it may very well be in the investor's best interest, but from the standpoint of the servicer, they want to take the cautious path. I do not think any servicer has ever been sued for not doing a short sale or a writedown. So, you know, the cautious thing for them is just sit there, go ahead with the foreclosure. That is a well-trodden path, and that is very safe.

So I think, you know, giving them symmetry that they do not have to fear either way so that they can make what is the best decision, I think that is the good way to go. And, again, I would agree with Ellen that I do not—I would not want to give any sort of carte blanche. I am not familiar with the legislation, the details of the legislation. I would not want to give some carte blanche immunity in consumer lawsuits because there were improper actions in cases, and, you know, you might want to hold those servicers responsible. So I would be hesitant on that.

Senator CARPER. All right. Thank you.

The Hope for Homeowners proposal allows a mortgage to be refinanced and insured by FHA, as you know. In return for accepting the risk, FHA receives, I think, 50 percent of all future profits. I think that is the way it reads. The FHA should, in my opinion, share some of the future profit to help pay for the program, and the House bill allows FHA to share—I think a lot during the first few years, maybe 100 percent in the first year, down to 0 in the fifth year of a refinance. But, in any event, it is less over time.

How much should FHA receive for accepting this risk?

Mr. STERN. I would be happy to address that, and it might surprise you to know that there are State-run mortgage programs that currently allow for the State program to participate in the appreciation of a home. I would be surprised if you did know that.

In the State of Missouri, there is an organization known as the Missouri Housing Development Commission, and specifically they supply first-time homebuyer funds for borrowers with a median—who have an income below the median level in the area where they buy. In exchange for receiving those funds—they are subsidized interest rate and down payment funds. In exchange for receiving those funds, the buyer agrees to a concept called a "recapture tax," and that recapture tax agreement says: If you sell your house in the future and you make money on the home investment, and your income has increased above the median level, you must pay a percentage of those profits back to the Missouri Housing Development Commission. And what happens in that case is that money is used

to then replenish the system so that future buyers have the benefit of the first-time homebuyer system.

I just thought it would be helpful to you to know that it is not unprecedented. It works extremely well in Missouri, so the concept is called the "recapture tax," and they do have the benefit of the appreciation of the property in exchange for providing a subsidy.

Senator CARPER. All right. Thank you.

Ms. Harnick.

Ms. HARNICK. Thank you, Senator. I think it is a good idea for the homeowner to share some of the appreciation with the program, both for the soundness of the program and because as a fairness issue.

I think that my recommendation, our recommendation would be that we track more closely to what the House bill does. What the House bill does is it allows shared appreciation over 5 years, and, by the way, it tracks both shared appreciation and also making sure that the borrower can't immediately get the benefit of the 10-percent haircut. And the proposal here does the same. I think that is an excellent idea.

At the end of the 5 years under the House bill, the recapture tax, as it were, is capped at 3 percent, and I think that that is a more appropriate mechanism than having an indefinite 50/50 sharing of appreciation. I was saying earlier, quite apart from whether it is wise social policy to deprive the homeowner of 50 percent of the wealth-building value of a home indefinitely—I think that that is a real question. And I also think it is hard to administer. If the homeowner invests in a new kitchen, redoes the kitchen, and 15 years later the home is appraised at a value that exceeds both the refinance price and the value of the kitchen, how much of that appreciation is attributable to the work that they did and how much is attributable to the refinancing?

So for that reason, I would say I think it would be better to cut it off and cap it.

Senator CARPER. Well, we all know that when people want to raise the value of their home for sale, they improve those kitchens. And what do they do next? The bathrooms. At least that is what I am told.

Dean Baker.

Mr. BAKER. Yes, I would very much agree with that. I think the basic point here is that we do not want someone to be able to cash in, you know, at the FHA's expense with the initial 10 percent. So something like 100 percent to start and then phasing down close to 0 over 5 years, I think that is a reasonable framework we are talking about. And once you get further out, again, the value of that home is going to reflect, to a large extent, how much people have maintained it, what they have put into it, so it does make sense that that be, you know, a much lower tax, or however you want to put it, at some future point.

So something like what you have in the House bill I think makes a lot of sense.

Senator CARPER. All right. Great.

Mr. Chairman, thanks for the chance to ask these questions, and again to each of you for—I missed your testimony. I am told it was just a terrific panel. I am glad I got to ask you some questions.

Chairman DODD. It was very, very good.

We have a safe harbor provision in our bill, as does the suggestion of the House. The difference is the safe harbor that—in fact, the counseling provision is to protect the servicer from investor lawsuits. It is not to protect the servicer from consumer lawsuits. And there is more of a concern, I think, from that side of the equation.

In fact, I was curious. I know there are not many examples of this, but I was curious as to whether or not if you did not do something—if I am an investor and I discovered that a servicer refused to have a workout and the option was losing everything, I would be curious if there wasn't more of an action, a possibility of action there, why didn't you take that 50 cents on the dollar? I would be at least 50 percent better off than I am now if I end up losing everything. Again, I do not know if there is any precedent for any of this at all or not, but it would seem to me that might be a more likely outcome in some ways than the likelihood you are going to be sued because I am getting less than 50 cents—or 50 cents less than I would have otherwise gotten under the circumstances.

Mr. STERN. Yes, I would say—Dr. Baker said he has never heard of a servicer being sued for not doing a short sale, except I would say this is a very unusual time. If you have a chance to do a short sale for 50 cents on the dollar and you do not, and you do lose everything, I agree, this is a very unusual time. You could be sued for not doing the workout, where they might not have in the past.

Chairman DODD. Exactly, so it is interesting. Thank you, Senator Carper, very much.

Just going back over—and I am going to—not to keep you, just an additional point here. As I mentioned, Larry Summers and Doug Elmendorf had to attend a conference they are hosting today, and as I said at the outset, the proposal that I have suggested—back in January, in fact—raised this idea and then met—it is not a new idea, either. These are ideas that have been tried, as you point out. There are States that have tried variations of this. I was in Pennsylvania with Bob Casey, Senator Casey, the other day for a hearing, and I think it is the HEMAP program in the State of Pennsylvania, something very similar to what we are talking about here. In fact, they go further. They have another program, a HERO program, which really does take these underwater—completely underwater programs to try and salvage something out of them as well. So, again, people have identified the program in the Depression era, which was a more direct participation, a direct, I guess, acquisition and purchasing of these discounted mortgages.

I am told historically that the Federal Government actually made some $14 million. I do not know what that was in today's dollars, what it would be at the end of the day.

But I want to emphasize the point, I think there are some very, very good points. I think, Dean Baker, you raised, along with Larry, some cautionary notes, so as you start down this path, understand and think about them. That is why it is very important to me. This ought not to be an ideological debate. This ought to be a discussion about if we are going to do something, do it well, and make sure you are not going to do more harm. I guess to use your medical analogy, we ought to apply the Hippocratic oath here as

well. The first rule is do no harm. In a sense, while we are talking about mortgage malpractice, I want to make sure that we do no harm, that as we try to fashion ideas that can limit the number of foreclosures that are being filed every day in the country, as I mentioned, close to 8,000 a day; 240,000 people went into foreclosure in the month of February. And there is always a normal amount of this. I think one of the things that—maybe some people would assume we never had any foreclosures, and there are always a certain level of them occurring. But this time it is compounded in a way because of the liquidity issues that have arisen, and I want to underscore Larry Summers' suggestion. I do not know if any of you have any views on this or not, but the notion of the GSEs seeking more capital, and while there is a legitimate shareholder interest in all of this, they are called Government-sponsored enterprises for a reason, and there is something called a "Mission Statement," and the Mission Statement should reflect circumstances not unlike the ones we are in, as unprecedented as they are in many ways, but they exist, in effect, for dealing with moments like this.

And so I support his underlying idea of having them go out and raise more capital at this point, and the shareholders certainly have to be considered. But they, it would seem to me, have to take a secondary position considering what is the rationale for the existence of Fannie and Freddie anyway.

I do not know if you have—does anybody have any views on that? Do you have any view on that, Dean, what Larry talked about earlier?

Mr. BAKER. Yes. I did not quite agree with him on that because then we are asking Fannie and Freddie to take on, you know, more risk. And if you do not increase the capitalization, then that is putting—it is coming out of the taxpayer's expense. So the question is: How do you balance that, the shareholders versus the taxpayer? As they are taking on more risk, that is all going on the taxpayer side. It seems reasonable to say, OK, there also ought to be more on the shareholder side; therefore, there has to be more capital there.

So I think that is going in the right direction. How much, you know, what is the magic number there, I do not know. But I think certainly increasing their capitalization is the right thing to do now.

Chairman DODD. Ellen or Scott, any views on this?

Mr. STERN. Well, I will share with you that right now there are only four reliable sources of capital in the mortgage market today: Fannie Mae, Freddie Mac, FHA, and VA. There is no reliable private source of capital from anyplace else, from Wall Street to insurance companies, even to banks lending their own money. And the reason for the reliability is the implied guarantee of the GSEs.

So I would suggest that especially now, the liquidity of the GSEs is important. It probably has been never more important. And as long as they remain the most reliable source of funding for an average borrower who needs a home for a purchase or refinance, I would encourage liquidity of the GSEs.

Chairman DODD. Ellen.

Ms. HARNICK. I do not have anything to add on that point, Mr. Chairman, but I did want to come back to a point that was made just before the break. May I do that?

Chairman DODD. Sure.

Ms. HARNICK. Because it goes to the——

Chairman DODD. What was the point?

Ms. HARNICK. The point is the issue of how difficult—the suggestion is that we have to be careful to make sure that appraisals are properly done in figuring out the current value. And I think what Larry Summers had said is we need to ensure that appraisers don't have the wrong incentives, that appraisers are not linked to the lender in any way or to the servicers, that the lenders do not have an incentive to overstate home values.

But I think what got lost when the conversation got broken off is the fact that appraisers do this sort of thing all the time. There is nothing unusual about the effort to appraise a property, even in markets where sales have been slow, even in illiquid markets. I mean, this is something that could be done—Dean Baker suggested various mechanisms that could be put in place to ensure that we are getting good appraisals.

So I think that any concern that was raised about that is certainly worth taking into account in shaping the kind of appraisals we do. But I think that is as far as the concern needs to go.

Chairman DODD. OK. Well, again, I wanted to come back and just suggest—these ideas and thoughts are very, very valuable to us as we try to fashion some good ideas, and I think Doug Elmendorf made a good point. He said, and I am quoting him, " . . . we must choose between messy policy options and inaction—and the cost of inaction is very high." And I agree with him on that. And he particularly said, ". . . a measured expansion in the role of the Federal Housing Administration as proposed by [myself] and Chairman Frank would contribute importantly to reducing the size of the coming foreclosure wave." I do not know if that was raised in my absence, this second tranche that we are approaching.

Larry Summers said careful consideration should be given to the type of measures that we are proposing, and I agree with him on that. He noted last week that the administration has put together programs and policies but have not really come to very much. We need a much more activist set of responses to maximize the chance that the current crisis is contained. I think he was speaking as well about the capitalization issue of Fannie and Freddie, as well as possibly the idea we are talking about here.

I want the Committee to know that I am committed to considering recommendations by our colleagues here, the witnesses. I invite your even further consideration as you look at these proposals, unless you just have an underlying total disagreement with the thrust altogether. But if you see that at least the thrust may be going in the right direction but it needs to be handled in a more balanced approach, I would be very interested in hearing your suggestions and thoughts on all of this. As I said, there is no silver bullets, but this proposal would provide both lenders and borrowers an additional tool to avoid unnecessary foreclosures—in a sense, unnecessary foreclosures.

You have two constituencies, one that I am sympathetic about. I do not want to see anybody lose money. But I feel absolutely no obligation whatsoever with the speculator community. I am sorry they lost money, but that is the nature of investment here. Those things happen.

The second group of people I feel very sympathetic about, and they never should have gotten a mortgage in the first place, and there probably is not a structure that we can come up with that they are going to be able to meet. Now, we ought to think about ways to help people in that category. But I do not see how these proposals are necessarily going to work for those people in that situation. I regret deeply the problems they have, but realistically it is going to be impossible in some cases to provide help at all.

And then there is that third group that plays such a critical role in all of this, and to the extent we are able to do something about that is where my interest is and my focus is, and so I am holding this hearing today, and we will have one again next week, and I will be in consultations with those of you here. And I really do—this is not a gratuitous comment. You are talented, you are knowledgeable, you understand these things very, very well. And it will be very, very helpful to share your ideas and thoughts with the Committee on how we can do a better job at this.

I am going to ask as well that we include an editorial from this morning—I believe it was this morning—in USA Today, which raises legitimate concerns about some of the things in the bill we just passed. And I will be the first to admit that there are some things in that bill that, had I been writing it alone, would not have been in there. There are lot of things that would have been in that bill had I had a chance to write it alone. And there are many things in there that I think are very good and can be very, very helpful. And I am grateful to Senator Shelby and his staff and others for allowing us to work through here, now allowing us to be in a position to work with the House of Representatives to fashion a more comprehensive set of thoughts on all of this in the coming weeks. And we will have markups in this hearing on GSE, on related matters, on the reform ideas that need to be considered as well. And I am going to be working with Senator Shelby and his staff and other Members of the Committee as we prepare for those to see if we cannot reach some strong bipartisan approval of some of these ideas.

But I am very grateful, again, for your testimony today. We will leave the record open because I know some other people have some questions. But I am very impressed with your testimony and very grateful for your presence.

The Committee will stand adjourned.

[Whereupon, at 12:49 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

Lawrence H. Summers
Harvard University

Summary of Testimony

The Current Economic Situation

I. The economy is very likely to be in a recession. If it is not in recession this is just a technicality. The dislocations typically associated with recessions are almost certain to be felt. The likelihood is very high that the downturn will continue for at least the next two quarters despite the many constructive steps including fiscal and monetary stimulus that have been taken in recent months.

II. More distress lies ahead. Confident forecasts are impossible but available futures markets' estimates suggest that house prices could easily fall an additional 15% to 25% from current levels. Declines are likely to be concentrated in lower priced homes that have been financed through sub-prime mortgages and in areas of the country where sub-prime lending has been especially prevalent. It is conceivable that if the recession proves protracted or there are further serious problems in the financial system the decline in house prices could be considerably more severe.

III. These declines in house prices are placing unprecedented burdens on the mortgage finance system. It appears that the dominant determinant of foreclosure experience is the behavior of home prices and not the financial fortunes of individual borrowers. It is likely that within the next 2 years up to 15 million homes will have negative equity and that more than 2 million foreclosures will take place. Because we are in unprecedented territory with respect to the pervasiveness of negative equity it is impossible to predict accurately how many people will walk away from their homes. I believe there is more room for foreclosures to surprise on the high than on the low side.

IV. While there has been some restoration of normality in the financial markets since the Bear Stearns events of mid-March, markets remain quite fragile. In particular there is considerable reason to believe that some debt securities, including those backed by mortgages, are selling at prices that reflect scenarios considerably more dire than those set out above. In the judgment of most sophisticated market observers, this reflects financial conditions rather than a market judgment that house prices will fall even more catastrophically than the consensus envisions.

Policy Choices.

There is no legitimate basis given the magnitude of disruptions in the financial markets for complete confidence that the housing market will be self-correcting. There is the risk of vicious cycles as declining prices lead to foreclosures which lead to increased supply which lead to declining prices. There are also risks of vicious cycles of a similar kind in the mortgage market. Prudent public policy can make an important insurance for the housing sector and by supporting the housing sector, to overall economic health.

