EXAMINING THE MAKING HOME AFFORDABLE PROGRAM

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

MARCH 19, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–16

U.S. GOVERNMENT PRINTING OFFICE

48–869 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan
DAN MAFFEI, New York

SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

MAXINE WATERS, California, *Chairwoman*

NYDIA M. VELÁZQUEZ, New York	SHELLEY MOORE CAPITO, West Virginia
STEPHEN F. LYNCH, Massachusetts	THADDEUS G. McCOTTER, Michigan
EMANUEL CLEAVER, Missouri	JUDY BIGGERT, Illinois
AL GREEN, Texas	GARY G. MILLER, California
WM. LACY CLAY, Missouri	RANDY NEUGEBAUER, Texas
KEITH ELLISON, Minnesota	WALTER B. JONES, JR., North Carolina
JOE DONNELLY, Indiana	ADAM PUTNAM, Florida
MICHAEL E. CAPUANO, Massachusetts	KENNY MARCHANT, Texas
PAUL E. KANJORSKI, Pennsylvania	LYNN JENKINS, Kansas
LUIS V. GUTIERREZ, Illinois	CHRISTOPHER LEE, New York
STEVE DRIEHAUS, Ohio	
MARY JO KILROY, Ohio	
JIM HIMES, Connecticut	
DAN MAFFEI, New York	

CONTENTS

EXAMINING THE MAKING HOME AFFORDABLE PROGRAM

Thursday, March 19, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING AND
COMMUNITY OPPORTUNITY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room 2128, Rayburn House Office Building, Hon. Maxine Waters [chairwoman of the subcommittee] presiding.

Members present: Representatives Waters, Lynch, Cleaver, Green, Clay, Ellison, Driehaus; Capito and Lee.

Chairwoman WATERS. This hearing of the Subcommittee on Housing and Community Opportunity will come to order. Good morning, ladies and gentlemen.

I'd like to thank the ranking member and other members of the Subcommittee on Housing and Community Opportunity for joining me today for this hearing on examining the Making Home Affordable Program.

Today's hearing will examine the White House's plan to prevent foreclosures and keep families in their homes through the modification and refinancing of troubled mortgages. I have identified foreclosure prevention and loan modifications as a priority for subcommittee oversight.

In February, we held a hearing on mortgage servicers and challenges to providing more effective loan modifications for troubled mortgages. Today, we will hear from government agencies and experts in the field to gain a better understanding and assessment of the President's plan and how it will assist troubled homeowners.

As we will hear today, a systematic, or systemic loan modification program is necessary to streamline foreclosure mitigation efforts.

Since day one, I have been a supporter of enacting a systematic modification program. On the first day of the 111th Congress, I introduced H.R. 37, the Systematic Foreclosure Prevention and Mortgage Modification Act of 2009, to put such a plan in action. The President's plan builds upon my legislation.

In addition to learning about the President's foreclosure prevention plan, I hope that this hearing will also provide members with an in-depth analysis of the types of loan modifications that have been effective in preventing foreclosures and re-defaults. I believe this information will assist us in understanding the role of the President's plan in fixing the housing crisis.

Loan modifications—that is, changing the terms of the loan—are essential to ending the foreclosure crisis. According to RealtyTrac, in 2008, 2.3 million households were in some stage of the foreclosure process, an 81 percent increase from 2007, and a 225 percent increase from 2006.

The foreclosure crisis shows no signs of slowing down, with Credit Suisse estimating that 8.1 million homes will enter foreclosure over the next 4 years.

The President has recognized the urgency of the foreclosure crisis with the release of the Making Home Affordable Program.

I'm interested to hear how the plan will provide fast and effective relief to troubled homeowners and begin the process of stabilizing the housing markets. The government witnesses today will discuss their collaboration to implement the President's plan.

We will also hear about the obstacles that are preventing borrowers from staying in their homes. According to a study by First American Core Logic, there are a growing number of underwater loans, loans where the mortgaged property is worth less than the amount owed on the loan.

As of December 31, 2008, more than 8.3 million U.S. mortgages, or 20 percent of all mortgaged properties, were underwater. Another 2.2 million are approaching that point.

The witnesses today will shed light on the types of loan modifications that may work best for these types of troubled homeowners.

In closing, I would like to comment on the urgent need for foreclosure assistance, and I'm pleased that the President and his Administration have taken some action to deal with this crisis.

Millions of families are struggling with their mortgages and millions more are at risk of losing their homes. Saving the housing markets and keeping families in their homes will require serious effort from all key players: Congress; the Administration; banks; mortgage servicers; and borrowers must work together to implement a plan to stop the rising tide of foreclosures and keep millions of families in their homes.

I am looking forward to hearing from our two panels of witnesses on the implementation and impact of the Making Home Affordable Program.

I would now like to recognize our subcommittee's ranking member to make an opening statement.

Ms. Capito.

Mrs. CAPITO. I'd like to thank the chairwoman for holding this hearing this morning.

As we know, many Americans are struggling to meet their financial obligations these days. What began as difficulties in the subprime mortgage market has evolved into a situation where many homeowners owe more on their mortgage than their home is worth. Foreclosures are rising and recent job losses will most likely exacerbate this problem.

There have been several attempts to address the rising foreclosures over the last 18 months. The HOPE NOW Alliance, the FHASecure Program, and the HOPE for Homeowners Program have been rolled out nationally by both the private sector and the Federal Government.

Some programs have been more effective than others. I'm cautiously optimistic about the proposal before us today. I do have concerns that the Treasury Secretary has announced that the President's Homeowner Affordability and Stability Plan could help up to 9 million homeowners.

We have heard estimates before, with some of the aforementioned programs, and unfortunately, these programs have not even come close to helping the estimated numbers of families.

We must identify who we are attempting to help, and also identify who we do not want to hurt.

We should help those who are truly in need of assistance, but at the same time, we should not harm responsible business owners, business borrowers. It is simply unfair to punish those who have acted responsibly and tightened their budgets to meet their financial responsibilities. We cannot forget that nearly 90 percent of homeowners are paying their mortgages on time.

I'm also concerned about the oversight and accountability of this program. I think this is the theme of not just today, the week, the month, the year, and probably the decade, which is more oversight and more accountability when large programs or large commitments of Federal dollars are made.

This program is set to go into effect within the coming weeks. There is uncertainty, and I hope to learn about that today, about the ability of the Treasury and other agencies to provide proper oversight.

Congress needs to know, up front, if more manpower or technology upgrades are needed so that modifications and refinances can be performed for those who merit assistance while ensuring that the taxpayers' dollars are being used in a prudent manner.

I look forward to hearing from our witnesses today and I thank the chairwoman for holding this hearing.

Chairwoman WATERS. Thank you very much.

I will now recognize Mr. Lynch for 2 minutes.

Mr. LYNCH. Thank you, Madam Chairwoman.

And I want to thank the panelists on both panels for their willingness to come before the committee and help us with our work.

Over the past year-and-a-half, we've seen a housing market that has played a central role in the economic crisis, causing great losses in our financial markets, but also a severe human toll in our communities as more and more Americans struggle to stay in their homes.

The Obama Administration, to our great appreciation, announced last month a new initiative designed to provide targeted assistance to homeowners who are having difficulty making their mortgage payments.

The Making Home Affordable Program is focused, as you all know, on reaching homeowners who thus far have not qualified for a break under any other assistance program, and the key to the success of this program is, importantly, the incentivization of the program for lenders who were lacking encouragement in the past and the previous Administration at foreclosure mitigation.

But with this program, participating lenders and borrowers will receive financial incentives if the mortgage holder stays in the home for up to 5 years, 5 consecutive years, and payments remain current.

Madam Chairwoman, we all know what kind of devastating effect foreclosure can have on families, communities, and the larger housing market, and I think it energizes us all to work together, both lenders and borrowers, to ensure that working families can stay in their homes.

I look forward to exploring this topic throughout this hearing, and I am waiting with great anticipation on the testimony of our witnesses.

So, Madam Chairwoman, I yield back.

Chairwoman WATERS. The gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Madam Chairwoman, Ranking Member Capito. I appreciate the opportunity.

Just a brief comment, since I'm more interested in our guests. I do think that it is imperative that we do, I think what the Supreme Court said in 1954 in the Topeka decision, that we need to move with all deliberate speed to try to do at least two things: first, make housing more affordable; and second, stop the spiral in the housing markets. I don't think that it is too ambitious at all to try to save a large number of Americans who are on the verge of losing their homes.

We have approximately 54 million mortgages in the United States. Fourteen million of them are in trouble, 27 percent, and in those cases, we have properties where the house is worth less than the mortgage, and so it creates some unique problems, and I'm very much interested in probing this issue to find out if we actually have the infrastructure in place to even do the refinancing, to handle all of the millions of people who will be coming to us.

I appreciate both panels coming, and I look forward to a vigorous exchange.

Thank you, Madam Chairwoman. I yield back the balance of my time.

Chairwoman WATERS. Thank you very much.

The gentleman from Texas, Mr. Green, for 2 minutes.

Mr. GREEN. Thank you, Madam Chairwoman, and I thank the ranking member, as well.

Madam Chairwoman, I want to extend a special thank you to you, because you have been a part of the avant garde on these issues.

You were quick to identify the servicers as a concern, and not only did you identify the concerns, you took immediate action to try to find solutions to what has proven to be a most enigmatic problem.

You held hearings, one in my home district, in Houston, Texas, the Ninth Congressional District, and I thank you for coming there.

You had a hearing in St. Louis. I was honored to be at that hearing with you. And you held hearings in your district in California.

At all of these hearings, you brought in witnesses who gave us intelligence that has helped us literally, in my opinion, to get to the point where we are today.

So I believe that it is most appropriate that I extend this debt of gratitude to you for being a part of the avant garde on these issues.

I'd also like to thank President Obama. I think that he has made a bold, aggressive move. He has made this an issue of great concern. It has become a priority issue, because he has identified it as such. And I'm of the opinion that this program, while it may not be a panacea, it may not be the silver bullet, I do believe that it will help a good number of persons who are in danger of losing their homes.

My intelligence indicates to me that the percentage of performing mortgages has decreased from 93.33 percent in the first quarter to 91.47 percent in the third quarter. This is a trend that we must reverse. We have about 8.3 million U.S. mortgages, or 20 percent of all properties, that are in need of some sort of modification, it seems.

And this program has two important elements. It has a "refi," refinance aspect to it; and it also has a restructuring. Refinancing can be great and can benefit a certain class of people, but you have another class of people who will need some restructuring, interest rates reduced, some means by which they can have a payment that they can afford.

Madam Chairwoman, I think that this is a hearing that is most timely, and I thank you for all that you've done in this area.

I yield back the balance of my time.

Chairwoman WATERS. Mr. Driehaus, would you like to have a couple of minutes to do an opening statement, also?

Mr. DRIEHAUS. Yes, Madam Chairwoman.

Chairwoman WATERS. You're recognized for 2 minutes.

Mr. DRIEHAUS. Thank you, Madam Chairwoman, and thank you so much for calling this hearing today. I, too, want to applaud your leadership on this issue.

My only regret is that we're having this hearing in 2009, and it's several years too late for many of the communities we represent, and many of the households that have already experienced the tragedy of foreclosure.

I think the President's initiative is an important one. I look forward to the testimony of the witnesses describing in detail how they envision the program to work, but I would challenge them to think about how we get the information to the homeowners, because while we can put great plans in place, it is critically important that people take advantage of the plans.

Many of the people we're talking about have been inundated with offers to restructure their debt, have been inundated with offers to remodify their loans from one entity or another. And so I think one of the greatest challenges that we will face as we move forward with the President's plan is being able to market the plan, and making sure that people are taking advantage of it, because as you know, people are very reluctant when they're facing foreclosure, when they're falling behind on their payments, to step forward and approach their lenders and approach the servicers, and suggest that they want to modify that loan.

So I hope, Madam Chairwoman, that as we move forward, we gain some greater clarity as to how this program will be marketed and how we intend to get to the type of numbers that we envision in terms of helping people prevent foreclosure as we move down the road.

And with that, I yield back the balance of my time. Thank you.

Chairwoman WATERS. Thank you.

There are no more opening statements. I will move to welcome our distinguished first panel.