At the same time, it is essential to recognize that policies that serve only to delay inevitable adjustments can easily prove counterproductive. There will be no ultimate stability until market prices reach levels at which potential investors and homeowners feel good about their prospects. The policy challenge is to mitigate market overreactions while not interfering with necessary or inevitable adjustments.

Policy makers should give serious consideration to these five areas:

I. GSE Policies: The GSE's have a potentially critical role at a time of cyclical disturbance to the housing finance system such that we are experiencing right now. It is important however to recognize that their viability is dependent on the government's implicit guaranty. A policy such as those suggested by some of simply allowing the GSE's to expand their balance sheets would provide support for the mortgage market and housing sector but it would do so in a highly problematic fashion because the burden on the Federal Treasury imposed by the implicit guarantee would increase and a significant part of the associated subsidy would flow to shareholders rather than to homeowners. It is essential therefore that the GSE's raise capital on a very substantial scale for both prudential reasons and to back expanded lending. While this may not be the first choice of their shareholders, it is essential to the national interest. No issue is more important for the housing sector than assuring that better capitalized GSEs are over the next year able to buy hundreds of billions of dollars more in mortgage product.

II. There is a strong case for federal support for the writing down of mortgages in selected cases. It is clear that the foreclosure process is enormously costly both for the value of the home in question and the community in which it is embedded. Action to purchase and renegotiate mortgages that would otherwise force foreclosure can benefit both homeowners, the housing market, and the broader financial system. Careful consideration should be given to measures of the type that have been discussed by Senator Christopher Dodd and Congressman Barney Frank. In such consideration, it will be essential to ponder design issues including:

a. The treatment of second liens
b. The integrity of appraisals on which valuations are based
c. Possible adverse selection effects on mortgages offered by servicer's.
d. Eliminating incentives for opportunistic behavior by homeowners

III. There are desirable changes in legal rules. Possible significant gains with almost no risks would come from relieving services of legal liability for decisions they make in renegotiating mortgages. Of even greater significance, proper bankruptcy reform would increase economic efficiency and equity. I believe it is very difficult to defend at a time like the present a bankruptcy code that provides more protection for the third home of a wealthy family than for the first home of a working family. Properly circumscribed bankruptcy reform could through its direct and indirect effects, facilitate a significant amount of private mortgage relief. I believe the concern that this would somehow inhibit the flow of new credit to owner occupied housing is often overdrawn and can be met through careful design.

IV. Stimulus tax measures should be directed to families burdened by disruptions in the mortgage and housing markets. In this regard I am concerned by proposals contained in Senate legislation. Providing tax credits conditioned on initiation of the foreclosure process is likely to have perverse effects -- foreclosures may be encouraged and the benefits will flow to financial institutions that have foreclosed on homes rather than to families in need. Experience and economic logic suggests that tax benefits targeted to those with loses are likely to have minimal stimulative impacts. To the extent that stimulus and responding to economic distress are key objectives, tax measures targeted at those who suffer foreclosure or at the conversion of foreclosed homes into rental housing would represent a substantially more effective public policy choice.

Testimony of Dean Baker

Before the Senate Committee on Banking, Housing and Urban Affairs
Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets
April 10, 2008

Thank you, Chairman Dodd and Ranking Member Shelby, for inviting me to share my views on the mortgage crisis with the committee. My name is Dean Baker and I am the co-director of the Center for Economic and Policy Research. I am an economist, and have been writing about the housing bubble since 2002.

The current situation in the housing market is potentially the largest economic crisis in the post-World War II era both for the country as a whole, and the millions of homeowners facing the loss of their home. By its actions, Congress can help to either ameliorate some of its worst effects, or exacerbate the problems. For this reason, it is crucial that it consider carefully the implications of any legislation.

The Hope for Homeowners Act of 2008 is an ambitious effort to address the crisis created by the collapse of the housing bubble, and the epidemic of predatory subprime mortgages over the years 2003-2007. In assessing the merits of this proposal, it is important to realize that there are large differences in the state of the housing market across the nation. Policies that may be appropriate for some parts of the country may not be appropriate for other parts of the country.

In my comments, I argue that the mortgage guarantee program that is at the center of the Hope Act may be useful for parts of the country where housing prices are not abnormally high, but that this program is not well-suited for areas that still have bubble-inflated house prices.

Specifically, the program in bubble-inflated areas:

1) Will lead to situations in which homeowners spend far more on housing than renters would pay for comparable units;
2) Will lead to situations in which homeowners are unlikely to accumulate any equity at the point when they leave their home;
3) Will fail to stabilize prices.

I also argue the effort to stabilize prices in bubble-inflated areas is counter-productive. Insofar as it succeeds, it makes homeownership less affordable for young people and families moving into the area. I also briefly describe an alternative "own-to-rent" proposal that would guarantee moderate-income homeowners facing foreclosure the right to remain in their home as long-term tenants paying the fair market rent.

The Differential Impact of the Hope for Homeowners Act of 2008

It is important to recognize the large differences in the housing market that exist in various parts of the country. In the years from 1996 to 2006 the country experienced a housing bubble that had no precedent in the country's history. In the century prior to 1996, nationwide house prices increased at the same rate as inflation overall. In the decade from 1996 to 2006, house prices rose by more than 70 percent after adjusting for inflation. While there were real price increases almost everywhere, the areas that experienced the sharpest increase were concentrated on the coasts.

The housing market peaked in July of 2006. According to the Case-Shiller 20-city composite index, in the last year and a half house prices have fallen by 12.5 percent in nominal terms and are down by 16.5 percent in real terms from their peak. This price decline has brought prices in parts of the country back in line with their long-term trends.

In these areas there is no imbalance between house-sale prices and rents. For these areas, which include many cities hard hit by foreclosures like Atlanta, Cleveland and Detroit, the mortgage guarantee program in the Hope Act may be a useful mechanism for keeping homeowners in their homes and stabilizing prices. This is possible because prices are not out of line with the fundamentals in the housing market. In this context, the government can help to play a stabilizing role in the market as it did during the Depression with the Home Owners' Loan Corporation.

However, the situation is fundamentally different in the cities where the housing bubble was concentrated. In cities such as Los Angeles, San Diego, and Miami, house prices are still way out of line with fundamentals. In the cities with bubble-inflated housing markets, sale prices are still more than 20 times annual rents.[1] The loan guarantee program in the Hope Act is far less suited for these cities. (It would be easy to distinguish between these markets by not allowing a price guarantee to exceed a multiple of 15 times the appraised annual rent for a unit.)

At the most basic level, it is easy to show that families will almost certainly spend much more than necessary on housing costs in these cities, even if the program allows for a partial write-down of their current mortgage, and a new mortgage at a relatively low-interest fixed rate.

The arithmetic on this point is straightforward. Suppose that the interest rate on the new mortgage is 6.0 percent (it could, of course, be higher). For a 6 percent, 30-year fixed rate mortgage, the annual interest payments would be equal to 6.85 percent of the principle. Adding in 1 percent of the sale price for property taxes, and another 1 percent for

[1] For a comparison of ownership and rental costs in twenty major cities see Baker, Pelletiere, and Rho, 2008. "The Cost of Maintaining Ownership in the Current Crisis," Washington, D.C.: Center for Economic and Policy Research [http://www.cepr.net/index.php/publications/reports/the-cost-of-maintaining-ownership-in-the-current-crisis/].

maintenance and insurance together, brings total ownership costs to 8.85 percent of the sale price.

If the sale price-to-rent ratio is 20 to 1 (in many cities it is higher), then this house would rent for just 5 percent of the sale price. This means that owners would end up paying 77 percent more in housing costs than a family who rents a comparable unit. This is a large and unnecessary drain on the budget of moderate-income families, with an annual income in the range of $40,000 to $60,000. For a home that costs $200,000, this would imply additional annual housing expenses of $7,700 a year. These additional housing costs would presumably come at the expense of other necessary items such as health care and quality child care.

In addition, since house prices will continue to decline in these areas as the bubble deflates, it is unlikely that many of these families will accumulate any equity by the time they sell their home. In fact, most of the homeowners in these areas are likely to end up underwater, since house prices in the bubble areas could drop another 20-30 percent. In these cases, taxpayers will likely have to make up a portion of these losses due to the guarantees in the Hope Act.

It is unlikely that the Hope Act would be able to stop, or even substantially slow, the deflation of the housing bubble in these markets. The fundamental problem is that the supply of housing exceeds the demand at current prices. If prices did temporarily stabilize at bubble-inflated levels, it would only lead to more construction, which would then place further downward pressure on prices. A government house-price stabilization program that tries to maintain artificially high prices would face all the same drawbacks as farm price support programs that target artificially high prices, except the housing market is far larger.

Furthermore, it is difficult to see why it would be desirable to sustain artificially high prices, even if it were possible. Sustaining bubble-inflated prices means that it will be much harder for young people and families moving into an area to afford to buy a home. The people who get priced out of the market will then be forced to rent, or worse, will stretch their resources to buy a house at a bubble-inflated price, and thereby risk large capital losses.

In addition, the longer house prices take to deflate, the more people will make consumption decisions based on the assumption that the equity they have in their home is real. Much of the baby boom generation neglected to save over the last decade, in part because they thought they would have substantial equity in their homes when they reached retirement. Now that the oldest baby boomers are reaching retirement, they are finding that the equity they had been relying upon is not there. Delaying the deflation of the housing bubble will ensure that more people reach retirement without adequate resources.

In deciding on various proposals it is important to keep in mind that a loan guarantee program, such as the one laid out in the Hope Act, would require substantial fees

associated with the issuance of new mortgages. At the very low end, the fees for issuing these mortgages would be 1.0 percent of the value of mortgages guaranteed. Since the process is fairly complex and creates a new financial instrument (the "soft second" mortgage), the fees could easily exceed 2 percent of the amount of loans guaranteed.

If the total value of the guarantees is $300 billion, then the commissions for issuing these mortgages will be between $3 billion and $6 billion. This is money that must come either from the taxpayers, or the homeowners, who are the intended beneficiaries. These fees do not necessarily over-ride the potential benefits of the program, but they should not be overlooked.

The Own-to-Rent Alternative – Providing Housing Security to Homeowners

A much simpler route, that could provide security to homeowners even in the most inflated markets, is to temporarily change the rules on foreclosure to allow homeowners the option to remain in their homes as renters paying the fair market rent. Under this proposal, a homeowner facing foreclosure could tell the judge, or court officer handling the foreclosure, that they would like to stay in their house as a renter.[2] The court would have an appraisal conducted to determine the market rent. The homeowner would then have the option to stay in the house as a renter, paying the market rent, for a substantial period (e.g., 10 years).

This policy would ensure that the homeowner is not left homeless. It also would keep the house occupied, and prevent the deterioration that typically afflicts the house and the neighborhood following a foreclosure. The policy could be carefully targeted both in time (e.g., it would only apply to mortgages issued prior to a certain date) and by home price (e.g., it would only apply to homes that sold for less than the median price in an area).

While providing a rental option, the "own-to-rent" plan is actually likely to lead to a situation in which many homeowners are able to stay in their homes as owners. Since most banks will not want to become landlords, this policy would provide lenders with a real incentive to negotiate terms that allow homeowners to stay in their homes as owners. In addition, it would require no tax dollars and no new bureaucracy.

Conclusion

There is no good way out of the crisis created by the collapse of the housing bubble. In the future, Congress and the Federal Reserve Board should act to ensure that we do not have such enormous bubbles in our housing market. However, good policy can alleviate much of the pain of the collapse, and that should be the focus of Congress at the moment.

[2] This proposal is outlined in Baker, D. 2007b. "The Subprime Borrower Protection Plan," Washington, D.C.: Center for Economic and Policy Research [http://www.cepr.net/content/view/1274/45/].

Testimony of Ellen Harnick
Center for Responsible Lending

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs

"Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets."

April 10, 2008

Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for holding this hearing on how we can stop the wave of coming foreclosures, break the cycle of spiraling losses in the housing and mortgage markets, and restore liquidity and stability to this crucial sector of the economy. We commend you for focusing on the problem and seeking positive solutions.

The U.S. economy faces significant challenges today, as 20,000 foreclosures on subprime mortgages are occurring every single week.[1] The negative spillover effects from these foreclosures are substantial: property values are dropping by billions of dollars, communities are losing precious resources, and millions of Americans who depend on a robust housing market are losing jobs and income. As foreclosures accelerate during the next two years, these economic effects will be felt even more strongly.

This crisis is not getting better on its own, and efforts to encourage lenders and servicers to modify unsustainable loans simply are not working. My major message today is that Congress has effective tools at its disposal to mitigate needless losses and avoid making an economic disaster even worse. It is too late to stop a severe downturn driven by reckless lending, but it is not too late to minimize the massive damage ahead. In these comments, I will discuss these issues:

- We face a severe foreclosure crisis with substantial negative effects on whole communities and the broader economy.

- Voluntary loan modifications cannot adequately address the problem. An effective government response is urgently needed to prevent the problem from growing worse.

- The Hope for Homeowners Act, proposed by Chairman Dodd, is an excellent proposal that can avert a significant proportion of unnecessary foreclosures that are otherwise inevitable. It provides a powerful tool to help stabilize the market and expedite economic recovery.

In particular, the Hope for Homeowners Act successfully meets the following policy criteria:

- It does not bail out lenders or investors whose actions led to the current crisis. By requiring mortgage holders to take a 13% "haircut" off the current value of the property, the bill ensures that lenders and investors shoulder a significant portion of the loss resulting from the lending and investing decisions that they made.

- It creates sustainable mortgages to preserve homeownership and family wealth. In contrast with recent subprime lending, FHA-backed loans are largely fixed-rate, amortizing mortgages, providing predictable expenses that many low-income households need rather than exploding interest rates two years after origination. They escrow for taxes and insurance, helping families budget for large certain expenses. They require documented income, making sure that the loans are affordable. And they require an assessment of the ability to repay the loan, helping ensure sustainable homeownership.

- It does not place taxpayers at undue risk. The Hope for Homeowners bill is well designed to ensure that the program is self-sustaining – as was the Depression-era Home Owners' Loan Corporation. Several mechanisms accomplish this: First, it permits refinancings for no more than 90% of the current value of the mortgaged property, which should reduce the incidence and severity of losses as compared with FHA's regular lending program, which allows for a ratio of 97% loan-to-value. Second, the 13% "haircut" includes 3% to be held in FHA insurance pool to cover losses. Third, borrowers will be required to pay an additional insurance premium of up to 1% annually to cover risk of loss. Fourth, FHA would recapture a share of the equity appreciation in home value when the house is sold. Fifth, the summary materials state that there will be a $20 billion appropriation into the fund. Finally, there will be interest earnings on the fund. The new FHA reserve fund should fully cover losses.

- It facilitates prompt action by relying on existing institutions. The Dodd proposal uses existing institutions: a modified loan product that is government-insured (FHA), a mechanism for private parties to provide the funding for the loans (through the secondary market entity Ginnie Mae), and a distribution mechanism (currently underemployed loan officers and motivated servicers with lending affiliates). Assuming servicers accept short refinances, it should not be difficult to make and fund the FHA loans.

Finally, even with the passage of the Hope for Homeowners Act, a significant proportion of troubled homeowners will be pushed into foreclosure because the loan servicer cannot or will not modify the loan or agree to a refinancing under the Act. The problem is particularly acute in the case of the large proportion of loans that were issued with "piggy back" second mortgages, which preclude relief absent the second lien-holder's consent. The Helping Families Save their Homes in Bankruptcy Act (S 2136) is the only solution that has been proposed that can address this problem, and for this reason remains an important companion to Chairman Dodd's excellent bill.

Self-Help and Center for Responsible Lending

I am Senior Policy Counsel at the Center For Responsible Lending (CRL), (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help (www.self-help.org), which consists of a credit union and a non-profit loan fund.

For the past 28 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get home loans. In other words, we work to provide fair and sensible loans to the people most frequently targeted for predatory and abusive subprime mortgages. Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country. Our loan losses have been less than one percent per year.

In addition to making direct loans, Self-Help encourages sustainable loans to borrowers with blemished credit through a secondary market operation. We buy these loans from banks, hold on to the credit risk, and resell them to Fannie Mae. We have used the secondary market to provide $4.5 billion of financing to 50,000 families across the country, loans that have performed well and significantly increased these families' wealth.

Through this lending experience, CRL understands the importance of promoting sustainable homeownership and maintaining access to affordable home loans, and recognizes how responsible use of the secondary market can contribute to such a result.

I. We face a severe foreclosure crisis that will grow worse without adequate policy intervention.

A year ago, some mortgage lenders still insisted that the number of coming foreclosures would be too small to have a significant impact on the economy overall.[2] No one makes that claim today. Today, as foreclosures are at an all-time high and projected to grow higher,[3] the "worst case is not a recession but a housing depression."[4] Projections by Fitch Ratings indicate that 43% of recent subprime loans will be lost to foreclosure,[5] and at least two million American families are expected to lose their homes to foreclosures initiated over the next two years.[6]

As we show in our recent report on the "spillover" effect of subprime foreclosures, the negative effects are not confined to the families who lose their homes. Forty million of their neighbors will see their property values decline as a result by over $200 billion.[7] Federal Reserve Chairman Ben Bernanke recently noted, "At the level of the individual community, increases in foreclosed-upon and vacant properties tend to reduce house prices in the local area, affecting other homeowners and municipal tax bases. At the national level, the rise in expected foreclosures could add significantly to the inventory of

vacant unsold homes—already at more than 2 million units at the end of 2007—putting further pressure on house prices and housing construction."[8]

Sadly, many of the borrowers who are losing their homes to foreclosure qualified for better loans that they would be sustaining today. A study for the Wall Street Journal found that of the subprime loans originated in 2006 that were packaged into securities and sold to investors, 61%% "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[9] And even those borrowers who did not qualify for prime loans could have received sustainable, thirty-year fixed-rate loans, for at most 50 to 80 basis points above the "teaser rate" on the unsustainable exploding ARM loans they were given.[10] Had these borrowers received the sustainable loans they qualified for, we would not be facing the foreclosure crisis we are in today.

Wall Street's appetite for risky loans incentivized mortgage brokers and lenders to aggressively market highly risky exploding ARM loans instead of the sustainable loans for which borrowers qualified. As Alan Greenspan told Newsweek, "The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime loan market would have been very significantly less than it is in size."[11]

Market participants readily admit that they were motivated by the increased profits offered by Wall Street in return for risky loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"[12] Even the chief economist of the Mortgage Bankers Association, when asked why lenders made so many loans that they knew were unsustainable, replied, "Because investors continued to buy the loans."[13]

For the sake of the economy as a whole, as well as individual families and their communities, it is essential that strong measures be implemented to avoid unnecessary foreclosures. This will entail addressing two problems – the reset of interest rates on subprime mortgages to unsustainable levels (a problem that has been at least temporarily ameliorated somewhat by reductions in short-term interest rates, but not eliminated), and the sharp increase in "under-water" mortgages – that is, mortgages that exceed the value of the mortgaged home.

Currently, 30% of families holding recent subprime mortgages now owe more on their mortgage than their home is worth.[14] These families are at an increased risk of foreclosure because "negative equity" precludes the homeowner from selling, refinancing or getting a home equity loan or other mechanism for weathering short-term financial difficulty.[15] Regulators and economists are increasingly cautioning that loan balances must be reduced to avoid unnecessary foreclosures that will further damage the economy.[16]

Federal Reserve Board Chairman Ben Bernanke recently observed, "[T]he current housing difficulties differ from those in the past, largely because of the pervasiveness of negative equity positions. With low or negative equity, as I have mentioned, a stressed borrower has less ability (because there is no home equity to tap) and less financial incentive to try to remain in the home. In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure."[17]

II. The current crisis calls for effective government action.

During the past six months, we have witnessed remarkable and highly disturbing events as the effects of unsustainable subprime mortgages spread through global markets and wreaked havoc on our national economy. Numerous companies have failed, and the government has found it necessary to intervene to keep Wall Street firms afloat.

Unfortunately, to date, Congress and the regulatory agencies have remained at least a step behind the problem, relying on the hope of voluntary measures by industry long after it became clear that meaningful modifications were not materializing to any significant degree. Already the government has recognized the need to intervene by facilitating substantial assistance for Bear Stearns and providing low-cost loans for investment banks through the Federal Reserve's discount window. However, to date Congress has not taken significant action to intervene on behalf of homeowners and prevent foreclosures.

Almost a year ago, in May 2007, Chairman Dodd convened a Homeownership Preservation Summit, which established a set of Homeownership Preservation Principles[18] that called upon lenders to modify loans to ensure long-term sustainability by reducing loan balances and switching to lower cost fixed-rate loans. Notwithstanding industry leaders' public endorsements of the principles, as well as widespread support for loan modification from President Bush[19] and all of the federal banking agencies and the Conference of State Banking Supervisors,[20] voluntary efforts by lenders, servicers and investors have been insufficient to address the massive number of foreclosures.

Looking at the first eight months of 2007, Moody's Investors Service found that lenders modified only 3.5% of subprime loans that reset to higher interest rates.[21] According to a recent report by the State Foreclosure Prevention Working Group, a collection of state Attorneys General and Bank Commissioners, only 24% of seriously delinquent borrowers were working with professionals in any type of loss mitigation activity that could lead to preventing a foreclosure.[22] Efforts of the Hope Now Alliance also fall short. As recently acknowledged by the vice chair of Washington Mutual, who helps run the program, many of the homeowners who have sought Hope Now assistance "will not receive long-term relief and could ultimately face higher total costs."[23] Chairman Bernanke noted that loan modifications involving "reductions of principal balance have been quite rare."[24]

While the government has encouraged private companies to do loan modifications and constructive refinances, the fact is that the private sector faces significant obstacles and disincentives because of the large number of players resulting from securitization.

Refinancing, for its part, has too often been unavailable because of the current lack of liquidity in the market generally, and because borrowers facing foreclosure do not qualify for refinancing due to their delinquency on current loans or the lack of sufficient equity in the home. Loan servicing companies fear lawsuits by affected groups of investors, face financial incentives to foreclose rather than modify or accept short refinances, and face the problem of loans made with "piggyback" second mortgages. These factors have tied the hands of servicers and made it impossible to modify or refinance the loan, even where doing so is clearly in the best interest of the investors as a whole.[25]

There is an emerging consensus that half-measures in the private sector are not working. FDIC Chairman Sheila Bair recently said that the current economic situation calls for a stronger government response, since voluntary loan modifications are not sufficient.[26] The necessity of government action also is gaining recognition among Wall Street leaders. Just this week, a senior economic advisor at UBS Investment Bank stated that, "when markets fail, lenders and borrowers need some sort of regulatory and legislative framework within which to manage problems, rather than be forced to act in the chaos of the moment."[27] Moreover, as former Federal Reserve Board Vice Chairman Alan Blinder recently noted, the fact that most of the mortgages at issue have been securitized and sold to investors across the globe "bolsters the case for government intervention rather than undermining it. After all, how do you renegotiate terms of a mortgage when the borrower and the lender don't even know each other's names?"[28]

III. The Hope for Homeowners Act will prevent foreclosures.

To further stabilize the economy and speed recovery, Congress must go beyond encouraging loan servicers and investors to do the right thing. Today strong, decisive action is necessary—not only for homeowners, but for the entire nation.

A. The Home Owners' Loan Corporation offers a useful model.

In crafting solutions to the worst housing crisis since the Great Depression, Congress can find useful guidance in a highly successful solution that was implemented at that time. The Home Owners' Loan Corporation (HOLC) was established in 1933 to help distressed families avoid foreclosure by buying mortgages at a discount from the banks that held them, and restructuring them into loans that borrowers could afford and sustain.[29]

HOLC purchased and restructured more than a million mortgages, 20% of all mortgages in the country, and over the life of the program, extended $3.5 billion in loans (the corresponding figures in today's economy would be 2.5 million loans worth $750 billion).[30] During the 1930s, nearly 20% of HOLC borrowers defaulted, and HOLC acquired 200,000 homes, most of which were sold by 1944. The average HOLC borrower was two years delinquent on their mortgage, and HOLC turned down 46% of applicants. It closed its books in 1951 having turned a small profit.[31] Very quickly, the government intervened in a massive way, and had an extraordinary impact ameliorating a housing crisis in which almost half of all mortgages were in default.[32]

From this experience, the Federal Housing Administration, Fannie Mae and then Freddie Mac, developed to facilitate widespread provision of the type of long-term, fixed-rate loans that HOLC provided.

B. Hope for Homeowners offers an excellent approach.
The Hope for Homeowners Act of 2008 creates a new program within the Federal Housing Administration (FHA) to help refinance mortgages that otherwise are highly likely to go into foreclosure. Under the Act, FHA-approved lenders will be encouraged to refinance abusive loans at a significant discount for homeowners who are trapped in abusive mortgages and face difficulty paying their mortgages.

The Act has a number of provisions to ensure that the loans are targeted to homeowners in real need, and that the new loans will be sustainable. New loans will be based on a family's ability to repay the loan, and no investors or investor properties will qualify for participation in the program, only owner-occupants. All loans eligible for the program must be 30-year mortgages with fixed interest rates. Finally, the FHA will not insure more than 90% of the current value of the home.

By providing loans with a 90% loan-to-value ratio, the program will create equity for the homeowners who qualify. However, the Act specifies that the homeowner must share this equity and future appreciation in the property's value with the FHA.

The Act would create the modern equivalent of the HOLC, although the structure of the modern mortgage market today requires a variation in approach. While HOLC purchased distressed mortgages from lenders who held them, today the vast majority of loans are securitized, which means they are owned by investors in different tranches often scattered around the world. Current accounting standards for off-balance sheet securitization transactions (specifically Financial Accounting Standard 140) make it impossible for servicers to sell securitized loans at a discount, making the original HOLC idea unworkable for most loans.

The Act recognizes this limitation, and rather than having the government buy mortgages directly, asks servicers to agree to forgive a certain amount of the balance of a loan on a mortgage headed for foreclosure in exchange for getting the loan off their books through being refinanced by a new government-guaranteed mortgage. Current accounting, tax and contractual standards do indeed permit loan servicers of securitized loans to voluntarily modify mortgages, including by reducing principal balances, in this way if these conditions are met: (1) a loan is in default or it is reasonably foreseeable that the loan will default; and (2) investors will recover more financially through a loan modification than if the loan goes through foreclosure.

The Hope for Homeowners Act offers an effective way to address the two key drivers of foreclosure today: unsustainably high mortgage rates and negative equity in the home. By incentivizing servicers to pursue refinancing in preference to foreclosing, the Dodd proposal will significantly reduce the number of coming foreclosures. The proposal encourages servicers to take an up-front write-down of principal by accepting a refinance

of a troubled loan, thereby offering servicers and investors a way to exit the loan and cut off further losses. Just as with foreclosure, the servicer would not be responsible for any subsequent borrower redefaults.

Given current and projected declines in home values,[33] we would expect that the refinancing terms will provide mortgage holders with better returns – and in many cases significantly better returns – than could be obtained at a foreclosure sale.[34] As a senior economic advisor at UBS Investment Bank noted, enabling the government to restructure loans at a discount by requiring lenders to accept a significant "haircut" as an alternative to "owning defaulted, non-earning assets" could provide an effective means to "lessen or draw out foreclosures and have a positive effect on the valuation of [mortgage] securities that now do not trade or do so at enormous discounts."[35]

Breaking the gridlock of families who cannot get a voluntary modification but can pay a reasonable FHA loan with a balance less than the value of the home through a new FHA loan would be a tremendous advance for borrowers and neighborhoods. Allowing the loan to be paid off by an FHA loan for less than the principal balance – a so-called "short refinance" – provides a new sustainable mortgage to the borrower and offers loan servicers a readily available mechanism for refinancing. Thus, the Hope for Homeowners Act holds great promise for foreclosure prevention on a much larger scale than anything that has been done to date.

IV. The Hope for Homeowners Act meets key policy goals.

We believe any action policymakers contemplate should be assessed against key policy goals. Specifically, any proposed policy solution should meet these criteria:

- Does not bail out the lenders and investors whose actions led to the current crisis;
- Creates sustainable mortgages to preserve homeownership and family wealth;
- Does not place taxpayers at undue risk; and
- Facilitates prompt action, therefore relies on existing institutions as much as possible so that solutions can be implemented in time to have significant impact.

A. No bailout of lenders or investors.

The Act is structured to avoid bailing out lenders or investors or rewarding the irresponsible lending that helped create the current crisis. It accomplishes this objective by limiting allowable refinancing to 87% of the current (not original) value of the mortgaged property. By requiring mortgage holders to take a 13% "haircut" off the current value of the property, the bill ensures that lenders and investors shoulder a significant portion of the loss resulting from the lending and investing decisions that they made. In the case of under-water mortgages, the 13% discount off the property's current value will reflect a larger discount off the outstanding balance of the mortgage loan. While the Dodd bill will put a floor under their losses in order to avoid further damage to the economy, it keeps a sufficient portion of the responsibility where it belongs, thereby ameliorating moral hazard.

This is an essential component of the bill, which should not be waivable under any circumstances. For this reason, we recommend that section 257(e)(6) of the bill be modified to remove any possibility that this requirement could be waived.

B. Sustainable loans.

For several generations now, FHA has provided sustainable homeownership opportunities for families who might not be able to get conventional mortgages. In contrast with recent subprime lending, FHA-backed loans are largely fixed-rate, amortizing mortgages, providing predictable expenses that many low-income households need rather than exploding interest rates two years after origination. They escrow for taxes and insurance, helping families budget for large certain expenses. They require documented income, making sure that the loans are affordable. The debt ratios of 33% mortgage debt to income and 41% total debt to income have proven prescient, as the 50% and 55% subprime total debt ratios have gone into default in alarming numbers.

Further, the loan balances on the loans will be written down to 90% of the current market value of the house, and interest rates reduced to conventional rates. The fact that both interest rates and principal balance will likely be lower than the families faced previously will significantly increase their chances of success.

C. No undue risk to taxpayers.

Just as the HOLC proved self-sustaining and even modestly profitable, the Hope for Homeowners bill is well designed to ensure that the program can sustain itself too. It has a number of mechanisms to accomplish this. First, it permits refinancings for no more than 90% of the current value of the mortgaged property and will use underwriting standards for borrowers that, while more flexible than current standards, are targeted at borrowers who can afford the new loans. By requiring a 90% loan-to-value ratio, the program should reduce the incidence and severity of losses as compared with FHA's regular lending program, which allows for a ratio of 97% loan-to-value. Second, the 13% "haircut" includes 3% to be held in FHA insurance pool to cover losses. Third, borrowers will be required to pay an additional insurance premium of up to 1% annually to cover risk of loss. Fourth, FHA would recapture a share of the equity appreciation in home value when the house is sold. Fifth, the summary materials state that there will be a $20 billion appropriation into the fund. Finally, there will be interest earnings on the fund. These factors are likely to ensure the soundness of the program and to prevent against the risk of taxpayer losses.