Our first witness will be Mr. Vance Morris, Director of Single Family Asset Management, U.S. Department of Housing and Urban Development. Welcome.

Our second witness will be Mr. Patrick Lawler, Chief Economist, Federal Housing Finance Agency.

I thank you for appearing before our subcommittee today, and without objection, your written statements will be made a part of the record.

You will now be recognized for a 5-minute summary of your testimony.

We'll begin with Mr. Morris.

STATEMENT OF VANCE T. MORRIS, DIRECTOR, OFFICE OF SINGLE FAMILY ASSET MANAGEMENT, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. MORRIS. Chairwoman Waters, Ranking Member Capito, and members of the committee, thank you for the opportunity to appear before you today.

Many homeowners and communities throughout the country have been severely hurt by the current economic crisis. This includes many responsible families who are making their mortgage payments, but have experienced falling home values that disqualify them from opportunities to refinance with today's low interest rates.

Millions of American workers have been laid off or forced to accept lower-paying jobs, and are significantly challenged to produce income to make their mortgage payment.

Now is the time to act. The President has proposed a comprehensive strategy to rebuild the housing market and revive the economy. This will enable many of these homeowners to have a fighting chance to stave off foreclosure and keep the American dream of homeownership.

The Making Home Affordable Program is targeted to reach as many as 7- to 9 million homeowners who are at risk of foreclosure and are struggling to stay in their homes. While this program supports the recovering housing market, it will not provide money to speculators.

The program helps responsible homeowners at risk of losing their homes and helps to stabilize neighborhoods by slowing the rate of foreclosure that fuels falling home values.

The Making Home Affordable Program has two components: the Home Affordable Refinance Program; and the $75 billion Home Affordable Modification Program announced by the Department of Treasury on March 4, 2009.

The Home Affordable Refinance Program is expected to help 4- to 5 million borrowers who have an existing mortgage held by Fannie Mae or Freddie Mac.

This initiative is designed for borrowers who have a solid payment history but have been unable to refinance to a lower payment due to the decline in the value of their homes, which pushed their current loan to values above 80 percent. This initiative expands the maximum loan to value ratio for refinanced loans owned by Fannie Mae and Freddie Mac from 80 percent to 105 percent.

The other component is the Home Affordable Modification Program, which provides an opportunity to modify existing loans to an affordable and stable monthly payment. The Home Affordable Modification Program is expected to help 3- to 4 million at-risk borrowers in all segments of the mortgage market avoid foreclosure, by having the government partner with lenders to reduce the homeowner's monthly payment to an affordable level.

The modification program offers a number of incentives to both families and servicers to avoid foreclosure and minimize the damage that foreclosure imposes on financial institutions, borrowers, and the community. The program aims to protect taxpayers through sound loan modifications.

No incentive payments will be made unless the borrower completes a 3-month trial period, and most payments of incentives are tied around the concept of "pay for success."

FHA, the Veterans Administration, and the United States Department of Agriculture are working to implement practices that allow for comparable programs that will also work in tandem with the expanded and improved HOPE for Homeowners Program.

As part of the American Recovery and Reinvestment Act, the Department of Housing and Urban Development will also award $2 billion in competitive Neighborhood Stabilization Program grants for innovative programs to mitigate the impact of foreclosure by supporting new strategies to address the problem of vacant properties.

The Department of Housing also looks forward to helping millions of homeowners to stay in FHA-insured mortgages.

Through the new and expanded authorities included in the Helping Families Save Their Homes Act of 2009, H.R. 1106, FHA will be able to more effectively modify FHA loans.

Finally, I am pleased today to announce some very good news. The Departments of Treasury and Housing and Urban Development have launched a new Web site to help borrowers determine their eligibility under the Making Home Affordable Program. This Web site will enable them to look up their loans, to find out what servicers they're with, to find out what options they have, to see if they qualify.

The Web site is www.makinghomeaffordable.gov, and it's active now.

Thank you very much, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Morris can be found on page 126 of the appendix.]

Chairwoman WATERS. Thank you very much.

Mr. Lawler.

STATEMENT OF PATRICK J. LAWLER, CHIEF ECONOMIST, FEDERAL HOUSING FINANCE AGENCY

Mr. LAWLER. Thank you, Chairwoman Waters, Ranking Member Capito, and members of the committee. Thank you for the opportunity to testify before this committee on the Making Home Affordable plan.

My name is Patrick Lawler. I'm the chief economist of the Federal Housing Finance Agency.

FHFA, and the housing GSEs, are actively working on foreclosure prevention to help homeowners in trouble through Making Home Affordable. This plan is a critical component of the President's program to restore financial stability. It will help millions of American homeowners refinance or modify their mortgages so that they will have more affordable mortgage payments.

There are two principal initiatives in Making Home Affordable. One is the Home Affordable Refinance Program. Fannie Mae and Freddie Mac will provide access to low-cost refinancing for loans they own or guarantee. It is designed for borrowers who are current in their payments and seek a lower rate or a safer mortgage, but who have experienced difficulties due to declining home values and limited availability of mortgage insurance.

The other major initiative is the modification plan, a $75 billion program that will establish a national standard for loan modifications.

Before going further, let me stress that a lot of work remains to implement these programs, so my testimony today is a status report. There will be further details and information rolled out to servicers and to the public in the days and weeks ahead.

During the last 2 months, FHFA has been working with Treasury and HUD and the other agencies to develop the details of the Making Home Affordable Program. Drawing on the loan modification experience of Fannie Mae and Freddie Mac, we have provided experience and information to structure the new affordability plan to make it as effective as possible.

The new loan modification plan is more aggressive than previous programs designed to lower borrowers' mortgage payments to no more than 38 percent of their income. The Making Home Affordable Program lowers the debt to income ratio to 31 percent, with the government paying half the cost between 38 and 31 percent.

It is critically important to get to troubled borrowers as soon as possible before they are significantly behind on their payments. The Home Affordable Modification plan goes farther than previous programs and includes homeowners who are facing reasonably foreseeable or imminent default, but are still current on their mortgages.

Both Fannie Mae and Freddie Mac will participate in the Home Affordable Modification Program, both for the loans that they own or guarantee, and as administrators on behalf of the Treasury Department for all other loan modifications under this program.

In addition, Fannie Mae and Freddie Mac are implementing the Home Affordable Refinance Program, which includes refinancing flexibilities for homeowners whose loans are owned by each of the enterprises.

As an administrator of the modification program, Fannie Mae's guidance to seller/servicers addresses not only loans owned by Fannie Mae and Freddie Mac but also those owned by investors in private label securities. Many of these securities have pooling arrangements that require that servicers can modify loans only if they follow industry standards. Fannie Mae's guidance will establish the new industry standards.

This overcomes a major obstacle to loan modification, and will contribute, along with cash incentives, to increased efforts by servicers to modify loans instead of foreclosing on homes.

Each enterprise has other key roles in the implementation of this program. Fannie Mae also has a paying agent role to provide the incentive payments to servicers who have modified loans.

Incentives for modifications on loans that Fannie Mae and Freddie Mac already own will be paid out of their funds, while incentive payments on loans owned by other investors will be paid with TARP funds.

In addition, Fannie Mae will be required to maintain data and report on how many loans are refinanced or modified, as well as relevant statistics about those loans.

Freddie Mac has an important audit and compliance role with the modification program. It will take a lead role in reviewing servicers' compliance with the program guidelines and ensuring that non-compliance is reported and handled properly. This job includes required reporting, documentation, and onsite visits to the servicers.

Both enterprises are hiring or transferring the necessary staff to conduct their respective roles in the program, and both enterprises are developing appropriate systems, confidentiality standards, and firewalls to ensure that this program has the highest integrity.

FHFA is confident that both Fannie Mae and Freddie Mac have fully embraced their roles and are on track in developing the necessary infrastructure.

As the enterprises' regulator, we will oversee the implementation of this plan and monitor its results. Our examination staff will focus on the data used and created by the program, anti-fraud efforts, servicer registration, human resources, system development, and Freddie Mac's compliance function, and internal controls over Fannie Mae's paying agent role.

A great deal of information is available at financialstability.gov or, as Mr. Morris has pointed out, the new Web site, makinghomeaffordable.gov. At these Web sites, homeowners can learn more details about the plan and the options.

If they are current on their mortgage payments, they can learn if Fannie Mae or Freddie Mac owns their loan, and the steps to apply for the refinance program.

If they are behind on their mortgages or in imminent danger of falling behind, they can identify who to contact and what information they need to apply for the modification program.

There is also a self-assessment tool for homeowners to determine if they are eligible.

Homeowners with questions or uncertainty about their situation should call 1–888–995–HOPE, the HOPE NOW hotline, to reach a free HUD-approved housing counselor.

I'll be happy to answer questions.

[The prepared statement of Mr. Lawler can be found on page 119 of the appendix.]

Chairwoman WATERS. Thank you very much.

Let me begin by asking questions about whose responsibility it is to deal with some of the scams that are developing on loan modifications. There are several things going on.

One is, for example, there is something called the Federal Home Loan Modification Program that advertises extensively on television, and others that are popping up, that charge money. They sound as if they're government, and the one that I had a long conversation with asked for $3,500.

And I'm worried that in this era where we're trying to teach people to reach out to get their loans modified, that some people are going to think this is part of the plan.

Secondly, another effort is being made to sell mortgage protection insurance. The mailboxes are just being flooded with this material.

I have not investigated these plans, and I don't know if they really pay off, or what kind of monies they are charging for it, but it now appears to be an aggressive campaign.

Whose responsibility is it to look at these efforts and move on them to do something about it?

Mr. MORRIS. Madam Chairwoman, it is an ongoing shared responsibility to, when we become aware of these agencies or entities, we work with our Office of Inspector General, we work with the U.S. Attorney, we take them very seriously.

The investigation that we do, we usually have people evaluate the Web sites. We immediately contact the firms. And we also make a referral to the IG and also work with the U.S. Attorney's Office.

It's very challenging, because there's money to be made there, so in addition to our enforcement and compliance issue, we have a comprehensive outreach campaign in both Spanish and English. We have over 2,700 housing counselors that we're working with. We're developing a national public awareness campaign. And we're also doing public service announcements. So the—

Chairwoman WATERS. Let me just ask, are you aware of the Federal Loan Modification Program?

Mr. MORRIS. I have seen that commercial myself.

Chairwoman WATERS. What have you done about it?

Mr. MORRIS. I'm not the enforcement—

Chairwoman WATERS. That's what I was asking. Who is responsible for looking into those kinds of things?

Mr. MORRIS. What generally is done, we have a couple of entities, we have an enforcement center within HUD, we have our Office of Inspector General, and they also coordinate with the U.S. Attorney's Office.

Chairwoman WATERS. Is anybody looking into these loan modification programs that charge money and practically guarantee people that they can get their loan modified, and they take the money up front?

And of course, as you know, if you've been involved in loan modifications, you may or may not be able to get a loan modified, based on a number of possibilities.

One, right now, servicers cannot modify loans where they have in the contract with the investor that they will not modify their loan when they invest their money.

Secondly, the person calling may have no income stream, and you can't do anything for them. So when they hold out that, "Just call us, we can guarantee, we can get one," it's misleading.

But I guess what I'm asking is, is there anything that you know about that's being done now to look at these products and these services that are being put out there so that we can do something and not go down the road that we've gone down with all of the exotic products that were offered by the loan initiators that kind of got us into this trouble; what's being done and what should we do?

Mr. MORRIS. Well, the best answer I can give you is that I will follow up with HUD officials and find out exactly how we coordinate with the Federal Trade Commission and the U.S. Attorney's Office, because candidly, I'm not the enforcement side of the office, I'm the marketing, origination, servicing side, and you're asking enforcement questions.

Chairwoman WATERS. That's why I asked whose responsibility—

Mr. MORRIS. Right. I was saying I would follow up—

Chairwoman WATERS. We will follow up. If it's not your responsibility, we'll get to the right agency with the information, but I think that you should be aware of what's going on, and you should be feeding information to the right enforcement agencies, also. You can't just sit back and watch it happening and not do anything about it. I think it's going to get us all into a lot of trouble.

And let me just ask you, while I'm talking, what do we do about seniors and others who are not computer literate, don't look at Web sites, looking for help? How do we help them get to their servicer?

Mr. MORRIS. That's the reason why we're working with various groups. We're working with the HUD-approved counseling agencies that do face to face counseling and do outreach in the communities. All of these are local groups.

We also work with the local governments, and also local HUD housing offices, as well.

Chairwoman WATERS. Thank you. My time is up. I'll have to call on Ms. Capito now. Thank you.

Mr. LAWLER. Madam Chairwoman, if I might, the phone number I gave at the end of my testimony is something someone without a computer can use to get to HOPE NOW and get access to a HUD-approved counselor.

Chairwoman WATERS. Have you ever called HOPE NOW?

Mr. LAWLER. I have not personally.

Chairwoman WATERS. Okay. I have many times. We'll talk about that later.

Ms. Capito.

Mrs. CAPITO. Thank you.

Mr. Morris, a simple question. On the Web site makinghomeaffordable.gov, can anybody input their data in there, and you have every mortgage in America to find out who the—if it's a Fannie or Freddie? Is that how we determine that? Is that what you're telling me?

Mr. MORRIS. The Web site, and Mr. Lawler probably can speak more extensively, I was on the Web site, tested it yesterday, and

I was using it this morning. It has a couple components that an individual can use to look up Fannie and Freddie loans, and what it does is, if you are non-Fannie or Freddie, it directs you to where you can get the information on how to contact your servicer, like it will direct you to the HOPE NOW network. And so it gives you information on how to obtain the information.

Mrs. CAPITO. But it can actually tell any individual whether they have a Fannie or Freddie?

Mr. MORRIS. It has a look-up link for both Fannie and Freddie, if it's a Fannie—

Mrs. CAPITO. And you just input your name? Is that how it works?

Mr. LAWLER. You need your address, as well. And you can also do this on Fannie and Freddie's Web sites themselves. But that's two separate Web sites. This is one Web site where you can do the whole thing.

Mrs. CAPITO. Right. Okay. Because I think that is confusing to a lot of people.

My constituents that I've talked to, the first thing I asked them when I read about this program is, "Do you have a Fannie or Freddie loan," and they have no idea. And they don't even know who Fannie or Freddie are. They think they might.

And so I think that's a real issue for people who are holding mortgages.

Mr. Lawler, you mentioned that you were going to do $75 billion worth of loan—there's going to be $75 billion worth of loan modifications and you're going to have a Federal standard.

I believe we had a lot of the large private entities in here who were saying that we have no standard for a loan modification.

Is this going to address that issue, and how is that going to roll out?

Mr. LAWLER. That's what we're trying to do, and the outline of the plan has already been pretty clearly stated on our March 4th announcements. There will be some further details coming forth. There have been lots of meetings with the various servicers. We will have a very clear set of standards—

Mrs. CAPITO. Well, give me some examples, like what?

Mr. LAWLER. We—

Mrs. CAPITO. Like your loan to value, or you've lost a job, or your income—

Mr. LAWLER. The debt to income ratio, for example, is it greater than 31 percent. If it is, can we reduce the interest rate first? Can we go down as low as 2 percent? Will that solve the problem? If that doesn't solve the problem, can we lengthen the time of mortgage? And so forth.

But you have to be able to show documents that show you will be able to make the payments of the modified loan.

Mrs. CAPITO. Where is the infrastructure going to be to—this is complicated, these are complicated matters for the individuals who are the homeowners, and for a lot of other people, as well.

Do you have the infrastructure in both of your agencies to begin to deal with all of this? I mean, if you're talking 9 million families, that's a lot of long conversations.

Mr. LAWLER. This is a very major project. It involves not only Fannie Mae and Freddie Mac and government agencies like FHFA and HUD and Treasury and so forth, quite a few more agencies, as well, also the servicers, to be able to develop their own infrastructures to process all of these loans.

Mrs. CAPITO. So basically, no, you don't have it right now?

Mr. LAWLER. No, but we have developed the structure for it, and the organization. Fannie and Freddie have developed, with the help of a lot of other agencies, the basic tools that the servicers need.

Mr. MORRIS. Can I—

Mrs. CAPITO. Yes.

Mr. MORRIS. I can also clarify the question.

There are two components. One is, do we have the infrastructure to oversee—

Mrs. CAPITO. And that was going to be—

Mr. MORRIS. —and that's what FHA or Fannie will do. And—

Mrs. CAPITO. But who is the over-arching person who is going to watch what this money is doing and where it's going?

Mr. MORRIS. For Fannie, that will be Fannie, and for FHA-insured mortgages, it will be FHA, for VA-insured mortgages.

But then, you're asking the capacity to actually do the loan modification?

Mrs. CAPITO. Right.

Mr. MORRIS. That is the servicers. So we're constantly checking with the servicers to ensure that they have sufficient capacity.

Currently, now in FHA, we have about 4.7 insured mortgages, and we do about 100,000 modification and loss mitigation actions per year, so—

Mrs. CAPITO. How many a year?

Mr. MORRIS. We do about 100,000 per year with our current authority, and we're trying to get expanded authority.

But we're confident, because it's the same servicers that are doing the loan modifications, so the servicers are already existing. We're not creating new—but of course, there have been more demands put on the servicers.

Mrs. CAPITO. Okay, then, let me fast forward—

Mr. LAWLER. Freddie Mac will be overseeing the compliance of the servicers with all the rules, and they in turn will be—

Mrs. CAPITO. And do they have the capacity to do this right now?

Mr. LAWLER. They are well on the way to having it developed. They have isolated resources, the people, and the organizations to be able to do this.

We will be reviewing them, our IG, Treasury, all of the TARP oversight apparatus. So there's quite a number of layers of oversight here.

Mrs. CAPITO. Well, then, that kind of concerns me, as well, because then in a year from now, say we're sitting here in the same hearing, and you're coming back and giving us a status report, you know, you've now mentioned probably seven or eight different entities that, you know, a lot of this is going to be spread over.

Is there going to be an effort, then, to gather information in one central repository so when I ask you, how many people have been helped—

Mr. LAWLER. Yes.

Mrs. CAPITO. —to what extent—

Mr. LAWLER. Yes.

Mrs. CAPITO. —how are they doing, what—

Mr. LAWLER. It's Fannie Mae's job to get that information from the servicers. It's Freddie Mac's job to review and see that those loans have been handled in compliance with all the rules that have been set out.

Mrs. CAPITO. Thank you.

Chairwoman WATERS. Thank you. Mr. Lynch.

Mr. LYNCH. Thank you, Madam Chairwoman.

Mr. Lawler, in your testimony, you mentioned, I understand we're doing whole loans and then we're also doing private label securitized mortgages.

Mr. LAWLER. The loans that back those private label securities are a focus of the loan modification program.

Mr. LYNCH. Right. And that was a real problem in the first iteration of this. We were getting pushed back from the servicers, because in some cases, it actually incentivized foreclosure rather than modification.

How are we handling that right now? Do we have enough data? I know you said, you know, some of the stuff you're still compiling data on.

How is that going with the pooling arrangements, or the securitized mortgages? What is our experience in terms of getting those modified, and what are the incentives that we're introducing to overcome that earlier barrier?

Mr. LAWLER. We can't, with this program, actually modify the terms of the pooling agreements.

What we can do is establish industry standards by making them applicable to everybody who participates in this program, which will be virtually the entire industry, that will establish what kinds of loans should be modified, and it would be a much more aggressive modification plan than has been viewed as industry standards before, and that will enable many of these servicers of the loans behind private label securities to take action when they felt they couldn't before.

Mr. LYNCH. So, Mr. Morris, do you want to add to that?

Mr. MORRIS. Yes. Reading the plan, one of the key components that differentiates them from the government loan is that they have a net present value test, and so this net present value test is an objective tool that shows the investor that it's in the investor's best interest to accept a modification as opposed to a foreclosure.

Mr. LYNCH. Right.

Mr. MORRIS. And so that was the tool that was incorporated into their infrastructure, as well.

Mr. LYNCH. Reading between the lines here, you're trying to give cover to the servicers so they don't get sued?

Mr. LAWLER. That's definitely an important consideration. That's something that was holding servicers back. This is—

Mr. LYNCH. You're saying, if we give you the stamp of approval on these standards, these industry standards, and you use these industry standards, it will somehow immunize you from being sued by—

Mr. LAWLER. Not completely. It will address important problems in the servicing, the pooling agreements.

Mr. LYNCH. Yes.

Mr. LAWLER. It won't solve all the problems.

Mr. LYNCH. Yes. That's—well, that is a problem. That is a problem.

Have you done any of these yet?

Mr. LAWLER. The program has just gotten underway. We hope to have all of the documentation and infrastructure finished in the next very few weeks.

Mr. LYNCH. Okay. So the standards aren't in place yet?

Mr. LAWLER. The standards are generally in place. There are some servicers that are already working with borrowers. But it will take a while to have everything operational fully.

Mr. LYNCH. Yes.

Mr. LAWLER. And it takes 3 months of demonstrated performance by the borrowers before the loan is actually modified.

Mr. LYNCH. Yes, I'm not—

Mr. MORRIS. I talked to our senior officials, who work with Treasury and HUD, and all the major servicers have told us they are on board with the program.

The next thing that they're waiting for is that there's a contract that has to be signed between the servicer and the Treasury. The contracts aren't completed, but will be completed shortly.

So all the—most of the major servicers are on board. They're waiting to get an executed contract. But, as Mr. Lawler also mentioned, this is our pay for success component.

There will be a lag time anyway, because we have to have three successful payments before the modification is actually executed, so—because we don't want modifications that would re-default.

Mr. LYNCH. Right.

Mr. MORRIS. We want modifications that are effective. So that's where we—

Mr. LYNCH. To even get that far, you know—I'm running out of time—but this whole framework, I just have some skepticism, given the way these CDOs and these pooling arrangements are made, and the incentive for those in the top tranche to protect themselves with the lower equity and mezzanine tranches. It's just a thorny issue.

But rather than get into it further, maybe I could submit something in writing, and we can go back and forth, rather than use up the committee's time.

Thank you. Thank you, Madam Chairwoman.

Chairwoman WATERS. Mr. Lee.

Mr. LEE. Thank you.

Just a few questions, and I appreciate you coming today to help educate us about this, what I think is a very important issue.

I want to talk more about capacity and metrics. And either one of you can jump in on this question.

But in your mind, are servicers and lenders truly prepared to handle homeowner inquiries about who is eligible for the Administration's Homeowner Affordability and Stability Plan?

And then secondarily, what capacity do these servicers and lenders have to handle the expected nearly 3- to 4 million loan modifications that the Administration plan envisions and the 4- to 5 million GSE refinancings?

Mr. LAWLER. That is going to vary from servicer to servicer.

One of the things we have tried to do on determining who is eligible, as both of us have discussed before, is create the Web sites that borrowers can go to to establish some of the basic facts and document needs, and then they need to talk to their servicers, and obviously, servicers have had now several months to prepare for this, at least since early in January, in anticipation.

Mr. LEE. So you think they're adequately prepared to handle this?

Mr. LAWLER. Well, I believe that many of them are still in the process of getting more prepared, so I wouldn't say that everybody is there yet. I think it will take more work.

Mr. LEE. One other question: Do you believe homeowners who have put nothing down, or withdraw all their equity, would be eligible for refinancing?

Mr. LAWLER. For refinancing?

Mr. LEE. Yes.

Mr. LAWLER. If it is a Fannie or Freddie loan, then they, even if declines in the value of the property have absorbed most of their down payment, as long as their current mark to market loan-to-value ratio is not greater than 105 percent—

Mr. LEE. But they put nothing down. Are they—

Mr. LAWLER. Well, Fannie and Freddie didn't really have zero down payment loans. Their limit was generally 97 percent. But a 3 percent down payment that can get easily eaten up with declines in house prices.

Mr. MORRIS. Just to answer your question, Congressman Lee, as Mr. Lawler said, the Fannie/Freddie was an 80 percent loan to value. That product refinances someone who had a decline in home value. So they had the equity position in some measure before in their home.

If a person—you're asking if a person had no equity down, would they qualify for a home modification program loan? Yes. The answer is, they would be eligible, not saying they would qualify, because there is certain underwriting analysis that's performed to qualify.