Adding together the 3% equity from the initial refinance; four years of 0.50% annual insurance payments by the borrower, totaling 2%; 3% from equity appreciation recapture; and just a $3 billion appropriation to cover $300 billion of lending, for a final 1%, equals a total reserve pool of 9% of the amount of lending accomplished. (Nine percent could be accumulated in other ways too, of course, by adjusting each factor up or down, potentially without an initial appropriation at all.)

According to the 2006 FHA actuarial review, the average lifetime default rate for 30-year fixed rate FHA loans is 10.97%.[36] Even if the default rate for loans under the Hope for

Homeowners proposal were twice the FHA's normal default rate, which would roughly correspond to the 20% default rate experienced during the 1930's by HOLC,[37] the program would have sufficient reserves to cover these losses. Assume loss severity were 45%,[38] meaning that each loan recovered 55 cents on the dollar and lost 45 cents. In this conservative case, total losses for the program would equal loss incidence (20%) times loss severity (45%), or 9%, which would be covered by the reserve pool.

While there is risk in any lending program, particularly one that targets borrowers in severe financial difficulty, there are substantially greater risks if the government does not step forward and substantially address the problem. Massive further foreclosures begetting boarded up damaged homes begetting further house price declines by neighbors begetting further foreclosures is an all too likely scenario absent implementation of the Dodd proposal.[39] The current harm to our national economy is severe enough, and worse is sure to come.

D. Speed of implementation; uses existing institutions.
The scale of the foreclosure crisis requires a quick and a major response. In practice, these two factors are often in tension with each other. In order to get help to families that need it, there should be a policy bias toward using existing institutions as much as possible, to avoid the delays of designing and staffing new ones. The Dodd proposal accomplishes this goal by using existing institutions: a modified loan product that is government-insured (FHA), a mechanism for private parties to provide the funding for the loans (through the secondary market entity Ginnie Mae), and a distribution mechanism (currently underemployed loan officers and motivated servicers with lending affiliates). Assuming servicers accept short refinances, it should not be difficult to make and fund the FHA loans.

As discussed below, this is still a large, new program, and will take time to implement.

V. Suggested adjustments to the bill.

We agree with Chairman Dodd that there is no need for an eligibility screen for borrowers that would require that the borrower currently have a 40% current debt-to-income (DTI) ratio, as Chairman Frank's excellent proposal states. Such an eligibility requirement will exclude many deserving homeowners who, although they have a less than 40% DTI, cannot pay their current mortgage because they have other debts that they need to pay or unique expenditure circumstances. A 40% DTI is especially burdensome for lower income homeowners, as it leaves little residual income for other necessities. In addition, it is not necessary to impose an existing mortgage debt-to-income payment, as other factors already screen potential borrowers.[40] Given that many borrowers will not be helped by any program that is purely voluntary for servicers and lenders, as described in Section VI, the program should not be further restricted with a DTI requirement.

However, we do have a small number of suggestions to improve the measure. First, Chairman Dodd's idea of recapturing equity from borrowers helped by the program when they later sell their house is fair, and will help keep the program solvent and prevent

taxpayers from having to cover those losses. We also agree that the amount of recapture should reduce on a sliding scale over a five-year period. However, Representative Frank's formulation of cutting off the appreciation recapture at 5 years for sale or refinance, except for a flat 3%, rather than sharing appreciation half and half in perpetuity, strikes us as preferable. Chairman Dodd's proposal will need to permit households to retain appreciation due to capital improvements; calculating costs of such improvements beyond a five-year period would be administratively difficult. Further, cutting the amount of recapture after five years to a flat 3% would be fairer to the families involved.

Second, the bill appears, at section 2(e)(6), to permit the next Administration to waive any of the protections in the bill. That authorization is dangerous, because it would permit a full lender bailout. For a bill with such a short time horizon, the bill should not permit such broad powers to waive the important protections. Third, the section on encouraging Fannie Mae and Freddie Mac to similarly refinance distressed loans is worthy, but may not be workable; in any case, the GSEs' housing goals should not be waived. Fourth, it is not clear how the auction process would work. For such a process, it is important that Sen. Dodd retains all the protections against investor bailout, such as the 13% haircut requirement.

Finally, the administrators of the program will need to issue rules to protect against mortgage broker abuses in originating loans under the program. Compensation to brokers or retail originators that increases when the interest rate charged borrowers rises, through yield spread premiums or overages, should not be permitted. Further, FHA should police the terms of these loans in the market to make sure that lenders are not charging excessive fees or interest rates, since the loans are fully government guaranteed.

VI. Court-supervised modifications are necessary complement to bill.

Even with the passage of the Hope for Homeowners Act, a significant proportion of troubled homeowners, who could afford to sustain a mortgage on economically rational terms, will be forced into foreclosure because the loan servicer cannot or will not agree to modify the loan or refinance under the Act. Often this result will be to the clear detriment of investors as a whole. It is critical in such cases, as a last alternative to foreclosure, to permit a court to adjust the mortgage if the borrower can afford a market rate loan. Currently, bankruptcy courts can modify any type of loan, including yachts and vacation homes, with the exception of one type: primary residences. Removing this exclusion would help homeowners (not speculators) who are committed to staying in their homes, without bailing out investors and without costing taxpayers anything. The Helping Families Save their Homes in Bankruptcy Act (S2136) provides a narrow, time-limited mechanism for breaking the deadlock that is forcing into foreclosure families who can afford a market rate loan.[41]

We believe that the court-supervised loan modifications bill is a necessary complement to the FHA refinance program for three reasons. First, it provides important incentives to get lenders to voluntarily agree to the short refinances. Second, it's an important

backstop for families who fall between the cracks and can't get the FHA refinance. There are a number of reasons that voluntary modifications are not occurring in sufficient numbers, including overwhelmed servicers and fear of investor lawsuits (Chairman Dodd's proposal to provide a safe harbor against lawsuits for servicers participating in this plan is a positive step, but won't stop all lawsuits or prevent all fears of them). The most vexing obstacle, however, is when there is a piggyback second mortgage holder who won't agree; a third to a half of 2006 subprime borrowers took out piggyback second mortgages on their home at the same time as they took out their first mortgage.[42] The presence of these loans often makes it impossible for servicers to modify either mortgage because the second mortgage holder has no incentive to cooperate.[43]

Finally, it could take as much as a year to get a large, new program of this scale up and going, while the bankruptcy change can be implemented immediately. Thus, to address the current subprime default crisis, we'd need the court supervised modification program. The FHA refinance proposal would still provide important help for many subprime borrowers and, unfortunately, it will also be needed for the second wave of foreclosures, namely poorly underwritten option ARM and Alt-A mortgages that are scheduled for payment increases loans in 2009 and beyond.

Together, the Hope for Homeowners Act and the Helping Families Save their Homes in Bankruptcy Act, would prove highly effective at stemming the tide of coming foreclosures, and providing urgently needed relief to struggling homeowners, the communities they live in, and the economy as a whole.

Conclusion

Effective government action is urgently needed to avoid a flood of needless foreclosures that will devastate families, destroy communities, and do further damage to the economy as a whole. We believe that the Hope for Homeowners Act is a strong proposal that will provide an effective tool for stabilizing the economy and speeding recovery. We applaud the Committee for focusing on the need to find a prompt and effective mechanism for breaking the cycle of spiraling losses in the housing and mortgage markets.

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[1] *See* Written Testimony of Mark Zandi, Moody's Economy.com before House Subcommittee on Commercial and Administrative Law (January 28, 2008), available at: http://judiciary.house.gov/media/pdfs/Zandi080129.pdf; *See also* Center for Responsible Lending , Subprime Spillover, (Rev. Jan. 18, 2008), http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[2] *See, e.g.*, Statement of John M. Robbins, CMB, Chairman, Mortgage Bankers Association at the National Press Club's Newsmakers Lunch – Washington, DC (May 22, 2007) (Speaking of predicted foreclosures, Mr. Robbins stated: "As we can clearly see, this is not a macro-economic event. No seismic financial occurrence is about to overwhelm the U.S. economy."); Julia A. Seymour, "Subprime Reporting , Networks blame lenders, not borrowers for foreclosure 'epidemic,'" Business & Media Institute (Mar. 28, 2007) ("[T]here are experts who say the subprime 'meltdown' is not the catastrophe reporters and

legislators are making it out to be. 'We don't believe it will spill over into the prime market or the U.S. economy,' said [Laura] Armstrong [Vice President, Public Affairs] of the Mortgage Bankers Association.").

[3] Renae Merle, Home Foreclosures Hit Record High, Washington Post, March 6, 2008.

[4] David M. Herszenhorn and Vikas Bajaj, "Tricky Task of Offering Aid to Homeowners," The New York Times (Apr. 6, 2008) (quoting Susan M. Wachter, a real estate finance professor at the Wharton School of the University of Pennsylvania. According to Professor Wachter, "In the market that we have in front of us, prices decline and supply increases, driving prices down further.").

[5] Fitch Ratings estimates total losses of 25.8% of original balance in Q4 2006 loans placed in MBS they rated, and that loss severity will be at 60%, which means that 43% of the loans are projected to be lost to foreclosure (25.8/60); lack of home price appreciation said to increase defaults. Glenn Costello, Update on U.S. RMBS: Performance, Expectations, Criteria, Fitch Ratings, p. 17-18 (not dated, distributed week of February 25, 2008). According to Michael Bykhovsky, president of Applied Analytics, an estimated 40% of outstanding subprime mortgage loans could go into default over the next three years; the dire outlook due to declining home values (press briefing at the Mortgage Bankers Association's National Mortgage Servicing Conference, February 27, 2008).

[6] *See* Written Testimony of Mark Zandi, Moody's Economy.com before House Subcommittee on Commercial and Administrative Law (January 28, 2008), available at: http://judiciary.house.gov/media/pdfs/Zandi080129.pdf; *See also* Center for Responsible Lending , Subprime Spillover, (Rev. Jan. 18, 2008), http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[7] *See* Center for Responsible Lending, Subprime Spillover, (Rev. Jan. 18, 2008), http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[8] Statement of Federal Reserve Chairman Ben Bernanke on March 4, 2008, reprinted by Bloomberg.com and available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apeU.0IaETdM ("Bernanke statement")

[9] Rick Brooks and Ruth Simon, Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market, The Wall Street Journal at A1 (Dec. 3, 2007).

[10] January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.

[11] "The Oracle Reveals All," *Newsweek* (Sept. 24, 2007) pp. 32, 33.

[12] Vikas Bajaj and Christine Haughney, Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages," The New York Times (Fri. Jan. 26, 2007) C1, C4.

[13] "Subprime Loans Defaulting Even Before Resets," CNNMoney.com, February 20, 2008.

[14] Edmund Andrews, Relief for Homeowners is Given to a Relative Few, New York Times (March 4, 2008) (loans originated in 2005 and 2006).

[15] Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures, Federal Reserve Bank of Boston Working Papers, No 07-15 (Dec. 3, 2007) at 3-4 (this otherwise good article misses the fact that certain loans themselves can create the cash flow shortfall that cause underwater loans to fail, when they are structured with initial low

payments that are scheduled to rise, such as subprime 2/28 hybrid ARMs, and that certain loan terms have been statistically demonstrated to increase foreclosures, such as prepayment penalties)

[16] Federal Reserve Chairman Ben Bernanke recently said, "When the mortgage is 'underwater,' a reduction in [loan] principal may increase the expected payoff by reducing the risk of default and foreclosure." "Preventable foreclosures" could be reduced, he said, by enabling loan servicers to "accept a principal writedown by an amount at least sufficient to allow the borrower to refinance into a new loan from another source." This would "remove the downside risk to investors of additional writedowns or a re-default." See Bernanke statement.; see also, Edmund L. Andrews, Fed Chief Urges Breaks for Some Home Borrowers, The New York Times (Mar. 4, 2008); John Brinsley, Bernanke Call for Mortgage Forgiveness Puts Pressure on Paulson, Bloomberg.com (Mar. 5, 2008).; Phil Izzo, Housing Market Has Further to Fall, The Wall Street Journal (Mar. 13, 2008) ("Last week, Federal Reserve Chairman Ben Bernanke suggested that lenders could aid struggling homeowners by reducing their principal — the sum of money they borrowed — to lessen the likelihood of foreclosure. Some 71% of respondents [i.e., economists surveyed by the NYT] agreed with the suggestion.")

[17] Bernanke Statement, note 8.

[18] Homeownership Preservation Summit Statement of Principles (May 2, 2007), http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Chairman Dodd, and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae).

[19] White House press release, August 31, 2007. See also the Interagency Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages, http://www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (Encouraging lenders to address subprime hybrid ARM resets by pursuing "appropriate loss mitigation strategies designed to preserve homeownership. . . . Appropriate loss mitigation strategies may include, for example, loan modifications, deferral of payments, or a reduction of principal.")

[20] Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages http://www.federalreserve.gov/boarddocs/srletters/2007/SR0716.htm.

[21] Aashish Marfatia, US Subprime Market Update November 2007, Moody's Investors Service (Dec. 17, 2007) at 2.

[22] Analysis of Subprime Servicing Performance, Data Report No. 1, February 2008.

[23] David Cho and Renae Merle, Merits of New Mortgage Aid Are Debate – Critics Say Treasury Plan Won't Bring Long-Term Relief, The Washington Post (Mar. 4, 2008) (citing remarks of Bill Longbrake, senior policy adviser for the Financial Services Roundtable and vice chair of Washington Mutual).

[24] Bernanke statement.

[25] http://www.responsiblelending.org/pdfs/court-supervised-modifications-would-make-large-scale-foreclosure-prevention-possible.pdf, p. 2.

[26] FDIC Chairwoman Sheila Bair (stating ""We've got a real problem. And I do think we need to have more activist approaches. And I think it will be something we need to be honest with the American public about. We do need more intervention. It probably will cost some money."), Real Time Economics, The Wall St. Journal (April 7, 2008) available at: http://blogs.wsj.com/economics/2008/04/07/fdic-chairwoman-calls-for-activism/?mod=google_newsThe

[27] George Magnus, "Large-scale action is needed to tackle the credit crisis," Financial Times (Apr. 8, 2008).

[28] Alan S. Blinder, "From the New Deal, a Way Out of a Mess," The New York Times (Feb. 24, 2008).

[29] See C. Lowell Harris, History and Policies of the Home Owners' Loan Corporation (National Bureau of Economic Research) 1951; Alex J. Pollock, American Enterprise Institute for Public Policy Research, Crisis Intervention in Housing Finance: The Home Owners' Loan Corporation, December 2007; Andrew Jakabovics, Throwing Homeowners a Lifeline: A Proposal for Direct Lending to Qualified Troubled Borrowers, Center for American Progress, December 2007, available at: http://www.americanprogress.org/issues/2007/12/pdf/holc_paper.pdf.

[30] Alan S. Blinder, "From the New Deal, a Way out of a Mess," The New York Times (Feb. 24, 2008).

[31] Alan S. Blinder, "From the New Deal, a Way out of a Mess," The New York Times (Feb. 24, 2008); see also, David M. Herszenhorn and Vikas Bajaj, "Tricky Task of Offering Aid to Homeowners," The New York Times (Apr. 6, 2008) ("During the 1930s, when the government set up the Home Owners Loan Corporation to buy and modify defaulted loans, the agency ended up foreclosing on 20 percent of its borrowers, said Alex J. Pollock, a fellow at the American Enterprise Institute. He said any new plan should be set up to withstand losses on a sizable number of loans.")

[32] Pollock, p. 2.

[33] Home prices have fallen by 5% to 10% nationwide, and market experts predict that prices will decline by an additional 20%. See Lawrence Summers, Prevent US Foreclosures, Financial Times (Feb. 24, 2008).