There is the net present value test. There is an analysis to see if they can afford the payment. You're not going to just modify—it's only for sound modifications. It's not for a modification that's going to re-default or for a household that candidly cannot afford to make the modified loan payment.

Mr. LEE. One more question?

Mr. LYNCH. [presiding] Certainly.

Mr. LEE. Thank you. In your mind, how is the Administration collaborating with Congress on establishing benchmark and reporting requirements?

Mr. LAWLER. Well, we certainly have a very elaborate program being developed, and Fannie Mae is going to be collecting enormous amounts of data from the servicers, which will be a repository that can be used by Freddie Mac to establish compliance, and by others to evaluate the success of the program.

So I think we have a plan that is developed to provide that kind of information.

Mr. LEE. Thank you.

Mr. LYNCH. Okay. The Chair recognizes the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. Morris, I'm a little concerned, although I think what you're doing is good with the Web site, in a way. I am concerned, however, about issues of privacy. Just because a homeowner is underwater is no reason for them to be—their finances to be under review by their neighbors.

And if you're saying that any person can go to this Web site and find out the mortgage status of any other person, I'm nervous about it.

Mr. MORRIS. I'm sorry, Congressman Cleaver. I misspoke.

The purpose of the Web site is for you, if you had a mortgage, to determine if it's a Fannie Mae or Freddie Mac guaranteed mortgage or held mortgage. It's also for you to determine if you're eligible. And it's also for you to determine what resources are available to estimate what your new payment would be. It's not used to invade someone's privacy.

Mr. CLEAVER. All right, I apologize. I thought you were saying that you can go in and find out the status of where your loan is and that kind of thing.

Mr. MORRIS. Ranking Member Capito was saying how people don't even know if they have a Fannie Mae or Freddie Mac loan.

Mr. CLEAVER. Yes, I want to get to that.

Mr. MORRIS. And this Web site will enable someone with information on their loan to determine where their loan is. It's an information tool, just to make it easier. Some people like using the Web, some people might prefer to call.

Mr. CLEAVER. Yes.

Mr. MORRIS. So it's just a way to make it easier to find out the basic information of someone's mortgage.

Mr. CLEAVER. I want to follow up on my friend, Ms. Capito's, discussion because I also think we need to take another step, and I don't know if this step can be taken, must be taken legislatively or administratively.

I agree, most people don't know—I mean, when you say is your mortgage with Fannie in Washington, they think you're talking about Fannie Fox who was in the Tidal Basin naked with Congressman Wilbur Mills. They're not—you know, they have no idea.

But it troubles me that people's loans can be sold and they have absolutely no idea who holds the mortgage, whether it's been securitized.

I mean, do you believe that there's something that should be put in place so that people realize when their mortgage has been placed with some other institution or entity?

Either one of you.

Mr. MORRIS. Congressman Cleaver, the most important step in this plan, one of the most important components is the borrower just reaching out to the servicer, because the servicer has all the information, because that's who you're making the payment to, and they know exactly what type of loan, who holds it, and what are the parameters.

Mr. CLEAVER. I know. We agree on that.

The point I'm trying to raise, and perhaps unsuccessfully and inarticulately, is that homeowners ought to know who is the final arbiter on their mortgage, and the fact that we have to—that a homeowner has to ask someone, you know, "Who is the entity holding my mortgage," just seems to me to be a little off center.

Mr. Lawler?

Mr. LAWLER. Well, in many cases, servicers are going to be going out with announcements to the people whose loans they are servicing. For the most part, borrowers are indifferent to whether Fannie Mae or Freddie Mac has bought their loan.

Mr. CLEAVER. They used to be. That's not true anymore.

Mr. LAWLER. And now it's not true. So servicers, we expect, will be contacting borrowers, but borrowers can easily find out on Web sites or by calling the companies.

Mr. CLEAVER. Perhaps my question is more fundamental, and it goes way past the housing plan that we have before us, whether we have the housing plan or not.

Do you believe that you ought to know whether your house is underwater, under attack, that you ought to know where your mortgage has been sent—who holds your—has somebody purchased your mortgage? People don't know, and that's why you have to put this program together.

I guess my question is, do you think that there ought to be something in place—forget what we're talking about today, this is a slight digression—that would require that people be informed when their mortgage is sold?

Mr. LAWLER. It might be very complicated, in many cases. I think what most borrowers most want to know is if their responsibilities have changed. If they're still sending a check to the same address and have to send it by the same date, and they have the same rules about the consequences of being late, it may not be that important.

If the mortgage gets sold to Fannie Mae or put in a Fannie Mae security and the original lender takes those securities back, is that a sale that should require notification?

Mr. CLEAVER. I'm going to work on how to ask the question, because I'm asking it poorly, I see, so I'm going to work on it and ask it again.

I yield back.

Mr. LYNCH. The gentleman's time has expired.

Mr. CLEAVER. Thank you.

Mr. LYNCH. But we can come back to it.

Mr. CLEAVER. Thank you.

Mr. LYNCH. We'll do a second round.

The Chair recognizes the gentleman from Ohio, Mr. Driehaus.

Mr. DRIEHAUS. Thank you very much, Mr. Chairman.

I would like to pursue a couple lines of questioning, one going back to, you know, these ads that are running on TV and the potential for fraud, and then the other as to what we're doing to market the program.

Mr. Morris, I have to tell you, I was a little less than happy with your response to the chairwoman about your viewing the ad and then suggesting that it doesn't fall under your purview, that that's really someone else's job at HUD.

The fact of the matter is that the folks who are out there trying to scam homeowners are very aggressive. They have been very aggressive for years. And it's our job to fight against that.

So it seems to me that as soon as we see an effort to suggest that this entity has the backing of the Federal Government, and then they're using that to scam a homeowner, all of us should be working aggressively with each other in making enforcement extremely aware of that, and then moving forward very aggressively.

My fear is that they're going to use these Web sites, they're going to go on, they're going to determine that, yes, you have a Fannie Mae-backed loan, you have a Fannie or Freddie-backed loan. They're then going to call the consumer. They're going to say, "You have this loan backed by Fannie or Freddie; we can help you out." And they're going to do that before the Federal Government does that, because they're out there every day, pushing it and pushing it hard.

That's how we got into this situation, in part, because so many people were over their head in loans that they never should have gotten into, but they were being aggressively marketed.

My fear is that we're not aggressively marketing the solution. We have a Web site. That's great. But, you know, that's not marketing, that's not a campaign.

I want to know how we're marketing this thing, how are we taking it to the streets, how are we making people know that this is the Federal Government program, that we have the support? What community agencies are we working with to get the word out? How are we going on TV?

How are we marketing this so that you don't fall into the same trap of having the tools out there, but it's the aggressive folks who are out there scamming consumers in our neighborhoods, who are actually taking advantage of it.

So if you can help me with that, I would appreciate it.

Mr. LAWLER. That's one of the major work streams that is currently underway. Fannie Mae and Treasury are primarily responsible, and they are developing a significant rollout program to do precisely what you are suggesting.

Mr. MORRIS. We can submit what the plan is, because what you're asking is, what is the rollout plan.

There are various teams working. There are teams to develop the modification guidelines. I'm just trying to answer your question. And there are teams that are developing the oversight. And we do have a team working on that.

If you're asking me if I can submit the plan to you at this moment, I cannot, but I can get the—I can have the plan submitted to the Chair, you know, in the future when it's—they're working on it as we speak.

Mr. DRIEHAUS. I guess I—you know, I appreciate the fact that there's a plan and there's going to be a rollout, but I feel a certain sense of urgency here.

You know, people are losing their homes every day. We have millions of people who are facing foreclosure. We've already lost millions of homes in this country. And I guess I'm a bit impatient when we're talking about a plan.

You know, we have the crux of the solution together, and we need to get out this word just as quickly as we possibly can, and it should be every Member of Congress, it should be every local government helping people understand what's available to them.

So while I'm encouraged that there is a plan, I'm very anxious, because I don't see it being done nearly quickly enough.

And like I said, I very much appreciate the fact that this President has come in, and taken this issue extremely seriously. It's many years too late, in my mind.

But I guess what I don't feel from you is the sense of urgency, and I want to know how we are dealing with that sense of urgency to get the information out there.

Mr. MORRIS. Well, candidly, I'm sorry, I can't be more demonstrative for you, but there is a sense of urgency. The plan was announced March 4th. You would not believe the hundreds of staff hours and the hundreds of staff who are working to bring this up, to bring national standards.

We have had conference calls with law enforcement communities, we have had outreach to housing counselors. We have worked with servicers. And we have to roll out a plan that's going to protect borrowers, that's going to be well-received, and reach the disadvantaged community. So we're working aggressively, we're working with subject matter experts, and we're working in cross-departmental areas. We're working with Treasury. We're working with the FDIC. We're working with Housing.

And so the work is enormous. The plans will be sound. There is a sense of urgency. I'm just impressed—I guess it's because you're not in the actual, in the office—I'm impressed with the level of effort that the team is putting in. There are literally people coming in 7 days a week, on weekends, 12, 14 hours a day to roll these plans out.

And Congressman, we are really conscientious of all the risk. This is the President's plan. We're dedicated to it. And it's going to be effective. We're doing everything we can.

So there is a sense of urgency. We have senior professionals working on it. And it's being managed by the highest levels of our departments.

Mr. DRIEHAUS. I appreciate that, Mr. Morris, and I appreciate that, Mr. Chairman. Anything we can do to help to move that up and get that work out there, we certainly want to be doing.

Thank you, Mr. Chairman.

Mr. LYNCH. Thank you.

Now, I understand we're going to have votes here very shortly, and I think it might work out that we'll be able to let you guys off the hook, and then we'll bring in the next panel.

I do have just a couple of ballpark questions.

When we first heard of this program, there was a universe of about 9 million homeowners who were identified as being eligible for our program and able to be helped.

Now, is there a way to determine how many of those folks, that 9 million, are in whole mortgages that we can get at without getting into the whole securitization problem? Do we know what the mix is there?

Mr. LAWLER. No. Of the total, I think 4- to 5 million were identified as potential refinances for Fannie Mae and Freddie Mac.

The other part of this was 2- to 4 million, if I added that up right, for the loan modifications, and some of those would be Fannie Mae and Freddie Mac loans and another large portion would be loans backing private label securities. Some of them would be just whole loans held by institutions.

Mr. LYNCH. Right. But we don't know what the mix might be?

Mr. LAWLER. I would guess of that amount, probably about half of it would be in loans backing private label securities.

Mr. LYNCH. Okay. I'm not sure if any of the other members have any—oh, I'm sorry. The gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. And I again thank the witnesses.

I am interested in making sure that I have recorded information correctly. I have indication that the Web site for persons to visit, to literally perform an asset test on your circumstance, is www.makinghomesaffordable.gov; is that correct?

Mr. MORRIS. "Home," makinghomeaffordable.

Mr. GREEN. Okay, homeaffordable.gov. Thank you.

And I have the phone number to receive a service from a person, a counselor, if you will. It is 888–995–HOPE?

Mr. LAWLER. 888–995–HOPE, yes.

Mr. GREEN. Right. 888–995–HOPE.

Now, was a second Web site voiced? Because it seems as though I may have missed it. I've been in and out. By the way, I'm in two places at the same time all day today, so if I appear to be a little bit discombobulated, it's because I'm really not here, I'm at Homeland Security right now.

So if you would, was there a second Web site?

Mr. LAWLER. There's a lot of information at the Treasury's financialstability.gov Web site, as well.

Mr. GREEN. Financialstability.gov. Okay—

Mr. LAWLER. Makinghomeaffordable.gov is specifically designed for borrowers. The financialstability.gov has a wealth of information about all TARP programs and so forth.

Mr. GREEN. Okay. This is one that gives information on programs. Okay.

Now, are there any other numbers that we can make available to our constituents?

Mr. MORRIS. We have the HUD home counseling number, and what—the way that hotline works is, you would have to put in your—it's in English or Spanish, but you would put in your ZIP Code, so it would transfer you to the right geographical area, but that number is 800–569–4287.

Mr. GREEN. 800–569–4287?

Mr. MORRIS. Yes. And there's another HUD line, as well, which is—

Mr. GREEN. All right.

Mr. MORRIS. —if you have even broader issues besides that, it is 800–225–5342. Both of those are HUD—

Mr. GREEN. HUD numbers, okay.

Mr. MORRIS. Yes.

Mr. GREEN. And any additional numbers or Web sites? That's it?

Mr. LAWLER. If you're interested in finding out if Fannie or Freddie own your loan, you can either use the makinghomeaffordable.gov or you can use the fanniemae.com or freddiemac.com Web sites.

Mr. GREEN. Okay, thank you.

Mr. MORRIS. And HUD, of course, has its www.hud.gov, which explains the entire department. It links into the makinghomeaffordable Web site, you know, talks about all our programs, if you're interested in a stabilization program, to see what the allocations were for the local governments, things like that.

Mr. GREEN. And what was that one again, please?

Mr. MORRIS. www.hud.gov.

Mr. GREEN. www.hud.gov. All right.

Now, let me just do this quickly. And this is not in any way to demean what you have said, because I greatly appreciate what you've said and I've already indicated that it's not the yellow brick road, it's not a panacea, it's not a silver bullet.

So now with reference to these phone numbers, what is the wait time? And I ask, and it may be a rhetorical question, but I ask, because one of the complaints that I get quite regularly is that persons will call and not get an answer, not in the sense that there won't be a phone that will ring and you'll get some recording that says, "The next available person will be with you," but in the sense that they never talk to the next available person.

So do we have enough staffing for the phone numbers that you have given me?

Mr. MORRIS. Yes. At HUD, the services are either contracted out; in addition, as I said, there is Hub technology that directs the call to a local counseling agency.

We constantly monitor our Web sites. We constantly have active managers overseeing the wait times. And we respond as quickly as possible.

It has been challenging at times, because what has happened with new initiatives and new programs, there has been unprecedented spikes in the demand for the services, but we're confident that we have sufficient capacity at this point, and I'm not aware of any recent service issues.

Mr. GREEN. Well, I trust that you'll be prepared for a spike sometime probably around next week, because when I go back to my district, I'm going to give this number out over the air waves, and—

Mr. MORRIS. We'll be ready.

Mr. GREEN. —so be prepared. Thank you.

Mr. LAWLER. Fannie and Freddie are dramatically increasing their staff for this purpose, and they each have call centers, as well.

Mr. GREEN. Thank you, Madam Chairwoman. I yield back.

Chairwoman WATERS. You're welcome. Mr. Ellison.

Mr. ELLISON. Thank you, Madam Chairwoman, and let me thank you again for your excellent leadership on all housing issues, and all other issues, really.

And also, members of the panel, let me thank you.

You know, we had a forum on the foreclosure crisis in Minnesota about a year ago. Chairman Frank came.

And one of the witnesses said that, because of a lack of low-income affordable housing, that he felt that—and because of a lack of requirements for documentation—he was able to get into a subprime mortgage that had a teaser rate that was literally lower than market rent, and that worked out great until the adjustment.

How much of this kind of phenomenon are we seeing around the country? Is this part of—is the lack of affordable low-income housing part of what drove people into subprime mortgages over the last several years?

Mr. LAWLER. I think it certainly was an important factor, because as house prices were rising extremely rapidly, affordable housing was much more difficult to find, and so that contributed. We think that essentially we put a stop to that kind of lending at this point. We still have a horrible problem to deal with the loans that were made in the past, though.

Mr. ELLISON. Yes. So some of those people are—those loans might have sort of trickled down, but the effects of those loans we're still living with.

Could you—one of the untold stories, or lesser-told stories, is how about 40 percent of the foreclosures are in multiple housing dwellings, and when the landlord goes into foreclosure, the renters are then put in a very difficult situation. Is this something that you could offer some views on?

I sponsored, along with several other members of this committee, a bill that would provide various protections for tenants on foreclosed properties. Specifically, the bill would allow renters to stay in investment properties through the end of their lease, and would give them a 90-day notice prior to eviction.

Do you have any views on this legislation that you would share with us today?

Mr. LAWLER. Both Fannie Mae and Freddie Mac, with respect to their properties, have implemented just such a program.

Mr. ELLISON. Yes, they have. But, of course, not everybody lives in Fannie and Freddie, so this would apply generally. Are there any views you'd like to share, Mr. Lawler or Mr. Morris?

Mr. MORRIS. For FHA-insured mortgages, when we have occupied conveyance requirements, which means the properties with the tenants, our contractors can accept the properties with rental agreements with those tenants. So we try to protect the tenant during the transition from the owner defaulting on the mortgage.

Mr. ELLISON. Yes. And you all are doing a great—Fannie and Freddie and FHA are good, but for the people who fall outside that ambit, you know, do you think it would benefit citizens?

Mr. LAWLER. Not only benefit citizens, but it could help benefit the ultimate owners of those loans, because if there's money coming in, evicting people just makes the problem harder.

Mr. ELLISON. And it would also help preserve the asset. I mean, the fact is, if nobody is living in that place, what happens to it? Do you have any ideas on that?

Mr. LAWLER. Properties deteriorate very rapidly without anybody in them. That's been the record.

Mr. ELLISON. Is that your view, Mr. Morris?

Mr. MORRIS. Yes. We think if a property is occupied, it's much less subject to abuse, and, you know, also, in those situations, we think that leveraging the Neighborhood Stabilization Grant Program, which is really flexible—

Mr. ELLISON. Yes.

Mr. MORRIS. —and then also with the competitive grants, that could sort of help maintain those properties and repair those properties, as well.

Mr. ELLISON. You know, Mr. Morris, thanks for mentioning the Neighborhood Stabilization Grant.

In the latest stimulus package, the House version was $4 billion, the Senate version was no billion, nothing, and then it ended up being about $2 billion.

Do you believe that's adequate to meet the needs across America?

Mr. MORRIS. Well, the only thing I can say is, an additional $2 billion is helpful. It's going to be competitive grants.

Mr. ELLISON. Right.

Mr. MORRIS. And the way it's going to be geared is that you have to spend the money, so we'll be able to determine if it's effective.

Mr. ELLISON. Okay.

Mr. MORRIS. Half the money has to be spent in 2 years, and 100 percent of it in 3 years, and I think the notice of funding availability will be coming out from HUD in May.

So to answer your question, in a very short period of time, we'll be able to determine if it is adequate, because we'll be actually using and allocating the money.

Mr. ELLISON. Yes, and that's really—and thank you for explaining the process and the fact—it sounds like you're saying you don't really know, but is that really your answer? I mean, do you have any preliminary view of whether the $2 billion is fit to deal with the largest foreclosure crisis since the Great Depression?

Standing from where we are now—I mean, I know time will tell, but from standing where we are now, do we have any reason to believe that this is going to get it done?

Mr. MORRIS. I'm being coached by Congressman Cleaver—

Mr. ELLISON. You know, I'm one who really loves the advice of the great Congressman Cleaver, but I'd just as soon hear what you have to say about it.

[laughter]

Mr. MORRIS. I don't—

Mr. ELLISON. We're not going to have them—I only got—

Mr. MORRIS. I don't have an answer for that, actually—

Mr. ELLISON. Okay, Dr. Lawler, do you have a view on this? Is $2 billion going to do it?

Mr. LAWLER. I really don't know.

Mr. ELLISON. All right. Well, thank you.

If I have time for a last question, please explain the importance of bankruptcy reform legislation in buttressing the President's plan. What do you think the consequences are if the Senate fails to pass this bill? That was asked already?

Chairwoman WATERS. I'm sorry. Please go right ahead.

Mr. ELLISON. Okay. Was that asked already? I don't want to— okay, yes. What's your view on cramdown?

Mr. MORRIS. Well, the bankruptcy reform legislation is something that the Administration favors. We think it could be a good tool to help reduce foreclosures, and that's the reason why we would think it would be very helpful in the situation of avoiding foreclosures.

Mr. ELLISON. Mr. Lawler?

Mr. LAWLER. We really think that if bankruptcy can be avoided, that's better for the borrower, and we're very hopeful that this loan modification plan we have will address the needs, and prevent a lot of people from getting into bankruptcy.

We are somewhat concerned about that if there are cramdowns in bankruptcy legislation, that they be done in a way so as not to unduly alter the payment structure of securities that are based on an assumption that there won't be any such cramdowns, which could cause some problems in the securities market.

So there are some issues to deal with that we hope are addressed.

Mr. ELLISON. Thank you.

Chairwoman WATERS. Thank you very much.

I would like to thank this panel. And the Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

This panel is now dismissed, and I would like to welcome our second panel. Thank you very much.

Our first witness will be Dr. Roberto Quercia. Did I pronounce your name correctly? Would you please speak into the microphone?

Mr. QUERCIA. Yes, you did, Madam Chairwoman.

Chairwoman WATERS. Thank you very much.

He is a professor and director of the Center for Community Capital, University of North Carolina at Chapel Hill.

Our second witness will be Dr. John Geanakoplos, and I know I didn't pronounce yours correctly. How do you pronounce your name?

Mr. GEANAKOPLOS. You got it.

Chairwoman WATERS. Oh, all right. Very good.

He is a professor of economics at Yale University.

Our third witness will be Ms. Ellen Harnick, senior policy counsel, the Center for Responsible Lending.

Our fourth witness will be Dr. Dean Baker, co-director, Center for Economic and Policy Research.

Our fifth witness will be Mr. Andrew Jakabovics. Is that correct? Say it again.

Mr. JAKABOVICS. "Jakabovics."

Chairwoman WATERS. Okay. "Jakabovics," associate director for housing and economics, Center for American Progress.

Our sixth witness will be Ms. Faith Schwartz, executive director for the HOPE NOW Alliance.

Our seventh witness will be Mr. David John, senior research fellow, Heritage Foundation.

Without objection, your written statements will be made a part of the record. You will now be recognized for a 5-minute summary of your testimony.

Let us begin with our first witness, Dr. Roberto Quercia.

STATEMENT OF ROBERTO G. QUERCIA, PH.D., DIRECTOR OF THE CENTER FOR COMMUNITY CAPITAL AND PROFESSOR OF CITY AND REGIONAL PLANNING, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

Mr. QUERCIA. Thank you. Good morning, Madam Chairwoman, Ranking Member Capito, and members of the subcommittee, and thank you for inviting me to be here today.

I am Roberto Quercia, professor, and director of the Center for Community Capital at the University of North Carolina at Chapel Hill, and if I may add, I know the President speaks for NCAA basketball champ.

In my remarks, I will summarize the findings of our recent study on loan modifications.

First, I want to highlight my key findings and policy implications. There are three of them:

First, our study finds and quantifies that modifications that lower mortgage payments significantly reduce foreclosure. Second, the finding supports the basic premise of Making Home Affordable plan, that loan modifications and refinances that reduce payments will prevent foreclosures. And third, for homeowners who owe more than their house is worth, the so-called homeowners "underwater," we believe that a more explicit use of principal reduction may be appropriate in some circumstances.

The foreclosure crisis shows no sign of abating. You all know the statistics.

The Obama Administration has recognized the urgency of addressing the root cause of the problem, the homeowner's inability to meet mortgage payments.

Studies have found that most loan modifications do not reduce mortgage payments. In fact, the so-called "traditional modifications" that take the late fees and payments owed and add them to the loan amount often result in higher payments.

Our study examines the re-default rates of different types of loan modifications.

Not surprisingly, we find that not all modifications are created equal. The key to sustainable modifications over time is to reduce the mortgage payments significantly.

Six months later, homeowners whose payments were reduced have a relatively 60 percent lower rate of delinquency than those who got traditional modifications with a payment increase.

We found that nearly half of all modifications received no payment reduction. In fact, one third of delinquent borrowers got a payment increase. To us, this is like throwing a rock to a drowning person.

Modifications that incorporate both payment reduction and principal reduction re-default even less.

As expected, we find that local economic conditions play a key role in the success of loan modifications over time.

The Making Home Affordable plan incorporates the key finding from our study. Namely, it relies on making home mortgages more affordable by lowering payments or refinancing loans, using a systematic and consistent framework.

With regard to modifications, servicers are expected to follow a series of steps to reduce monthly payment to no more than 31 percent of household income.

An important part of the President's plan is to focus on homeowners at risk. This is consistent with our finding that early modifications re-default less, so the more we wait to modify, the higher the risk of re-default.