[34] See Bernanke Statement ("A recent estimate based on subprime mortgages foreclosed in the fourth quarter of 2007 indicated that total losses exceeded 50 percent of the principal balance, with legal, sales, and maintenance expenses alone amounting to more than 10 percent of principal. With the time period between the last mortgage payment and REO liquidation lengthening in recent months, this loss rate will likely grow even larger. Moreover, as the time to liquidation increases, the uncertainty about the losses increases as well. The low prices offered for subprime-related securities in secondary markets support the impression that the potential for recovery through foreclosure is limited. The magnitude of, and uncertainty about, expected losses in a foreclosure suggest considerable scope for negotiating a mutually beneficial outcome if the borrower wants to stay in the home.")

[35] George Magnus, "Large-scale action is needed to tackle the credit crisis," Financial Times (Apr. 8, 2008) (Speaking favorably of the likelihood that Congress "will almost certainly pass a first round of legislation before August, using the government's balance sheet to purchase eligible mortgages at a discount and restructure them, and requiring lenders "to accept a 'haircut' of up to 25 percent.").

[36] The 10.97% figure represents a combination of actual claim rates and projections of future losses for their 1977-2007 years of originations. An Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund for Fiscal Year 2007, Prepared for HUD by Integrated Financial Engineering, Inc., October 12, 2007, Available at http://www.hud.gov/offices/hsg/comp/rpts/actr/2007actr.cfm, Econometric Results Appendix, worksheet F30_Orig_CumC.

[37] Pollock at 2, 5.

[38] The average loss severity for 2006 FHA loans was 39.05%. On the one hand, 85% of FHA loans were originated at over 90% LTV for the period 2000 - 2007, so we would expect severities under this program to be lower than 39%. On the other hand, property values continue to decline. Thus, we conservatively assume average severities of 45%.

2007 Actuarial Review.

[39] See, e.g., Eugene A. Ludwig, "Viewpoint: Economic Sense in Foreclosure Plan," p. 11 American Banker (April 4, 2008); (former Comptroller of the Currency stating that the Dodd proposal is needed to stop the devastating fiscal and social effects of foreclosures and affirming that "bold legislative intervention is not just the right thing to do now but also sound economics. Government has an ethical responsibility to help citizens in trouble, many of whom were victimized by the unregulated and unscrupulous.")

[40] Because of the obligations of the servicer under the pooling and servicing agreement between servicer and the trust holding the loans, accounting (FAS 140) and tax (REMIC) rules, the servicer cannot accept a short payoff without having done an individualized determination that the borrower is likely to be foreclosed on and recovery from foreclosure is likely to be less. The consequences for the servicer to not make these determinations is sufficiently severe – they face lawsuits from investors under the pooling and servicing agreement, the off-balance sheet structure must be dismantled and brought back on-balance sheet to the original lenders, and the trust loses its pass-through tax status – that Congress should be able to rely on them to screen eligible borrowers.

[41] CRL Issue Brief, Solution to Housing Crisis Requires Adjusting Loans to Fair Market Value through Court-Supervised Modifications (Apr. 1, 2008), available at http://www.responsiblelending.org/pdfs/senate-bankruptcy-support-brief-feb27.pdf; see also http://www.responsiblelending.org/pdfs/senate-bankruptcy-support-brief-feb27.pdf.

[42] Credit Suisse, Mortgage Liquidity du Jour: Underestimated No More, March 12, 2007, p. 5; see also Bernanke Statement ("data collected under the Home Mortgage Disclosure Act suggest that nearly 40 percent of higher-priced home-purchase loans in 2006 involved a second mortgage (or 'piggyback') loan.").

[43] William Launder, Second Liens Proving Hurdle on More Refis, American Banker (Mar. 6, 2008) ("In better times, getting approval for subordination was considered a formality that at worst might set the borrower back a few hundred dollars in fees. But in today's tanking housing market, lenders are finding that a second mortgage is virtually unsecured, and they are doing what they can to protect their interests — even if that means making it harder for the borrower to get out of an onerous first mortgage."); Kenneth R. Harney, Actions Don't Match Words of Help, The Washington Post (Mar. 1, 2008) ("Bottom line: If you've got a second mortgage and need to refinance, there could be a big pothole in the road. The second-mortgage holder might stand in the way."); William Launder, Servicers Have Full Plate In Dealing with Seconds, American Banker (Feb. 20, 2008); Vikas Bajaj, "Equity Loans as Next Round in Credit Crisis", New York Times (March 27, 2008), available at: http://www.nytimes.com/2008/03/27/business/27loan.html?_r=1&hp=&adxnnl=1&oref=slogin&adxnnlx=1206626472-UGVenBqi0sm7/UXhhFpe9Q

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HEARING BEFORE THE SENATE BANKING COMMITTEE

TURMOIL IN US CREDIT MARKETS: EXAMINING PROPOSALS TO MITIGATE FORECLOSURES AND RESTORE LIQUIDITY IN THE MORTGAGE MARKETS

TESTIMONY OF
Scott Stern, Chief Executive Officer,
Lenders One

April 10, 2008

Thank you Chairman Dodd and Ranking Member Shelby for the opportunity to testify today. Since this is our first appearance before the committee, I'd like to say a few words about the unique role that Lenders One plays in the mortgage industry. As the country's largest mortgage cooperative, Lenders One represents the nation's "Main Street" lenders. Our 110 shareholder companies originate approximately $40 billion annually in mortgage loans to make homeownership possible in communities across the United States. Since our inception in 2000, Lenders One companies have made over one million home loans and our members include some of the leading experts in FHA lending. Much like the agricultural cooperatives that enabled family farmers to survive in an era of large scale agribusiness, the Lenders One mortgage cooperative permits locally owned independent mortgage bankers to compete on a level playing field in an industry that in recent years has been dominated by Wall St and a few mega-originators. Lenders One is founded on the principal that a thriving independent mortgage banking sector increases competition in the industry and provides borrowers with more choice, lower costs, and innovative products.

Our main message today is that from the perspective of the community based lender, there are substantial challenges ahead to the stability of the mortgage and housing market, and we believe the federal government continues to have a role to play in meeting these challenges.

This committee, this Congress and the administration have taken important steps to address the mortgage crisis. Increasing the GSE and and FHA loan limits, progress toward FHA modernization, expansion of mortgage revenue bond authority, and foreclosure counseling are all

positive developments and proposals. However, the mortgage storm is far from over, and more needs to be done to address the root of the problem -- the pool of defective subprime loans with interest rates that are due for significant resets in the coming months. These pools of loans represent a toxin in the mortgage system that has spread far beyond the subprime sector to infect liquidity in the prime mortgage market, accelerate home price depreciation, and cause ripple effects throughout the nation's economy.

As FDIC Chairman Sheila Bair testified before this committee in January, negative housing trends are likely to continue at least through this year. The bulk of subprime hybrid ARM resets are still ahead of us. Over 1 million such loans valued in the hundreds of billions of dollars will reset in 2008. A similar volume of payment option ARMS and interest only loans are also on the horizon. The vast majority of these loans are stated income or low documentation loans, and reports indicate that 75% of borrowers are making the minimum payment. As the housing market has declined and homes have lost value, the ability to refinance out of these loans has become more difficult. Merrill Lynch reports that nearly 9 million households owe more on their mortgages than the value of their home, and for the first time ever aggregate mortgage debt exceeds the total value of homeowner equity, by a staggering $836 billion.

The economic disruption that Congress seeks to address through stimulus legislation has its root in these distressed loans. We cannot address the broader economic issues without addressing the heart of the problem in the subprime sector. The longer we wait for action, the more foreclosures will mount, and the harder the recovery will be.

Loan modification efforts to date have fallen short of the scale necessary to make a significant reduction in foreclosures. The main federal effort, FHASecure, while well intentioned, is not serving enough borrowers. FHASecure was designed to help those borrowers who had become delinquent due to a reset of a subprime ARM. Credit Suisse has estimated that only 44,000 borrowers would be eligible for a refinance under FHASecure. And the latest numbers from HUD indicate that since the inception of the program in September 2007, just 1500 conversions have been made from a delinquent conventional loan to an FHA loan. HUD's own projections indicate that only 19,000 such loans will be made in 2008 through the FHASecure program.

We believe that an enhanced federally assisted effort to cleanse the market of distressed subprime loans will contribute to stabilizing the mortgage finance system. Chairman Dodd's bill, the Hope for Homeownership Act, is carefully drawn to achieve that goal. The concept is simple: lenders and investors would take a loss by marking the loan down to market value. Borrowers would refinance at a rate higher than their initial teaser rate. No one gets a free ride. The FHA would do what it has historically and successfully done: offer federal insurance on privately originated loans to qualified borrowers who meet FHA underwriting standards. If managed properly, the program will save the loan and save the home. That's a good outcome for everyone, including communities and taxpayers.

Consider a typical example where a borrower has a $200,000 loan on a home now worth $180,000 with a subprime hybrid ARM carrying an initial interest rate of 2%. In this scenario,

when the interest rate resets, the borrower's payment will increase significantly, but his ability to refinance will be eliminated because he simply has no equity in his home. In other words, a foreclosure is looming. Our members see these borrowers every day and are unable to help. Under Chairman Dodd's proposal, the initial $200,000 loan would be written down to $162,000 (90% of the home's value) while the borrower's interest rate would be reset at a rate at which he could reasonably be expected to repay. In order to take the loan off the books, the investor is taking a significant loss. And the borrower is paying substantially more than their initial interest rate on the original loan, but in a less risky and more affordable 30 year fixed rate. Where a foreclosure crisis once loomed, a stable and secure loan takes its place.

You can see from the example that Chairman Dodd's Hope for Homeowners approach and the similar approach in Chairman Frank's proposal do not amount to a bailout for anyone. Investors take a loss and borrowers who refinance will pay more. If anything, most of the concern we hear about the proposal is whether there is enough incentive in the prospect of an FHA guarantee on the write down to persuade the investor to take what is likely to be a steep loss. Each investor must make the calculation as to whether to take the certain loss today, or face the potential of further declines in the housing market and the additional future losses that may accrue. That's no bailout.

With regard to the borrower, some have argued that a loan restructuring is unfair to other homeowners who are paying their mortgages and working hard to stay in their homes. We are not unsympathetic to that view. However, the fact is that foreclosures create home equity losses,

tighter credit and a strained tax base. Therefore all homeowners are affected by the foreclosure crisis, not just the borrower who is losing his home. By reducing foreclosures through broader loan modifications available in an expanded FHA refinance program, all homeowners will see the benefits of market stability.

Not every borrower can or should stay in a mortgage loan. Speculators, and borrowers who simply cannot afford any reasonable mortgage, should not be eligible for a refinance. But we believe a significant number of borrowers can responsibly avoid foreclosure.

As a mortgage practitioner who has personally originated over $300 million in home loans, I also have to say that a knee jerk condemnation of borrowers who took out risky loans is misplaced. The truth is that many of us in the industry were deeply distressed by the growing practice of pushing high risk loans on borrowers who had no reasonable expectation of being able to repay the mortgage. Disclosures were often less than adequate, and faced with a bewildering array of loan terms, borrowers tended to trust their mortgage banker or broker. The broken trust that resulted has damaged borrower confidence in the mortgage industry. I liken the situation to that of a doctor and patient dealing with a medical procedure. The patient bears some reasonable risk. But they don't bear the risk of malpractice by the doctor. In our industry, we have frankly seen too much mortgage malpractice. "Curing" a loan that had a high risk of failure creates no moral hazard. Just the opposite...modifying a loan which probably shouldn't have been made in the first place is the kind of action that can help restore integrity and trust in the mortgage market.

I want to emphasize that the core business of traditional mortgage bankers like Lenders One members was not in subprime lending. In fact, the proliferation of reckless lending products from 2000 through 2007 diminished the conventional and government lending market which forms the backbone of our members business. We weren't making high risk loans, but the collateral damage from these products has impacted us in the form of a disrupted market and a failure of confidence by borrowers and investors alike.

While we support the overall approach of the Hope for Homeowners Act, we do have some suggestions for improving the proposed legislation.

• Remove the foreclosure prevention mandate on the government sponsored enterprises.

The proposed legislation would add a mandated "foreclosure prevention goal" that would be required of Fannie Mae and Freddie Mac. In general, we believe that it is critical that Fannie and Freddie remain focused on mortgage market stabilization by providing a steady and predictable flow of mortgage credit. Policymakers should be wary of placing additional burdens on the agencies at a time when the GSEs are being relied upon to shoulder a central role in ensuring liquidity. In addition, in every other respect, the Hope for Homeowners Act relies on voluntary action by market participants. The addition of a mandatory requirement forcing loan modification quotas on the mortgage market is inconsistent with the thrust of the bill and sets a worrisome precedent for federal policy.

- Create a mechanism to ensure independent mortgage bankers have significant opportunity to participate in FHA refinances

Federal policy should avoid an outcome in which the primary originators of subprime mortgage refinances are the same lenders that made the troubled loans in the first place. Main street mortgage bankers can play an important role in refinancing borrowers out of troubled mortgages. Independent bankers provide a trusted, community based partner for borrowers. We would be happy to work with the committee to explore the best way to integrate local mortgage bankers into the refinance mechanism.

Once again, I would like to thank the Committee for today's opportunity to share the views of independent mortgage bankers, and we look forward to continuing to work with you to bring stability and fairness to the mortgage market.

Policies for Tackling the Mortgage Mess

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Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs
April 10, 2008

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to appear before you today.

This hearing addresses a set of serious and interrelated challenges now facing the American economy. The latest data on employment, spending, and production suggest that the economy is very likely in recession. Housing construction has fallen more than half since its peak and has yet to level out, much less to resume an upward trajectory. The turmoil in our credit markets has lasted much longer and become much more severe than most observers predicted even six months ago. And, in the absence of further policy action, several million families will probably default on their mortgages in the next few years and lose their homes to foreclosure.

Designing effective policy responses to the housing and mortgage problems is not easy. In particular, it is neither feasible nor appropriate for the government to ensure that all homeowners, regardless of their mortgages or overall financial situations, are able to stay in their homes. However, it is both feasible and appropriate in my view for the government to reduce the number of homeowners who will lose their homes in the next few years. Policy actions in this direction would also have favorable effects on the broader economic problems we face today.

The first section of this testimony summarizes briefly the causes of the current housing and financial crisis, and the second section reviews the significant problems we now confront. The next section of the testimony presents the case for greater government involvement in the mortgage market today, acknowledging the legitimate arguments of those who prefer to let market forces play out unhindered, but emphasizing the strong justifications for a vigorous government response under current circumstances. The following section turns to specific policy options, commending some provisions included in the compromise Senate housing bill but urging additional timely action—especially regarding an expansion of the FHA's role in helping families with negative home equity to refinance their mortgages.

Causes of the Current Housing and Financial Crisis

It is now apparent that many individuals and institutions took greater financial risks than they intended during the past several years. Excessive risk-taking occurred through both the risk of the assets purchased and the degree of leverage used to finance those asset purchases. Numerous factors contributed to this over-reaching, but the following ones seem to have played central roles.

The first key factor was macroeconomic conditions, especially the low level of short-term interest rates. Because the recovery from the 2001 recession was slow, and because inflation was low and declining for part of the recovery, the Federal Reserve kept the federal funds rate very low in the first part of this decade. The nominal federal funds rate was below 3 percent continuously from September 2001 through May 2005 after being below 3 percent for only five months of the preceding decade. The real funds rate was negative for several years, the longest sustained period of a negative funds rate since the mid-1970s. I have argued elsewhere that the course of monetary policy was largely justified by the outcomes for inflation and unemployment, but the policy nonetheless contributed to the excessive leverage. In particular, low short-term interest rates induced greater short-term borrowing. They also seemed to encourage investors to take greater risks in a "reach for yield." A natural way to take greater risks in such an economic environment was to use additional leverage to buy more assets.