There are additional implications of the study that can inform the potential effectiveness of the plan.

The plan to refinance GSE borrowers with high loan to values up to 105 percent can only partly solve the problem. We believe that more consideration needs to be given to incorporating principal forgiveness in loan modifications more broadly.

Although permitted under the plan, the lack of guidelines and standards for principal reduction may limit or discourage its use in situations where it may be appropriate and necessary.

Our study findings on the importance of principal reduction also support the use of bankruptcy courts as an avenue for modification.

Finally, we know that government agencies are collecting more and better data on modifications than we have available. I would encourage the agencies to make the data available to researchers so that we can all examine what works and what is not working.

In closing, I commend President Obama for proposing guidelines to streamline the modification process, allowing troubled borrowers to get fair, timely, and consistent help. I applaud the committee's interest in these topics, and I'll be glad to answer any questions you may have.

Thank you.

[The prepared statement of Dr. Quercia can be found on page 132 of the appendix.]

Chairwoman WATERS. Thank you very much.

Mr. John Geanakoplos.

STATEMENT OF JOHN D. GEANAKOPLOS, PH.D., PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. GEANAKOPLOS. Thank you, Madam Chairwoman. Ms. Capito, thank you for inviting me.

I just have two simple points to make:

First, the only way to truly stop non-prime foreclosures, which are 70 percent of the total, is to write down principal. This can be done without hurting bond holders and without spending a time of taxpayer money.

Second, the decision on whether to modify or foreclose needs to be taken away from servicers and given to an unconflicted agent. Servicers are standing in the way of sensible modification decisions.

The Obama plan, which rejects principal reductions in favor of interest reductions, does not give underwater homeowners real incentive to pay. It will not stop the avalanche of foreclosures to come. At most, it will postpone the devastation. The people the President's plan really helps are the servicers, who are now owned by the banks.

There are two ways to see that principal reductions are needed to stem foreclosures.

First, the data, which I hope we talk about, basically shows that above-water loans pay, and underwater loans default, even when the payments are low.

For underwater subprime homeowners who owe 60 percent more in mortgages than their house is worth, 8 percent default each month. At that rate, they'll almost all be gone in a year. The numbers for other non-prime borrowers are also dire. This is an urgent crisis.

Second, we don't only have the data, there's logic to this. For underwater homeowners, with already compromised credit ratings, defaulting is the economically prudent thing to do.

Think of a couple with a combined income of $75,000, who took out a mortgage for $280,000, but whose home has fallen in value to $200,000. Say they're paying $25,000 a year in mortgage payments. The problem is that this couple is underwater and no longer really owns the house in any meaningful sense of the word. Selling isn't an option. That would just leave them $80,000 in the hole.

The couple will eventually walk away, save the $80,000 in principal, and rent a comparable home for less than half their current mortgage payments. Of course, walking away from their home will further weaken their credit rating and disrupt their lives, but pouring good money after bad on a home they will never own is costlier still, especially if their credit rating was not good to begin with.

President Obama's plan won't even reduce the mortgage payments by much for the family in our example, because 31 percent of $75,000 income is basically the $25,000 payment they are making anyway.

Now, if the family were poor enough, then the Obama plan might cut their payments to near the rental, but thinking of this family, when the interest rate goes back up in 5 years, or the family needs to move, then we'll be back where we started. They will have no choice but to walk away and see their home foreclosed.

At best, the Obama temporary interest rate reduction plan defers foreclosure; it doesn't stop it.

Foreclosure is stunningly wasteful. Bond holders today anticipate getting back only 25 percent of the loan value through foreclosure. In our example, that means they would only expect $70,000 on the $280,000 loan.

But consider how much might change if we wrote down the principal a lot, to say $160,000, 20 percent below the current appraised value of the house. The payments would thereby be dramatically reduced and wouldn't be much more than renting, and the couple would have equity in the house, a reason to continue to pay, or to spruce up the house and find a buyer.

Either way, though, the original bond holders would have a very good chance of making $160,000 instead of the $70,000 that they're expected to make from foreclosure.

Principal reduction helps the bond holders and the homeowners. And the best part is, the government doesn't have to pay a penny.

The Obama plan, by contrast, does envision the government paying a lot to servicers, to make the modification decisions, but this neglects that servicers have different interests than bond holders or homeowners.

Consider our example. Would the servicer choose to write down the principal to $160,000 in our example? No. That would immediately cut his fees by the same proportion. And if it enabled the homeowner to sell the house, then the servicer would lose the fees altogether.

Servicers win by reducing interest as much as they can. Why? That's why they're in favor of this plan. Why? Because writing down interest costs the servicer nothing. He gets the same fees for a longer period of time.

Second mortgage holders make out, too. While the first mortgage lender is getting its interest payments dramatically reduced, the second mortgage holder is getting paid in full.

And who owns the second loans? The biggest holders of second loans are again the four biggest banks. Now we know who makes out best under the proposed plan—the servicers and the banks behind them.

We don't need another "help the banks" plan. We need a plan that will stop the avalanche of foreclosures, a plan that reduces principal for those underwater, and gives that job to unconflicted agents, not the servicers.

Last October, I proposed legislation that would remove the right to modify loans from the servicers and give it to community banks hired by the government. These community banks would have the power to modify mortgages, including reducing principal, when doing so would bring in more money than foreclosure.

And until the cavalry arrived to modify, homeowners now current would be expected to keep paying. Defaulting before then would make you presumptively ineligible for principal reduction.

That alone would serve to stabilize the current crisis.

Our plan is simple, and would require little government spending, somewhere between $3 billion and $5 billion over 3 years, not the $75 billion of the President's plan, and it would stop the foreclosures.

Thank you.

[The prepared statement of Dr. Geanakoplos can be found on page 56 of the appendix.]

Chairwoman WATERS. Thank you very much, and I certainly want to talk with you more about that plan. I also had an idea about community banks being able to service these loans.

However, we're going to take a slight break. We have 6 minutes left on the vote, I'm told.

We will go up and take a vote. Do we just have one or two? Three votes. They should be 5-minute votes, I believe. And we'll come right back.

So if you will be a little bit patient and relax, we will return as quickly as possible. Thank you.

[recess]

Chairwoman WATERS. While the other members are making their way to the committee, we will resume testimony from our witnesses. I thank you for your patience.

Our next witness will be Mr. Ellen Harnick.

You may begin.

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

Ms. HARNICK. Thank you very much, Madam Chairwoman. I appreciate the invitation to speak to you today.

The imperative to avoid preventable foreclosures is no longer in doubt. Not least among the stakeholders are the U.S. taxpayers, who now have a direct interest in the financial viability of major banks, and therefore, have every reason to want to prevent defaults on mortgages and mortgage-backed securities that these banks own.

The Administration's Making Home Affordable Program marks a significant step forward, long overdue. It's smart and comprehensive, and addresses some of the major challenges that have plagued other efforts to stem the crisis to date.

First, of three key aspects of the program, it sets clear standards as to what qualifies as an acceptable loan modification.

Currently, as we've heard, loan modifications often actually increase the monthly payments. These modifications will no longer pass muster. The program, as we've heard, requires that loan modifications must be sustainable, limiting monthly payments to 31 percent of the homeowner's documented income.

Second, servicers and investors are incented to participate. The program pays for each qualifying modification and offers success payments to give servicers a financial interest in the modification's outcome.

Third, because the payments to servicers should exceed the servicers' modification costs, this should incent and enable servicers to hire and train staff at a level sufficient to meet the demand. Hopefully, this will move us away from the current practice of servicers leaving borrowers on hold for hours, never reaching a human being who can actually help.

For the program to succeed, a large number of servicers will need to sign on. Participating servicers will need to work promptly to modify loans without delay, and the modifications will need to prove sustainable in practice.

Accomplishing those goals will require careful monitoring to ensure the compliance with program rules and also to identify ways to make the program more effective, particularly in light of economic conditions as they develop.

It's important to note that private mortgage-backed securities, the securities owned not by banks, not by Fannie and Freddie, generally, but by the private label mortgage-backed securities, comprise 61 or 62 percent of the failing mortgages, and so it will be very important to see that the servicers of these privately owned private label securities do participate.

It's encouraging to know that the four major banks have all expressed a willingness to participate in the program, but it will be important to see that they're able to participate not only on behalf—not only with regard to the loans on their balance sheets, but with regard to these private label securities

As we look at the actual effects of the program as it's implemented, we'll have to check to see if there are, for instance, too many re-defaults. This may suggest the need to mandate principal reductions, which are widely recognized as the most effective modification tool.

Similarly, too little servicer participation may suggest that stronger legislative or administrative measures may be necessary.

Vigilant monitoring is also essential to ensure that consumers are treated fairly, that they're not charged for fees that are prohibited by program rules, and that servicers are not violating the spirit of the rules by overcharging for costs that are permitted.

The program should have a well-staffed, well-publicized consumer protection hotline that homeowners can call to report concerns.

Finally, transparency is essential. Lenders and servicers must be required to provide loan-level detail on the terms of the modifications they offer, both within the plan and outside the plan, as well as on outcomes for homeowners who are rejected for modification.

This will enable State and local policymakers to keep abreast of mortgage-related trends in their jurisdictions and will ensure compliance with fair lending and other consumer protection laws.

Servicers need to know that Treasury is watching. Homeowners need to know they have a meaningful way to raise concerns about how particular services are acting under the program. Taxpayers need to know that their money is being well spent.

We applaud the House of Representatives for passing H.R. 1106, the Helping Families Save Their Homes Act of 2009, which provides an essential backstop for the voluntary efforts that we're hoping the program will bring about in large numbers.

It will give servicers both strong incentive to participate and also important cover from lawsuits by investors. There will be no basis for seeking damages against a servicer for a loan modification if the modification provides more than a bankruptcy court would provide.

Thank you very much. I look forward to your questions.

[The prepared statement of Ms. Harnick can be found on page 89 of the appendix.]

Chairwoman WATERS. You're welcome.

Dr. Baker.

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

Mr. BAKER. Thank you, Chairwoman Waters and Ranking Member Capito. I appreciate the chance to testify to the committee today.

I want to speak briefly about the housing bubble, which is the cause of the problems in the housing market and foreclosures; secondly, why the failure, the continued failure to recognize the housing bubble has made this plan less effective than it otherwise would be.

And I will at this point say, I think it's a very good plan, it's a very big step forward, but I think less effective than it could be, and like Dr. Geanakoplos, I will also give you my cost-less proposal for Congress to implement that will solve all the problems.

Very quickly, I think it's very important we recognize, and we should recognize at this point, that the nature of the problem, the cause of the problem was an unprecedented housing bubble. We had house prices rise on a nationwide average 70 percent above their trend level, and it is the collapse of house prices that is the cause of the foreclosure crisis.

Now, obviously, this was worsened by the abusive mortgages, the predatory mortgages that we saw, which both were a part of the bubble and fed the bubble, but the underlying problem here is that we have house prices that have fallen well below the value of mortgages in many cases, and that is what's causing the large majority of foreclosures. People do not get homes foreclosed if they're not underwater. It's fairly straightforward.

Now, the failure to recognize, and it was remarkable to me that there was little recognition of the bubble as it was inflating, but there still seems to be little recognition of the bubble even now, and the failure to do so in the construction of this plan, I think, makes it less effective in helping homeowners, imposes a higher burden on taxpayers, and it means that it will be much less effective in the hope of stabilizing house prices.

Taking each of those in turn, in the case of homeowners, where you have a situation where you still have a bubble in the market, and let's just say that you have a price to rent ratio, the ratio of the sale price to annual rent is on the order of 20 to 1, you're going to have a situation where homeowners will still be paying much more, even with the modification, in many cases, than they would to rent a comparable unit.

It's very hard for me to see how we're helping a homeowner if we're having them pay more to stay in their house than they would pay if they were renting a similar unit.

Secondly, we might say, well, if they ended up with equity, that would be fine, that might offset it. They won't end up with equity. As a nationwide average, house prices are failing 20 percent a year. In many of the most inflated markets, places like Phoenix, San Diego, and Los Angeles, it's close to 30 percent a year.