At the same time, house prices were rising rapidly, partly because of fundamentals that justified higher house prices in at least some parts of the country and partly because of the borrowing behavior just described. This house price appreciation fed on itself: Price appreciation made housing a more desirable asset for households, which encouraged further leveraging in order to buy more houses. Price appreciation also kept delinquency rates on mortgages very low, which encouraged lenders to provide more credit for housing. The induced housing demand generated further increases in house prices.

The second key factor was a wave of financial innovation during the past decade that created new products and institutions. These products and institutions addressed real needs but also carried substantial disadvantages that were not widely understood at the time, including a low degree of transparency, poor alignment of incentives, and greater difficulty in resolving credit problems. To take these disadvantages in turn:

- One disadvantage is that the new products and institutions had a low degree of transparency and a high degree of complexity. Some of the new products were nontraditional mortgages, including interest-only mortgages, negative amortization mortgages, and mortgages with teaser rates. The products were apparently not well understood by many who borrowed money this way and by many who lent money this way, and this problem was made worse by the expansion of mortgage credit to people with weak credit histories and other risk factors such as very low initial equity or undocumented income. Other new products were unconventional credit-market instruments, particularly derivatives on asset-backed securities that had complicated payoff patterns. The new securities went several steps beyond the basic mortgage-backed securities that had been widely used and traded for several decades, and they presented several transparency challenges: They were intrinsically more complicated than basic asset-backed securities; even supposedly sophisticated investors had little familiarity with them; and there was little track record of their performance. These problems were compounded because that limited track record was exclusively from a period of rapidly rising house prices, which disguised a multitude of sins. Yet more complexity and less transparency was introduced to the financial system through products that purported to protect or insulate investors from risk, such as credit

default swaps, bond insurance, and shifting liabilities off balance sheets onto structured investment vehicles (SIVs) or other entities.

- Another disadvantage of this wave of financial innovation was that the new products and arrangements worsened the alignment of incentives between the people making and advising about financial decisions and the ultimate investors. Such principal-agent problems are endemic in financial markets and institutions, but they were exacerbated in recent years by financial innovation. One example is mortgage brokers who were compensated for the volume of transactions they initiated and had little incentive to monitor the quality of loans they made. Another example is credit ratings agencies that are paid by the sellers of securities rather than by the buyers; as securities became more complicated, investors' reliance on the agencies' judgment increased. A further example is investment bankers who benefited from selling securities and did not bear the consequences of poor investments.

- Yet another disadvantage was that the new products and institutions presented greater difficulties in working out problems. For example, as discussed further below, modifying mortgages sometimes makes more sense for lenders than foreclosing on properties. The decision to modify a mortgage is administratively easy when the mortgage lender is also the servicer; the decision is administratively difficult when the lender is different than the servicer; and it is even more difficult when the lenders are numerous and hold different tranches of a mortgage pool that includes the mortgage in question.

Four Problems Now Facing the U.S. Economy

The U.S. economy now faces four serious and interrelated problems.

First, the economy is very likely in recession. Employment fell in each of the past three months, retail sales and industrial production both declined in the latest reports, and consumer sentiment has slipped to its lowest level in five years. Moreover, financial conditions are hardly conducive to spending: Since the middle of last year, stock prices have dropped roughly 10 percent, and house prices have dropped between 2 percent and 7 percent depending on the index one consults; the consequent reduction in household wealth is about $3 trillion. And despite the three percentage point cut in the federal funds rate since September, most interest rates paid by households and businesses are down only a little since the middle of last year or are actually up a little: For example, rates on 30-year fixed-rate conforming mortgages are down only 60 basis points, and Baa-rated corporate bond yields are up 20 basis points.

Second, housing is overbuilt and overpriced. Construction has fallen more than half from its peak and shows no signs of bottoming out, nor has the number of unsold new single-family houses substantially diminished. Moreover, both house-price futures and analysts' estimates of sustainable house-price levels point to further sizable declines in house prices.

Third, the financial system is reeling, and lending to households and businesses is impeded. Uncertainty about the value of mortgage-backed securities, and especially about the value of complex derivatives of those securities, induced a general reassessment of financial risk,

going well beyond the subprime mortgage market and beyond the residential mortgage market altogether. The resulting uncertainty about the solvency and liquidity of many financial intermediaries has led these institutions to try to reduce the risk and augment the liquidity of their balance sheets. Those steps in turn have pushed down the price of risky or illiquid assets and pushed up the rates charged for borrowing by households and businesses, as just noted.

Fourth, absent further policy action, several million families will likely default on their mortgages in the next few years and lose their homes to foreclosure. In some cases, this will occur because resetting mortgage rates push monthly payments out of people's reach. However, declines in short-term interest rates since last year have reduced the magnitude of this problem. In more cases, foreclosures will occur because falling prices push house values below mortgage amounts, and people struggling to make their mortgage payments decide to stop struggling. Economist Mark Zandi of Moody's has projected that 14 million families may end up with negative equity in the next two years and that 2 million of them will lose their homes. Foreclosures are clearly costly to homeowners in both personal and financial terms, and foreclosures are costly to borrowers, who may recover no more than half of the mortgage principal. Foreclosures are also costly to neighborhoods, communities, and cities, especially when the foreclosures are concentrated in geographic areas as they often are.

These four problems have generated a number of significant policy responses. Congress and the President agreed on a tax rebate that will be distributed in coming months to roughly 130 million families. The Federal Reserve has slashed the federal funds rate by 3 percentage points since September. In addition, the Fed has fulfilled its role as "lender of last resort" by providing a good deal of additional liquidity to financial institutions through a series of creative new lending arrangements and by organizing the sale of Bear Stearns to JPMorgan. All of the fiscal and monetary actions I have just described have been appropriate in my view, but they are not the focus of my remarks today.

Congress and the Administration have also recognized the importance of policies that tackle the housing and mortgage mess directly. In the fall the Administration expanded eligibility for refinancing into mortgages guaranteed by the FHA, the Federal Housing Administration. The Treasury Department coordinated an agreement among industry participants to freeze mortgage-rate resets in those cases where borrowers are unlikely to meet the higher payments. Congress raised the threshold amount for mortgages covered by Fannie Mae, Freddie Mac, and the FHA. And this week, of course, the Senate is acting on a collection of proposals directly aimed at the housing and mortgage markets.

Designing effective policy responses to the housing and mortgage problems is not easy: Many analysts and policymakers have struggled during the past six months to develop effective forms of government intervention and have been disappointed by a lack of appealing options. Still, the government can and should do more. In the next section I present the general case for further government involvement, and in the following section I turn to specific policy options.

Why Should the Government Become More Involved in the Mortgage Market?

History shows that the best way, by far, to organize economic activity in order to maximize people's material well-being is through markets and private property. One hallmark of market-based economies like ours is that people generally make their own economic decisions—what to buy and sell, what to save and borrow. This system is sustainable only if people bear the consequences of those decisions. Therefore, some analysts and policymakers have asked the very legitimate question of why the government should become more involved in the mortgage market rather than letting market forces play out by themselves.

This skepticism about a greater role for the government can be elaborated along several dimensions:

To start, skeptics can note, foreclosures are an unfortunate fact of life in this country. Even in good times, many families end up with mortgages they cannot sustain. For example, Federal Reserve Chairman Bernanke noted in a recent speech that foreclosure starts in 2005 and 2006 were under 1 million per year and that more than half of foreclosure starts typically result in sale of the property—suggesting that about half a million families actually lost their homes to foreclosure in each of those years. With the sharp deterioration in underwriting standards during the past few years, still more families presumably ended up in mortgages that are unsustainably large even with government help. Trying to keep these families in their current homes would, so the argument goes, simply prolong their struggle with high mortgage payments and prevent other families with stronger economic positions from buying and living in those homes.

In addition, skeptics can argue that many families who will lose their homes are not especially deserving of government help. People with negative equity in their houses will be disproportionately those who bought houses without putting much money down or who refinanced and withdrew equity to support other consumption. These people are not actually losing much housing equity and have enjoyed a comparatively nice lifestyle. It is unfair, so the argument goes, to help homeowners who are defaulting and facing foreclosure while not helping people who kept renting rather than taking out mortgages beyond their reach or people who are also stretched to meet their mortgage payments but are making the sacrifices to do so. Moreover, helping borrowers and lenders who entered into contracts that are now unworkable will create so-called "moral hazard" by encouraging unduly risky borrowing and lending in the future.

These arguments contain some truth. However, and I want to emphasize this point, they are not the whole truth. Despite these legitimate concerns, the government has a crucial part to play in resolving the current mortgage mess. Let me explain why:

First, the government has long had an active role in housing and housing finance. This role stems partly from the view that homeownership encourages responsible citizenship and strengthens people's ties to their neighbors and communities. It also stems partly from the view that financial markets do not always conform to economists' idealized conception of markets: Asymmetric information between borrowers and lenders, leveraged financial institutions that are vulnerable to "runs" when savers' confidence falters, and the possibility of contagion in the financial sector all justify government involvement. For these reasons and others, the federal government has granted tax deductibility for mortgage interest and excluded most house-price appreciation from capital gains taxes; it has fostered mortgage lending through its regulation of

savings institutions; it has established the Federal Home Loan Bank System and the Federal Housing Administration; it has created Fannie Mae and Freddie Mac and provided an implicit guarantee to their securities; and so on. We now face challenges in housing finance that are unprecedented since the Depression of the 1930s, and it natural to think that the government's role should be increased under these very unusual conditions.

Second, government policy never does—nor should—follow free-market principles absolutely. In all areas of economic policy, we balance the need for people to bear responsibility for their decisions with the goal of protecting vulnerable members of society. The families facing foreclosure appear to be a tremendously varied group: Although some struggling mortgage borrowers do not deserve our sympathy, many others were victims of predatory lending practices, entered into mortgage contracts they could not fully understand, or took risks on their mortgages to escape unpleasant or dangerous rental housing. These families do deserve our sympathy and our help. To be sure, some of these families would not own their current homes if risks had been recognized fully during the past several years, but government policy can ease their transition to a world with appropriate recognition of risks.

Third, the effects of turmoil in the housing and mortgage markets are felt well beyond the families that borrowed too much and the financial institutions that lent too much. Concentrated foreclosures lower property values throughout the communities in which they occur, hurting every family trying to sell its home in such areas. Wild gyrations in financial markets pose risks to everyone's savings, including many people who were not trying to increase their leverage to squeeze out a higher return. The weakening of the overall economy hurts many workers who lose their jobs and cannot find new ones. Indeed, the downside risks to economic activity are especially pronounced now, and continued distress in the housing and financial sectors could launch a reinforcing downward spiral in which financial turmoil begets economic weakness, which causes further turmoil, and so on.

Fourth, mortgage markets are not functioning in a normal manner now. For example, many families that could easily obtain mortgage credit just a year or two ago now have great difficulty obtaining mortgages, in part because some of the largest mortgage lenders have suffered massive losses and are struggling to maintain their viability and because many types of mortgage-backed securities are viewed especially negatively in financial markets. Regulatory policy should have been employed more vigorously to reduce the swing in the financial pendulum toward laxness in lending, and government guarantees can be used selectively to reduce the swing toward stringency in lending.

Fifth, our standard approach to mortgage securitization severely limits the likelihood that servicers will modify large number of mortgages in ways that will prevent defaults. Mortgage servicers and lenders have several legitimate reasons to avoid writing down principal, which may be the most effective way to induce borrowers who have negative equity to stay current on their loans: Other borrowers will want the same deal, which greatly raises the cost, and some borrowers will default later even with a principal write-down, which raises the cost as well. But other factors imply that yet fewer loans will be modified than is optimal from the perspective of lenders. One obstacle is the dispersion of ownership through securities and derivatives. Although the pooling and servicing agreements (PSAs) generally give servicers the authority to

make modifications that are in the interest of the lenders, the degree of latitude varies across contracts, and ownership of different tranches creates different incentives for different investors; all of this makes modifications a judgment call, which opens the door to legal challenges. In addition, some servicers who are willing to accept lower payoffs on some mortgages will want borrowers to obtain new mortgages from other lenders, and the current problems in mortgage markets make that very difficult for some borrowers.

With these points in mind, I now turn to specific policy options.

What Mortgage Policies Should the Government Pursue Now?

The compromise housing bill being debated in the Senate this week includes several provisions that will help to improve conditions in mortgage markets in the near-term.

One such provision is the appropriation of additional funds for mortgage counseling. Many families who lose their houses to foreclosure never contact a credit counselor or their mortgage servicer in advance. Yet, counseling by local organizations, and the interaction with mortgage servicers that results, has had a high success rate in the past. Therefore, it makes sense to appropriate additional funding for this purpose just as quickly as counseling organizations can build their capacity and use the funds effectively.

Other valuable provisions of the bill include the augmenting of funds for state and local governments through the increase in private-activity bond authority and the increase in Community Development Block Grants. These funds will help these governments to facilitate mortgage refinancing as a means of avoiding foreclosure, and to maximize the value of homes that have been foreclosed upon while minimizing the negative spillovers. Through both channels, some of the negative consequences of the prospective foreclosure wave will be staunched, especially in localities where foreclosures might be highly concentrated.

Despite these important provisions, however, the compromise housing bill falls short of what is needed in my view.

One major deficiency is that the bill does not include reform of the bankruptcy law to allow judges to write down principal amounts owed on mortgages. A careful examination of the merits and demerits of such reform is beyond the scope of this testimony. In brief, though, the reform clearly would not come without cost. As opponents argue, it would induce an increase in bankruptcy filings and would likely have some detrimental effect on the future supply of mortgage credit. However, if eligibility for "stripdowns" in bankruptcy were carefully limited, as is the case for the proposals that have received the greatest attention in Congress, then the effect on future credit supply would probably be quite limited as well. Moreover, this reform has the key advantage of targeting mortgage relief to those families that are in the most perilous economic circumstances and for whom relief is most appropriate—a targeting that is difficult or impossible to achieve through most other policies for addressing current mortgage problems. Therefore, I have reluctantly come to support this reform, and I urge Congress to pass it into law.

The other main deficiency of the compromise bill is that it does not include a significant expansion of the role of the Federal Housing Administration. Two templates for such an expansion have been circulated widely in Congress—one by Chairman Dodd of this Committee, and the other by Chairman Frank of the House Committee on Financial Services. Under their similar proposals, eligibility for FHA-guaranteed loans would be broadened to help more families refinance their mortgages when they have negative equity in their homes. Such an expansion would be an appropriate and important step forward for several reasons. (As this testimony was being finalized, news reports stated that the Administration would shortly announce an expansion in FHA eligibility to help families with negative equity in their homes. However, the scope and details of the Administration's proposal are unclear at this writing.)

First, the FHA's traditional mandate is to assist individuals underserved by the traditional mortgage market, and it has many years of experience in doing so. Given the pullback in private mortgage lending and securitization, it is natural to increase the FHA's role as a counterweight. Although under normal circumstances, the FHA helps only borrowers who are current on their loans, last fall the administration expanded the program to include adjustable-rate borrowers who had been making timely payments but became delinquent following interest-rate resets. With negative equity now becoming a key contributor to rising foreclosures, an expansion of FHA programs that addresses borrowers with negative equity is the logical next step.