It's unrealistic to think that people, most of whom are going to be moving in 3, 4, or 5 years, are going to end up with equity in their homes. So we're having them pay more than they would to rent the same home, and still leaving them with a situation where they're almost certainly going to be looking at a short sale or a foreclosure at some point 2 or 3 years down the road.

The second group we're not helping is taxpayers. If we don't target this to areas where the bubble is already deflated, or where there was not a bubble, we are going to be basically throwing good money after bad. It's using taxpayers' money in basically a hopeless task.

I don't think that's a wise use of the taxpayers' dollar, which brings me, of course, to the third point, that if we talk about stabilizing house prices, it's unrealistic to talk about stabilizing house prices in these bubble-inflated markets.

Where you have markets where house prices are still, in many cases, overvalued by 25, 30, even 40 percent above their trend levels, we cannot stabilize them at those levels. It's not even desirable, even if we could stabilize them. I don't think Congress wants to have an unaffordable housing program.

I don't think we consider it an end in itself to have house prices that are extraordinarily high so that young people, people moving into the area, can't afford decent housing. I don't think that's a goal that we strive for here.

So it's not possible, and even if it were possible, I don't think it would be desirable.

That brings up my cost-less alternative, which I call right to rent, and the idea here is a very, very simple one. It simply would grant people who are facing foreclosure the right to stay in their home for a significant period of time as tenants paying the market rent. This requires no taxpayer dollars, no bureaucracy. It could be implemented immediately the day it was passed and signed into law.

What that would do is two things. On the one hand, it would give homeowners security in their homes, so if they like the home, the school, the neighborhood, they would have the right to stay there; and secondly, perhaps at least as importantly, it would give the lenders a real incentive to negotiate terms that allow homeowners to stay in their home as owners.

In other words, by making foreclosure a much less attractive option for lenders, it makes it more likely that lenders themselves will take it upon themselves to renegotiate terms of a mortgage in a way that allows homeowners to stay in their home.

So I would say that I think President Obama's proposal here, his plan, is a very good one. It will help a lot of people. It could help a lot more if it were more carefully targeted to areas that are not bubble markets, and coupled with a right to rent provision, we could go a very long way towards solving this problem.

Thank you.

[The prepared statement of Dr. Baker can be found on page 52 of the appendix.]

Chairwoman WATERS. Thank you very much.

Next, we will have Mr. Jakabovics.

STATEMENT OF ANDREW JAKABOVICS, ASSOCIATE DIRECTOR FOR HOUSING AND ECONOMICS, CENTER FOR AMERICAN PROGRESS ACTION FUND

Mr. JAKABOVICS. Thank you, Chairwoman Waters, Ranking Member Capito, and distinguished members of the subcommittee.

It's an honor to be here today to discuss with you the President's recently announced Making Home Affordable Program, as well as several proposals for Congress to consider to ensure that the new program meets its projected goal of keeping up to 9 million American families in their homes.

My name is Andrew Jakabovics. My testimony today is based on my work as the associate director for housing and economics at the Center for American Progress Action Fund, as well as ideas developed in consultation with members of our Mortgage Finance Working Group. The shortcomings, of course, are my own.

The Home Affordable Modification Program is the piece I want to focus on this morning, and it's based on the simple truth that foreclosures are costly for nearly all involved: homeowners; mortgage lenders; and investors; as well as communities across the country.

The beauty of the program is that it requires servicers to do what is in the best interest of their customers, consistent with their existing legal obligations under contract, by requiring them to offer modifications in a consistent manner on all loans for which they are responsible, when modification maximizes the net present value of a mortgage compared to proceeding to foreclosure.

Success, however, is not guaranteed, which is why Congress, in its oversight capacity, as well as the Administration, in drafting the contract with servicers that we have heard already this morning is not yet finalized, must establish reporting requirements and benchmark for servicers to meet, with the recognition that constant evaluation should be built into the program from the beginning, so that if it is not working, or if some certain aspects are not, then we will know these things quickly and can take corrective action.

So what do we mean by "working or not?"

Well, HAMP is predicted to modify 3 to 4 million mortgages over the next 2 years, and working off of the low end of that range, it seems reasonable to set a performance benchmark of 750,000 sustainable modifications over the next 6 months. Or, calculated another way, mortgage servicers should be expected to modify 25 percent of their portfolios in that time frame.

I would also encourage Congress to take additional actions now, well in advance of our recommended 6-month evaluation date, to provide the Administration with the authority necessary to implement the suggested next steps should it become clear that the mortgage modification benchmark are not being met, either by the program as a whole, or by servicers individually.

There is no single performance metric that would unequivocally determine an individual servicer's success or failure, and by extension, that of the program as a whole, but we suggest a range of measurements that might be appropriate, including comparing a servicer's modification activities and re-default rates to those of loans held by Fannie Mae and Freddie Mac; but in short, we need both absolute and relative measures of modifications, as well as redefaults.

Crucial measurement of the program's success must be its ability to protect low-income and minority families from foreclosure. Congress and the Administration should demand strict adherence to fair housing laws and should monitor individual servicers closely to ensure that all eligible borrowers receive assistance.

Given the servicers' ability to choose an interest rate reduction or a principal reduction under the program, I would also urge reporting of the types of modifications offered by race and income, as well.

Beyond individual servicers, however, the whole program as currently conceived may not serve low-income and minority borrowers properly, and if we see them disproportionately continuing to lose their homes, program rules should be changed.

Many of these borrowers live in communities hard hit by the foreclosure crisis, with significant declines in home values off the peak.

Because of the high cost of proceeding to foreclosure, particularly the cost of securing and maintaining the homes, long holding periods, and steep discounts necessary to attract new buyers, borrowers in these communities may be more likely to be offered modifications than in places with fewer foreclosures or other homes for sale, whose property values may have remained relatively stable.

Yet minorities also have significantly higher unemployment rates than whites, and income is a crucial factor in determining eligibility for modifications.

It remains to be seen how house price trajectories will intersect with some of these income trends, particularly as they relate to low-income and minority borrowers.

The reporting and evaluation process outlined may uncover significant barriers to modifications that are difficult to remedy within the existing context, and if within the next 6 months it becomes clear that individual servicers are failing to meet reasonable levels of modifications, the time will have come to move from carrots to sticks.

Similarly, if the program as a whole does not meet the anticipated level of activity, more aggressive modification policies should be implemented across-the-board.

These steps include principal balance reductions, as we've already heard, but also applying eminent domain potentially to individual mortgages or to entire pools—and I'm happy to go into that in more detail under the questions—as well as using the REMIC status for a public purpose to encourage servicers and their trustees to modify the terms of the pooling and servicing agreements to eliminate barriers to modification, as well as under the expanded bankruptcy provisions. I would urge the House, should they have a chance at amending the bill that they've passed over to the Senate, or if it goes to conference, to urge consideration for amending the bill to sunset the 5-year clawback provision that would allow noteholders to recapture up to 90 percent of profits generated on sale after a writedown of principal balance, and make that sunset provision in force 6 months after enactment if the program, the modification program fails to meet the program's benchmark.

And so with that, I look forward to hearing your questions, and will be looking forward to answering them.

[The prepared statement of Mr. Jakabovics can be found on page 104 of the appendix.]

Chairwoman WATERS. Thank you very much.

Ms. Schwartz.

STATEMENT OF FAITH SCHWARTZ, EXECUTIVE DIRECTOR, HOPE NOW ALLIANCE

Ms. SCHWARTZ. Thank you, Chairwoman Waters, Ranking Member Capito, and members of the subcommittee.

I'm Faith Schwartz, the executive director of the HOPE NOW Alliance, and I'm here to testify on behalf of our efforts to help homeowners avoid foreclosure and work to respond to the President's Making Home Affordable Program.

HOPE NOW is a critical resource that is available to any distressed homeowner, 24 hours a day, 7 days a week. Any homeowner can call the 888–995–HOPE hotline, day and night, and talk to a HUD-approved agency, trained nonprofit counselor, who has the capability to speak to troubled homeowners in 21 languages.

Recent statistics of this hotline in February show that the calls that come in are answered, on average, in 35 seconds. Six percent of them are abandoned. And of the calls that come in, 50 percent choose to be counseled by the hotline.

The hotline is in existence for those troubled, when servicers are overwhelmed, and capacity problems at the servicers do exist. This is another way for borrowers to get help with HUD-approved counseling, trained people to give them counseling.

HOPE NOW continues to reach out and assist homeowners through local outreach events, direct mail campaigns of over 3 million mailings, free counseling through HUD-certified counseling agencies, and by helping homeowners contact their loan servicer.

We created an online form for the HOPE NOW Web site to enable homeowners to transmit their information directly to their servicer. That's new.

HOPE NOW is also serving as an important contact point between the government and the servicing community for discussions on implementing the Administration's plan.

We estimate, based on 40 million loans that we collect, that servicers have modified about 100,000 loans per month in the last 5 months. In January, that was a high of 123,000 loans.

Since HOPE NOW began, servicers have provided 3.4 million workout solutions, which do include modifications, repayment plans, and this number also does include re-defaults.

While HOPE NOW continues to help at-risk borrowers, our data shows that the problem is growing, and that as of January 30th, 2.9 million people were 60 days or more past due on their mortgage; 1 out of 10 were delinquent. It is clear more needs to be done.

HOPE NOW supports President Obama's new effort to help at-risk borrowers, and their new tools introduced to the program, such as the new refinancing options and the ability to help a current borrower who may be pending default.

We have been working with Treasury, HUD, Fannie Mae, and Freddie Mac to understand and begin to implement this important program, and will do our very best to make it a success.

Many major servicers are optimistic about the program, and will participate and will work to make it a success.

At this moment, the contracts with the U.S. Government and the program documents, such as NPV tests for servicers, are still being finalized by the Administration. Without final documents, I'm not yet able to state actual participation.

The conversations with the Administration and agencies have been very positive, very helpful, and we're optimistic about the impact of this program.

Servicers and the hotline are reporting large increases in calls from homeowners. The Administration has offered scripts for counselors and servicers to help navigate all questions from the homeowners. HOPE NOW and its members have taken action to handle these increased calls.

Servicers are expanding their capacity for calls Web site capabilities to assist the borrowers who want a refinance or a modification.

The hotline has significantly increased its capacity to handle more calls from troubled homeowners. Since the initial guidelines of the Administration's program were announced March 4th, more than 124,000 homeowners have called the hotline. Since the announcement, call volume has increased 3 times the daily average prior to the announcement.

HOPE NOW has upgraded our Web site to better inform, educate, and assist homeowners in need since the announcement, and HOPE NOW has experienced a doubling of visits to the Web site of 64,000 visits in one week.

Borrowers can now link directly into the HOPE NOW servicers, and to the HUD-approved housing counselors. HUD, Fannie Mae, and Freddie Mac, and financialstability.gov are also on the Web site, so they can link back into the government Web sites.

Most importantly, we created a customer intake form, which allows borrowers to input personal information, day or night, regarding their situation, which is then sent through a secured network directly to their servicers.

HOPE NOW also continues to host outreach events with partners such as the Federal Reserve Banks and NeighborWorks America.

For example, in 2008, we had five outreach events in California, including three in the Los Angeles area. One of those events was in December in L.A. That helped more than 1,600 families. We had 14 nonprofit counseling agencies and 21 mortgage servicers participate. Our last event was in Kansas City with the Kansas City Federal Reserve Bank, where we saw 736 families.

In all of 2008, we served over 20,000 families who came through these events last year.

And our forward events are listed in my testimony and attached to the written testimony for 2009. We will be educating borrowers and all partners about the Administration's affordability program at those events.

Finally, I want to thank you for your attention to the mortgage modification scams.

We actually have a celebrity campaign that we are working with Fannie Mae on, where we have used Queen Latifah to reach borrowers in a different way and warn them about scams, and that all of this is always for free. Counseling is free, servicer help is for free.

To further address this, HOPE NOW is working with the State attorneys general in New Jersey and Connecticut, and the Federal Trade Commission to make consumers aware of the situation.

We want to work with this committee to ensure all homeowners know that services provided by HOPE NOW and its members are absolutely free.

My recent experience with homeowners did result in an investigation being opened in Connecticut.

[The prepared statement of Ms. Schwartz can be found on page 166 of the appendix.]