Second, these proposals are appropriately selective in the families they help. Although every foreclosure can be painful for the families involved and for the neighborhoods and communities in which they live, not every family can afford to stay in their current homes with a reasonable amount of government help. The FHA expansions that have been put forward recognize this hard truth, and they are explicitly limited to owner-occupiers that satisfy solid underwriting standards and represent good credit risks at their new mortgage amounts.

Third, the proposals have been constructed carefully to limit eligibility to circumstances where loans can be refinanced at low or zero cost to taxpayers. The proposals do not simply throw open taxpayers' wallets to help anyone who would prefer to make smaller mortgage payments. Instead, they require servicers of existing mortgages to take substantial write-downs of the principal amounts owed, and they ensure that the FHA shares in any renewed house-price appreciation. The low expected cost to the government means that these proposals are not bailouts in the sense of providing large amounts of taxpayer money to get borrowers or lenders off the hook.

Fourth, these proposals provide an important incentive for servicers to reduce principal amounts owed. Chairman Bernanke and others have urged mortgage servicers to consider writing down principal amounts in the many cases where that approach will generate more value for investors than foreclosure. Mortgage servicers have not traditionally pursued this type of workout and probably lack standard procedures for doing so. In addition, they may be especially reluctant to mark down principal in cases where they would continue to hold the mortgage and thus be exposed to its various risks. The proposed legislation addresses these problems by offering a safe harbor against legal liability for servicers who participate in the program and by providing an FHA-guarantee for the new mortgage that facilitates its purchase by someone else.

Importantly, participation in the program would be voluntary for servicers and lenders, so this approach would not restrict future credit supply.

One remaining obstacle is the prevalence of second liens. Schemes to refinance first mortgages into more appropriate ones typically cannot go forward without re-subordination of the original second liens. This has reportedly proven difficult when the holders of the second liens are different from the holders of the first liens. Looking for ways in which the government could help to coordinate this process should be an important goal.

Lastly, I should note that I am skeptical about further proposals to use some type of auction process for bringing more loans to the FHA. The appeal of such auctions is clear: They appear to provide a mechanism for the government to take timely action on a large number of mortgages. However, it is unclear how such auctions could distinguish effectively among families and mortgages in the ways that are needed. For example, if the government buys pools of mortgages offered at the largest discounts, and if servicers know more about their customers than the government and are sophisticated in using that information, then the government will end up buying the riskiest mortgages. This selection problem would expose the government to additional risk and expense. That said, the auction idea deserves further study, and I would be pleased to see it included in legislation on that basis.

Conclusion

After the current housing and financial crisis has passed, reducing the probability of its recurrence must be a high priority for policymakers. Financial markets will always experience swings between confidence and fear, but appropriate changes to our system of financial regulation and oversight can reduce the frequency, magnitude, and broader consequences of such swings.

At this time, however, we do not have the luxury of choosing between the messy policy options available to us and an idealized world in which such ad hoc policies are not needed. Instead, we must choose between messy policy options and inaction—and the cost of inaction is very high. I urge this Committee and other Members of Congress to move beyond the policy responses already in law or under consideration as part of the compromise Senate bill. In particular, a measured expansion in the role of the Federal Housing Administration as proposed by Chairman Dodd and Chairman Frank would contribute importantly to reducing the size of the coming foreclosure wave.

To be sure, this proposal and others focused on the mortgage mess are not silver bullets for our economic problems: They will not completely prevent a rise in foreclosures, halt the decline in house prices, restore stability in financial markets, nor avert a recession. However, they can reduce the scale of these broader problems, helping to avert an overshooting of housing prices and helping to stabilize the prices of risky financial assets. Moreover, they can do so with limited repercussions for future mortgage lending and risk-taking, and at fairly low cost to taxpayers.

Thank you very much.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM LAWRENCE H. SUMMERS

WHAT WOULD GOVERNMENT INTERVENTION BUY US?

Mr. Summers, you note that the policy challenge is to mitigate market overreactions while not interfering with necessary or inevitable adjustments. At the same time, we hear that government intervention in the housing market is needed to essentially set a "floor" to housing values.

Q.1. Can government intervention alone set a floor on housing values? Won't the marketplace still ultimately determine values?

A.1. Government intervention may not singlehandedly solve the turmoil in the housing markets, but the risks of inaction undoubtedly far outweigh the risks of action. Simply because government intervention will not be a sufficient solution on its own does not mean that it is not one important—and perhaps even necessary—part of the solution.

Q.2. If the government does intervene, are we effectively putting all the risk of further price declines on the taxpayer rather than leaving it in private hands who benefitted from what we now believe may have been a housing bubble?

A.2. As I understand the proposals, there is substantial protection built in for taxpayers through fees and loan limits, and it would be appropriate to design procedures so as to minimize the risk of misappraisals. Regardless, in the event that the current economic problems prove profound, the costs of current intervention are likely to be the least of the federal budget's problems.

Q.3. What is the long-term cost of government intervention into the mortgage market to provide stability? Are we encouraging borrowers and lenders to pay even less attention to risk in the future?

A.3. Any time that the federal government intervenes to protect borrowers and lenders, moral hazard is certainly a concern. But in a situation where credit problems threaten economic stability at a fundamental level, the risk that inaction will cause significant financial distress for American families outweighs moral hazard considerations. The same people who cite moral hazard as a reason that government should not act to minimize the threats now facing the mortgage market would almost certainly not claim that the prospect that people might smoke in bed would be a plausible argument in favor of getting rid of fire departments.

IMPORTANCE OF DOWN PAYMENTS

A 20 percent down payment to purchase a home became increasingly rare in recent years as home prices accelerated. We now see that many of the borrowers who are in trouble made minimal, if any, down payment. It is not surprising that we would find a number of homeowners with negative equity, even with modest price declines in home values.

Q.4. As the Congress looks for ways to avoid repeating past mistakes, what should this tell us about down payment requirements, particularly with respect to any government-guaranteed mortgage programs?

A.4. One would hope that any long-term response to a crisis caused by excessive hubris and undervaluing risk would place substantial value on financial responsibility. Realistic and responsible down-payment requirements would constitute one of many possible measures for restoring stability and credibility to the housing market.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DEAN BAKER

IMPORTANCE OF DOWN PAYMENTS

A 20 percent down payment to purchase a home became increasingly rare in recent years as home prices accelerated. We now see that many of the borrowers who are in trouble made minimal, if any, down payment. It is not surprising that we would find a number of homeowners with negative equity, even with modest price declines in home values.

Q.1. As the Congress looks for ways to avoid repeating past mistakes, what should this tell us about down-payment requirements, particularly with respect to any government-guaranteed mortgage programs?

A.1. I would be hesitant to draw conclusions that might be too strong about down-payment requirements. Other things equal, it is desirable to require that buyers have a reasonable down payment so that they have an equity stake in their house from the outset. However, I think it is reasonable to lower these requirements to more modest levels (3–5 percent) in cases where individuals have solid work histories and generally good credit records. It is often difficult for moderate-income families to save much money, and even a 3 percent down payment can be a burden.

More than the down payment, I would emphasize the need to ensure that families are not getting into homes that they will not be able to afford. If a family has maintained a solid work history and generally good credit, then they are likely to act to ensure that their mortgage is paid in good faith, barring serious illness or family break-up.

The housing bubble and the resulting collapse in prices are unusual circumstances which hopefully will not be repeated. When house prices fall by 25–30 percent, as we have seen in some areas, no reasonable down-payment requirement can prevent homeowners from going underwater. I think it would be a mistake to set down-payment requirements based on such an extraordinary event. Rather Congress should try to ensure that comparable housing bubbles do not arise in the future.

DISCREPANCY BETWEEN HOME PRICES AND RENTAL PRICES

Mr. Baker, your testimony notes the large discrepancies between home prices and rental prices in much of the country. It would appear that the housing market needs to adjust so that these two prices are more aligned, especially if we would like to be able to help low and moderate income working families purchase homes in the future.

Q.2. Please explain to the Committee how a program such as Hope for Homeowners would stand in the way of such a necessary ad-

justment in home prices and also, what exposure the Federal Government would face if we intervene in this adjustment?

A.2. The Hope for Homeowners program could interfere with the price adjustment process in over-valued markets if it guaranteed mortgages at prices that are still above trend levels in these markets. In effect, the program would be providing an artificial source of demand that would be propping up prices above their market levels. At least for a period of time, this could sustain prices at artificially high levels.

This would place the Federal Government at risk because it would effectively guarantee a price on a mortgage that is above the trend market price for the house. If house prices eventually adjust to a lower level, homeowners are again likely to find themselves owing more than the value of their homes. This means they will have a temptation to default on their mortgage. Even if they continue making payments on the mortgage in spite of being underwater, many homeowners could end up selling their homes for less than the value of the mortgage. (The median period of homeownership for moderate-income families is just four years.) In both the cases of an outright default or a "short sale," the Federal Government would be obligated to compensate the lender for the difference between the guarantee price and the money the lender actually collects.

Of course, any time the government sets up a loan guarantee program of any type it puts itself at risk in this manner. However, I think it is important to distinguish between the type of risks that exist in a typical market, and the type that exist in an over-valued real estate market. As I said in my testimony, I think that the government can limit this risk if Congress bases the guarantee price on a multiple of rent (I suggested 15 to 1). However, if the government were to guarantee prices based on appraisals in a market that is still substantially over-valued, it is almost certain to incur losses on a large share of its guarantees.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM DEAN BAKER

Q.1. What do you suggest we do to find the $20 billion this bill costs to start up? What should we cut, or what should we raise taxes on?

A.1. Since the economy is currently facing a recession, or at least a period of very slow growth, it might be desirable to run a larger deficit, at least temporarily. This would provide stimulus to the economy, as Congress sought to do with the stimulus package it passed in February.

Obviously any tax increases or spending cuts that Congress puts in place would reflect its priorities. I would first and foremost look to removing tax breaks which distort the tax code without any obvious rationale.

The two that come to mind most immediately are the special treatment of carried interest which allows hedge and equity fund managers to have their compensation taxed at the 15 percent capital gains rate, instead of the 35 percent rate they would otherwise pay. This encourages gaming of the system and allows some of the

wealthiest people in the country to pay a lower tax rate on their earnings than school teachers or firefighters.

The other tax break that serves no obvious purpose is the mortgage interest tax deduction for expensive homes. While home ownership is often desirable, and it is reasonable to provide assistance to moderate- and middle-income homeowners, it is not clear what public interest is served by subsidizing the purchase of a multi-million dollar home by a family in the top 1 percent of the income distribution. Congress could substantially lower the caps on the amount of a mortgage for which the interest is deductible without affecting middle-class families at all. Moving the cap down from $900,000 to $500,000 would inflict little pain on anyone.

Q.2. Do you have any suggestions for making sure someone did not lie or not tell the whole truth on their original mortgage application?

A.2. In the future, it would be appropriate to require that lenders make a good faith effort to verify the information that borrowers put down on application forms. The Federal Reserve Board has proposed regulations that would require loans be properly documented. I believe that Representative Frank's mortgage reform bill, or at least some version of it, also had such a requirement. There may be legitimate reasons why it is not always possible to get full documentation of the information used by borrowers to secure a mortgage, but such instances should be the exception.

Clearly, issuers were anxious to issue mortgages in the housing boom because they made money on the issuance fees, whether or not there was reason to believe that the borrower actually could repay the loan. If issuers are made liable for the quality of loan, for example by requiring them to hold a 10 percent stake of loans sold in the secondary market, then they will have more incentive to ensure that the information borrowers provide is accurate.

Q.3. If home prices continue to fall, lenders would be protected. But what protection do the taxpayers have if prices fall 10% more?

A.3. If home prices continue to decline, and the government issues guarantees of mortgages at prices that are near current levels, then the government is likely to face a substantial cost associated with a high default rate. The most important factor determining both the default rate and the cost of each default is the movement in house prices.

If prices continue to fall, then many homeowners will again find themselves owing more than the value of their home. This situation leads to defaults for two reasons. First, if a homeowner owes more than the value of her home, then she does not have the option to borrow against equity in order to make her mortgage payments. This eliminates an important source of security if job loss or unusual expenses leaves the homeowner temporarily unable to pay his or her bills.

The other reason why this situation increases default rates is that homeowners who owe more than the value of their home can effectively save themselves money by simply surrendering their house to the bank. If a homeowner owes $200,000 on a home that is currently worth $180,000, the homeowner can effectively save $20,000 by just giving the house back to the bank. While this move

will hurt the homeowner's credit rating, if they don't have any special attachment to the house, a homeowner may choose this option.

In addition to increasing the number of defaults and foreclosures, falling house prices will also increase the loss on each foreclosure. If the house is still valued at close to the amount of the mortgage, then the losses on the foreclosure will just be the administrative and transactions costs associated with carrying through the foreclosure and reselling the house. However, if the house sells for less than the value of the mortgage, then this can be a substantial source of additional losses for the government.

As I argued in my testimony, the government can limit the risk that it will set the guarantee price on new mortgages too high by using an appraisal of rental price as the basis of the guarantee, rather than an appraisal of the sale prices. Since rents never rose out of line with fundamentals, an appraisal based on some multiple of annual rent (e.g. 15 times annual rent) should ensure that the government's guarantee price is set at a level that is close to the price that the home will command after the bubble has deflated.

Q.4. Should we be encouraging or subsidizing someone staying in a house if they would be financially better off if they were renting?

A.4. Homeownership can be a useful way for families to accumulate wealth and to provide good, secure housing. However, if families are buying homes at bubble-inflated prices, then they are not likely to accumulate any wealth in their home, since the price is likely to fall back to its trend level before they sell their home. (The median period of homeownership for moderate-income families is just four years.) Furthermore, they are likely to pay far more in housing costs each year, than they would to rent a comparable unit.

In the case of moderate-income families facing serious budget constraints, the additional housing costs associated with owning an over-priced home are likely to come at the expense of other necessary items, such as health care and child care. It is difficult to see how the government will have helped a family by encouraging them to remain in such a situation. The best way to avoid this problem would be to have the Hope for Homeowners guarantee price grounded in the rental price for the unit.

Q.5. Should we require financial sacrifices for participation in this program, such as selling vacation homes or investment properties, selling second vehicles, getting a second job, not taking on other debts, or selling non-retirement account investments?

A.5. I think it would be reasonable to take steps to try to ensure that any government aid program helps only low- and moderate-income families. One obvious way to do this would be to limit the size of the mortgages that can be financed, which I believe is already the case in all of the mortgage-guarantee programs being considered by Congress. It is possible to put additional asset restrictions on participants, but my guess is that in the vast majority of cases, such restrictions would not affect eligibility.

For example, there are not many people with vacation homes or investment properties who would also be living in a relatively modestly priced home as their primary residence. Furthermore, the few people who are in this situation are likely to find ways to hide their assets, so that they would still be eligible for the program.

The other suggested restrictions also pose problems. For example, a two-worker family may need two cars. Similarly, investment accounts can be hidden in the names of relatives. My view is that the cost associated with trying to enforce these sorts of restrictions, and the additional burden imposed on families who are genuinely in need of help and acting in good faith, outweigh the benefits of excluding the relatively small number of scam artists that may try to take advantage of this sort of program. We will never be able to exclude scam artists altogether from such programs and we undermine the purpose of the program if we place too many restrictions on homeowners.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ELLEN HARNICK

A 20 percent down payment to purchase a home became increasingly rare in recent years as home prices accelerated. We now see that many of the borrowers who are in trouble made minimal, if any, down payment. It is not surprising that we would find a number of homeowners with negative equity, even with modest price declines in home values.

Q.1. As the Congress looks for ways to avoid repeating past mistakes, what should this tell us about down-payment requirements, particularly with respect to any government-guaranteed mortgage programs?

A.1. Negative equity is a driver of foreclosure, as it deprives borrowers of the ability to sell the home (a particular problem for those who need to relocate for jobs or other reasons) or address short-term cash crises by tapping into home equity. High loan-to-value ratios or low down payments, if accompanied by other risk factors, can contribute to negative equity or elevate foreclosure risk. However, high loan-to-value ratios are not the primary driver of foreclosure, and do not create excessive foreclosure risk if the loan is properly structured. The most significant driver of foreclosure is the failure to ensure the affordability of the loan beyond an introductory period. Appraisal fraud, equity-stripping from successive refinancings, and declining home values are also important drivers of negative equity. For these reasons, ensuring affordability, utilizing reasonable debt-to-income ratios and residual income measurements, based on the borrower's reasonably documented income, are considerably more important than the loan-to-value ratio.

The use of high loan-to-value loans expanded homeownership opportunities for individuals who lack sufficient income to sustain them.

With respect to the government backed refinance loan program provided by the Hope for Homeowners Act, it is entirely appropriate to allow refinancing for up to 87 percent of the property's current value, and to require the lender to accept this payment in full satisfaction of the debt. This both avoids a tax-payer bailout and supports the sustainability of the program. For purchase money loans, in contrast, it is important to continue to enable government loan programs to serve underserved communities by mak-

ing loans with low down payments, structured as described above to ensure sustainability.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ELLEN HARNICK

Q.1. What do you suggest we do to find the $20 billion this bill costs to start up? What should we cut, or what should we raise taxes on?

A.1. The best way to cover the costs of the HOPE for Homeowners FHA program is to make the program self-sustaining, or as close as possible. As proposed, the HOPE for Homeowners Act is designed to accomplish this. In this regard, the essential aspects of the Act are those that require: (a) a loan-to-value ratio of no more than 90%, (b) the creation of an FHA insurance pool to cover losses, funded with 3% of the balance of each covered loan, (c) the payment by borrowers of an additional premium of up to 1% per year, and (d) the sharing of equity with the FHA. Even if the default rate on loans made under the HOPE for Homeowners program were twice the FHA's normal default rate (which would roughly correspond to the 20% default rate for loans made by the Depression-era Home Owners' Loan Corporation ("HOLC")), the program would have sufficient reserves to cover the losses. (The HOLC covered its losses and even turned a small profit.)

CBO estimates that the total cost of the program, as revised by the Committee, over a ten year period is $729 million in order to prevent 400,000 foreclosures. (See *http://www.cbo.gov/ftpdocs/94xx/doc9480/RevHR3221Table.pdf.*) That is a cost of $1,823 per foreclosure prevented. Given the spillover costs to neighbors and risks to the economy, not to mention the costs to the family who otherwise would face foreclosure, this is a modest expenditure that could be offset in a number of different ways, including an assessment on GSE business activities.

Q.2. Do you have any suggestions for making sure someone did not lie or not tell the whole truth on their original mortgage application?

A.2. It would be difficult, and administratively costly, to conduct a fact-finding into the truthfulness, as of loan origination, of data on the loan application, and would be harder still to discern whether the party responsible for any misstatement was the mortgage broker, loan originator, or homeowner. Given the purpose of the legislation in part to protect neighbors, municipalities and the economy from preventable foreclosures, and the necessity of acting promptly so that relief is available in time to accomplish its intended purpose, the benefits of such an exercise seem unlikely to outweigh the costs. However, going forward, the FHA needs to ensure that there is reasonable documentation of income and assets for any homeowner who refinances under the program.

Q.3. If home prices continue to fall, lenders would be protected. But what protection do the taxpayers have if prices fall 10% more?

A.3. A further 10% house-price decline beyond the 10% equity cushion created by the FHA bill could impact both the risk of foreclosure and loss severities in those markets experiencing such de-

cline. The factors identified in answer to Question 1 above will play an important role in minimizing the impact of these risks on the self-sustainability of the program, and we believe are sufficient to cover losses that would arise in this scenario. Acting expeditiously to avoid further unnecessary foreclosures will help avoid an over-decline in house-prices, and this would benefit the economy as a whole, and bolster the sustainability of the program.

Q.4. Should we be encouraging or subsidizing someone staying in a house if they would be financially better off if they were renting?

A.4. Losing a home to foreclosure has severe consequences for a homeowner's credit rating and financial stability, dramatically limiting the homeowner's post-foreclosure options, whether the homeowner seeks to buy another home, or rent. For many homeowners facing foreclosure the economically rational choice may be to avoid foreclosure by refinancing, and remain in the home long enough to rebuild their credit and get the benefit of any equity build-up over the next several years, than to surrender the home in foreclosure. This is so even if, in the same market, people who have not yet purchased their first home might deem it economically preferable to rent for a year or more, rather than purchase their first home now. Making sure that qualified, independent, not-for-profit housing counselors and lawyers are available to homeowners facing these hard choices, will assist troubled homeowners in making the best decisions given their circumstances.

Q.5. Should we require financial sacrifices for participation in this program, such as selling vacation homes or investment properties, selling second vehicles, getting a second job, not taking on other debts, or selling non-retirement account investments?

A.5. As a practical matter, lenders generally will agree to refinance on the terms required by HOPE for Homeowners only where this is preferable to other legal means of obtaining repayment, and likely will pursue such other means where there are assets available to fund the recovery.

Moreover, some of the specific suggestions could prove more costly than beneficial. For example, determining how many vehicles are required to transport a family's wage-earners to work would add administrative burden and cost, and, given the depreciating value of used vehicles, the sale of the vehicle might generate less cash than the vehicle's actual value to the family, without materially improving the family's ability to repay the loan. Nor is it advisable to require families to further deplete their savings to repay a loan for which many families over-paid in the first place.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DOUGLAS W. ELMENDORF

FURTHER HOUSING PRICE DECLINES

Q.1. Mr. Elmendorf, your testimony notes that "housing is overbuilt and overpriced." You further note that house-price futures and analysts' estimates point to further sizable declines in house prices. Assuming that is the case, I am concerned about what a further FHA expansion will mean for taxpayers.

If the FHA guarantees a mortgage for 90 percent of a home's market value today and the value declines 10 percent in the next year, where will that leave the FHA a year from now? And what if there is a further decline the following year?

A.1. Substantial further declines in house prices certainly pose risks for the FHA, and thus for taxpayers, if new mortgages guaranteed under an FHA expansion do not include an adequate financial cushion for the FHA. In my judgment, the cushion built into current legislative proposals—involving a combination of principal writedowns, premiums, and recovery of a portion of any house-price appreciation—is sufficient to limit this risk.

PROBLEMS WITH SECOND MORTGAGES

Q.2. Mr. Elmendorf, you noted that the prevalence of second liens creates an obstacle to refinancing first mortgages into more affordable mortgages. Just to cite one example, data collected under the Home Mortgage Disclosure Act suggest that nearly 40 percent of higher-priced home-purchase loans in 2006 involved a second mortgage (or "piggyback") loan.

What would you suggest be done to coordinate the process of dealing with the second lien holders?

A.2. Much of this coordination will need to be undertaken by the private lien holders. However, I would also explore whether the government could serve as a clearing house for the relevant information—for example, by offering to collect from lienholders the addresses of properties on which they hold liens, and then to share that information with any other lienholders who report liens on properties at the same addresses.

Q.3. Won't there be cases where the interests of the second lien holder are not aligned with those of the first mortgage holder?

A.3. Yes, some second lien holders will likely resist subordinating their claims to refinanced first liens. From the perspective of the second lien holders, even properties with negative equity on the first liens alone might ultimately yield some mortgage payments. Moreover, the process of resubordinating the second liens offers those lien holders some leverage for extracting money from the first lien holders. In some cases, small payoffs from the first lien holders to the second lien holders is likely to be part of the refinancing process.

IMPORTANCE OF DOWN PAYMENTS

A 20 percent down payment to purchase a home became increasingly rare in recent years as home prices accelerated. We now see that many of the borrowers who are in trouble made minimal, if any, down payment. It is not surprising that we would find a number of homeowners with negative equity, even with modest price declines in home values.

Q.4. As the Congress looks for ways to avoid repeating past mistakes, what should this tell us about down-payment requirements, particularly with respect to any government-guaranteed mortgage programs?

A.4. Requiring mortgage borrowers to have some equity in their homes—and thus some cushion against potential house-price declines—is a crucial part of responsible lending. Because this point is being brought home so forcefully now to many mortgage lenders and investors, I do not expect the very high loan-to-value ratios seen in some mortgages during the past several years to be repeated in the future. Similarly, government-guaranteed mortgage programs need to be ensure a financial "cushion" to protect taxpayers from losses. This cushion depends on loan-to-value ratios, the premiums that are charged, and the integrity of the underwriting process.

RATE RESETS NOT THE ONLY PROBLEM?

Mr. Elmendorf, at times the discussion of the mortgage situation has focused on how rate re-sets posed a huge problem as borrowers came to realize what was really in the mortgages they took out. Some pointed to the so-called 2/28 or 3/27 loans as fueling this crisis. You note in your testimony that declines in short-term interest rates since last year have reduced the magnitude of this problem.

Q.5. If the predicted foreclosure wave isn't due to rate re-sets, what is the underlying cause?

A.5. Experience suggests that mortgage foreclosures are most closely linked to movements in house prices. When prices decline and people lose equity (sometimes all of the equity) in their homes, then foreclosures rise. The mechanism is principally that people who encounter some obstacle to making their mortgage payments—losing their jobs, being hit with high medical bills, or something else—can often find a way to keep making those payments when they have equity—such as refinancing the mortgage or borrowing from relatives—but do not have access to these means when they are under water.

Q.6. Can we draw something from the fact that a large number of borrowers went into default only a few months into their mortgages?

A.6. The high rate of very early defaults on recent mortgage vintages suggests that some borrowers had no intention of making mortgage payments but planned instead to re-sell the houses quickly and benefit from the appreciation. Of course, with declining rather than rising house prices, this strategy failed. This experience emphasizes the importance of restricting FHA expansion to owner-occupied homes and to families who demonstrate in the underwriting process the ability to make payments on restructured mortgages.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM DOUGLAS W. ELMENDORF

Q.1. What do you suggest we do to find the $20 billion this bill costs to start up? What should we cut, or what should we raise taxes on?

A.1. To my knowledge, no official cost estimate has been produced for the plan put forward by Chairman Dodd. The CBO cost estimate for the similar plan put forward by Chairman Frank of the

House Financial Services Committee is less than $3 billion. I agree with the spirit of the question that decisions to raise spending or cut taxes should be accompanied by decisions about how to pay for those actions, because these financing decisions pose the ultimate cost-benefit test. As you know, the CBO regularly issues a lengthy report on budget options. Among the options in that document that I support, "Eliminate the International Trade Administration's Trade Promotion Activities or Charge the Beneficiaries," "Impose New Limits on Payments to Producers of Certain Agricultural Commodities," and "Reduce Payment Acreage by 1 Percentage Point" would collectively provide the amount required.

Q.2. Do you have any suggestions for making sure someone did not lie or not tell the whole truth on their original mortgage application?

A.2. In my judgment, independently verifying the honesty of people's initial mortgage applications is not worth the administrative effort involved. As with other public programs, designing an FHA expansion presents tradeoffs between one's ideal program (here, penalizing people who did not tell the truth) and a program that can be administered at reasonable cost. Many people who lied in order to buy a bigger house would not meet the underwriting standards imposed by the FHA and would not qualify for that reason. The retrospective underwriting required to precisely identify the others is not worth the cost in my view.

Q.3. If home prices continue to fall, lenders would be protected. But what protection do the taxpayers have if prices fall 10% more?

A.3. Substantial further declines in house prices pose risks for the FHA, and thus for taxpayers, if new mortgages guaranteed under an FHA expansion do not include an adequate financial cushion for the FHA. In my judgment, the cushion built into current legislative proposals—involving a combination of principal writedowns, premiums, and recovery of a portion of any house-price appreciation—is sufficient to limit this risk.

Q.4. Should we be encouraging or subsidizing someone staying in a house if they would be financially better off if they were renting?

A.4. People who would be better off renting than owning are likely to give up homeownership even under the proposed FHA expansion. As I mentioned in my testimony, it makes sense to appropriate additional funding for counseling as quickly as counseling organizations can build their capacity and use the funds effectively. One function that counselors can serve is to help people make informed decisions about whether to be homeowners.

Q.5. Should we require financial sacrifices for participation in this program, such as selling vacation homes or investment properties, selling second vehicles, getting a second job, not taking on other debts, or selling non-retirement account investments?

A.5. Again, I see tradeoffs between designing one's ideal program in terms of screening criteria or lending terms and designing a program that can be implemented quickly and administered efficiently. In my judgment, including these various penalties as a cost of borrowing would make the program too cumbersome to operate effectively.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PIMCO

840 Newport Center Drive
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April 9, 2008

The Honorable Senator Christopher J. Dodd
Chairman, United States Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Dodd:

At the epicenter of today's market turmoil is a domestic deflationary spiral in the American property market which has yet to find bottom. Housing, the most financially significant asset to the American household, is undergoing a disorderly decline. Should home prices follow their current path and sink lower still, the impact on the American economy will likely be severe.

Left unchecked, the current scenario includes the continuation of the mortgage market debacle, with millions of displaced homeowners, and unprecedented housing price declines leading to losses of consumer wealth, confidence and therefore spending. Ultimately this will lead to a weakening in corporate profits and hiring, already being reflected in first quarter results, with the specter of further employment declines ahead.

There are no perfect solutions to the country's current circumstances. We realize many find the idea of government support of home prices extraordinary and we share the view that only under the most ominous of horizons should fiscal interventions be encouraged. Given, however, the exceptional point at which we now find ourselves in this downward deflationary spiral, incremental steps relying on traditional policy tools are not enough. Disorderly markets now threaten Main Street with a housing recession which may yet prove capable of yielding to a housing depression. Adherence to orthodoxy is unlikely to prove sufficient in encouraging markets to clear. Indeed, the point of no return for "clearing" markets may already be behind us.

This is because home price declines of 20 percent are in fact much more of a shock to the American economy than the collapse of the Internet bubble and NASDAQ 5000, as the amount of homeowner leverage is so much greater. A 20 percent negative adjustment to home prices not only wipes out all ownership equity for millions of Americans, it turns their houses "upside down" – thus reducing the incentive and the ability for many to maintain their current property.

We believe policymakers must act quickly and with resolve, aiming their solution directly at the problem's heart: housing prices. Establishing a floor under property prices

P I M C O

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is critical to helping the homeowner out of his current dire condition. Were the government to aid households judged deserving in making sustainable the amount of mortgage principal owed, it would restore some degree of equity to the American homeowner, thus reassuring them with newly returned affordability and reducing the incentive to leave the keys behind. It also would provide lenders with a higher market value on their mortgage asset than they could achieve through foreclosure and sale into a strained housing market with limited capacity.

Unable to see the current spiral's bottom, investors will lack the confidence needed to come back to the market. With Washington and the public balance sheet acting in support of housing prices; however, investors such as PIMCO with pools of capital ready to deploy will return swiftly, buoyed by a sense that a floor may, indeed, be near.

Undoubtedly there will be negative externalities. The current situation ought never to have been reached, as PIMCO has written at length. However, now that we are here, the government should act with speed and purpose to help housing to stabilize, homeowners to afford their property, and the market to regain its confidence.

Sincerely,

William H. Gross
Co-Chief Investment Officer
Managing Director

Mohamed A. El-Erian
Co-Chief Investment Officer
Managing Director