Chairwoman WATERS. Thank you very much.

Ms. SCHWARTZ. Thank you.

Chairwoman WATERS. We will move now to our seventh witness, Mr. David John, senior research fellow, Heritage Foundation.

STATEMENT OF DAVID C. JOHN, SENIOR RESEARCH FELLOW, THOMAS A. ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION

Mr. JOHN. Thank you very much for having me today.

As I drove here this morning through my neighborhood in West Virginia, I passed two or three houses of neighbors that had been foreclosed.

Now, I also passed dozens of homes of my neighbors, many of whom, or actually most of whom are working-class neighbors—I don't live in a rich area—who actually are struggling and working and pushing as hard as they can to keep paying their mortgage. Their mortgage is more than just an economic decision, it's an indication that they have arrived at a certain area.

The only problem is that, if you start to look at some of the ways that this program has been structured, and I have some specific objections to it also in my written testimony, you find that basically, these neighbors are being treated precisely the same way as certain neighbors a little bit around the corner from us, who have been far less responsible in the way they have handled their home finances.

I was at my daughter's school on Friday, and one of the mothers came to me and asked, "Now, how in the world can I train my kids to accept the responsibility for their actions when all we ever see on the TV and on the radio and whatever is that you'll get bailed out no matter what?"

I think this is a very serious question, and I thoroughly believe that long-term consequences of this message being sent to our kids and our grandkids may actually have a higher cost eventually than what we're facing today in financial problems.

Now, let me address one other area of this, which is, I am very concerned about rising expectations, and whether this program is even going to be capable of meeting these expectations.

Yesterday, the Mortgage Bankers Association reported that mortgage applications rose 30 percent in the week ending March 13th, primarily driven by refinance applications due to low 30-year rates.

Now, these are people, for the most part, who have kept their mortgage current. They're all going to be calling pretty much the same people.

It's one thing to call for counseling, and counseling is a vital, crucial part of this thing. On the other hand, it's going to take some time before the mortgages can actually be modified.

We heard FHA today say that they can modify 100,000 mortgages a year. Well, to reach the 7- to 9 million, that's going to take 70 to 90 years to get that done.

We just heard from Ms. Schwartz that her members are doing about 100,000 a month, which is about 1.2 million a year, which comes to about 5 years to do 7 to 9 million.

We're going to have a lot of people who aren't going to be able to wait that long. We're going to have an equal number of people who are going to worry because they're not going to know what their ability is going to be to deal with this situation.

And as the gentleman from Ohio asked the first panel, it's very likely that the predators are going to be on the telephone much faster than they're going to be able to get their mortgages dealt with otherwise.

Dealing with that rising expectation is going to require admitting, pure and simple, that we can't deal with this problem as fast as we really need to, and recognize that we are probably not going to come out with the kind of results that we've been talking about otherwise.

One other point. There was an article in the Washington Post recently, looking at the rising default rate of FHA mortgages, mainly because FHA can't keep track of the mortgages that are coming in.

Should we find ourselves in a position where we do have millions of applications coming in quickly, we can expect that the oversight that Ms. Capito mentioned in her opening statement is going to be utterly crucial, and probably not enough.

Now, I am not unsympathetic in the slightest to this effort. I think this is very key. I want to be able to look my neighbors in the eye and tell them, "Yes, there are ways that if you work hard and you sacrifice to pay your mortgage, that you're going to be able to receive help," but the message has to be far more realistic, and we have to let people know far faster than they are now, that there is no magic bullet, there is no magic wand, this is going to take a great deal of time, a great deal of patience, and a great deal of suffering.

Thank you.

[The prepared statement of Mr. John can be found on page 112 of the appendix.]

Chairwoman WATERS. Thank you very much.

I'll recognize myself for 5 minutes to try and get a few questions answered. It's very difficult, in the short period of time that we have.

But I am very much interested in what I heard here today. On more than one occasion, I heard that we really do need to have capital reductions. I think that the first person who talked about it was Mr. Geanakoplos.

Do you want to just reiterate what you said about capital reductions having to be an important part of any loan modification program in order to be real?

Mr. GEANAKOPLOS. I would like to reiterate it, and thank you for pronouncing my name correctly twice now.

I think that the evidence is overwhelming that for a certain class of borrower who, actually the non-prime borrowers who are creating 70 percent of the foreclosures, when they're deeply underwater, they default, and that if you lower the interest, they're going to default eventually, anyway.

And I don't see how a program like this can succeed without principal reductions, and the way the program is being set up, it's giving the servicers and everyone else, really, the sign to make interest reductions and not principal reductions.

So I'm afraid we're not going to get principal reductions, and pretty soon, it's going to be too late, even if we want to do them.

They're defaulting 8 percent a month, the subprime, underwater homeowners. They're going to be gone in a year.

So I think it would be good to think about this now.

Chairwoman WATERS. All right. Thank you very much.

Mr. Baker, did you mention something about rent to own? Was that you?

Mr. BAKER. I said right to rent, sort of going the other way.

Chairwoman WATERS. Oh.

Mr. BAKER. Saying that the idea was that if you're facing foreclosure, we would temporarily change the rules on foreclosure, recognizing unusual circumstances, so that someone would have the right to stay in their home, say, for 10 years, paying the market rent, so they would be regarded as a renter, unless, of course, because of the changed terms of foreclosure, the lender decided to renegotiate terms to allow them to stay in their home as an owner.

Chairwoman WATERS. When you say market rent, that may be quite different than the mortgage.

Mr. BAKER. It would almost certainly be a great deal less, because again, the big problem is that you had bubble-inflated markets, so people are very often paying perhaps 80 percent more, perhaps 100 percent more on their mortgage than they would to rent a comparable unit, which to my mind, is a very serious problem, and under President Obama's plan, at least in some of these markets, they still might pay 100 percent more as an owner than they would to rent a comparable unit.

Chairwoman WATERS. Okay. Thank you very much.

And on HOPE NOW, you know, I've been critical of HOPE NOW, for a lot of reasons.

The HUD-trained counselors and the NeighborWorks and all of the people in your network are trained to do what by whom?

Ms. SCHWARTZ. Well, NeighborWorks has a great training program for foreclosure prevention, which is different than just credit card counseling for excess debt, so they have a lot of training for many counselors across the country, and work with HUD on training those counselors to—

Chairwoman WATERS. But what—

Ms. SCHWARTZ. —a debt management plan.

Chairwoman WATERS. Excuse me. What I'm really talking about is the homeowner who is in trouble—

Ms. SCHWARTZ. Yes.

Chairwoman WATERS. —who calls HOPE NOW.

Ms. SCHWARTZ. Yes.

Chairwoman WATERS. They need a loan modification. Who trained them to connect with servicers or to do what? How does it work?

Ms. SCHWARTZ. Through the HOPE NOW hotline, they just counsel the borrowers and go through debt management plans, budgets, and what all the issues are for that borrower, which sometimes are far beyond the house.

Sometimes it's—

Chairwoman WATERS. No, no, no, no. But I'm in trouble. I'm going to lose my house.

Ms. SCHWARTZ. Right.

Chairwoman WATERS. And somebody told me to call HOPE NOW.

Ms. SCHWARTZ. Right.

Chairwoman WATERS. What does HOPE NOW do?

Ms. SCHWARTZ. So the hotline, which is part of HOPE NOW, allows borrowers to call, day or night, and talk to a trained, certified housing counselor, who is able to walk through all the issues around modifications, repayment plans, the debt management plan of that borrower, if they want to get counseling, just as if they go to someone's—

Chairwoman WATERS. No, no, no. I don't want counseling. I know all of that.

Ms. SCHWARTZ. Okay.

Chairwoman WATERS. My income has been reduced.

Ms. SCHWARTZ. Right.

Chairwoman WATERS. I've been in this mortgage for the past 10 years. I've missed two payments already. I want a loan modification. What does HOPE NOW do for me?

Ms. SCHWARTZ. Well, they can be linked directly to the loan servicer through the hotline, and the hotline will take all the information on that borrower, including income, that the servicer needs to modify that loan, and maybe they're not calling the servicer because they're either not answering the phone or they didn't get through appropriately, so it gives them another avenue.

And we've—every servicer in HOPE NOW has agreed, and has a separate 800 number, to work with counselors on escalated cases like that, so they come to resolution, and it's really meant to help the frustrated borrower who may not be calling the servicer—

Chairwoman WATERS. Okay.

Ms. SCHWARTZ. —or couldn't get in contact.

Chairwoman WATERS. Well, let me just say this. I've held town hall meetings where I've asked HOPE NOW and servicers and others to come, and I know quite a bit about this.

While we were here in committee today, I asked one of my staffers to go call to see what happened. I'm not going to tell you openly, but I'm going to tell you privately—

Ms. SCHWARTZ. Okay.

Chairwoman WATERS. —what happened on this call. Okay? All right.

Ms. SCHWARTZ. They called the hotline?

Chairwoman WATERS. Yes.

Ms. SCHWARTZ. Okay.

Chairwoman WATERS. Okay. Ms. Capito.

Mrs. CAPITO. Thank you, Madam Chairwoman. I'd like to thank the panelists. I have a couple of questions.

First of all, HOPE NOW, I will say I spoke with a constituent on last Monday who was underwater, having a lot of difficulties, and our office had referred them to the HOPE NOW hotline, and they did have a satisfactory experience.

They called on a Sunday. The HOPE NOW counselor was going to be mediating the information between the servicer and the borrower. I'm afraid it's not going to have a happy conclusion, because this particular couple, they're underwater, they've already gone out and rented something, in anticipation of just walking away, and I'm certain that happens quite frequently.

So I did want to tell you that, in light of your efforts.

And so I had a quick question for Ms. Harnick.

When you talk about servicers in this plan, it's all optional, isn't it, servicer participation in this plan, still?

Ms. HARNICK. That is correct. Servicers can choose to participate or not.

Mrs. CAPITO. Okay. So then the bigger question, or a question—I believe it's tried to be addressed in the President's plan—is, are the incentives enough to have the servicers come to the table and make the tough decisions, and then do what Dr. Geanakoplos says, to modify, because you say, sir, that there's no cost to this plan, but somebody is eating the principal on that loan. I assume that's the bank or the holder of the note?

Mr. GEANAKOPLOS. Shall I respond?

Mrs. CAPITO. Yes.

Mr. GEANAKOPLOS. The point is, the bond holder is eating the reduction in principal. That's money the bond holder no longer has a right to. But by eliminating the foreclosure, the bond holders are only expecting 25 cents back on the foreclosure.

If you cut the principal to 50 cents and the homeowner now pays, or finds a way to sell the house at a profit and repay the 50 cents, the bond holder is better off than he was before.

So the bond holder—

Chairwoman WATERS. If it went to foreclosure?

Mr. GEANAKOPLOS. If it went to foreclosure. But the bonds are trading now. It's not just—it's where the bonds are trading.

So if the homeowner actually pays, if the reduction in principal gets the homeowner to pay, the bond holders will feel better off, if they believe that—if it's done properly.

Chairwoman WATERS. If they're only going to lose half instead of three-quarters?

Mr. GEANAKOPLOS. Exactly.

Mrs. CAPITO. Okay.

Mr. GEANAKOPLOS. So that's why it doesn't cost the government anything. The bond holders bear it.

Mrs. CAPITO. Okay. Thanks for that clarification.

Yes, Doctor? I had a question for you, too, while you're—you said in your statements that the loan modifications many times result in higher payments.

Are those loan modifications that would include principal writedowns, too, as well?

Mr. QUERCIA. No, they include principal forbearance, not principal writedown. So what is owed is up to the principal.

What I wanted to add is, if you—indeed, the bond holder may be better off losing 50 percent than 80 percent.

The problem with that is when you have credit enhancement, and AIG, as we all know, is in trouble because of the credit enhancement, both insurance and credit swaps, that they provided to these bonds.

And so from a bond holder, they may be better off foreclosing, and getting only 20 percent from the borrower, but they get the rest from AIG, meaning from us.

Mrs. CAPITO. Okay. Mr. John, I would like to thank you for pointing out the consequence of rising or over-expectations here.

If we're telling 7- to 9 million Americans that, sitting here, if they're watching this hearing—God bless them if they are—if they're watching the hearing or in the next 6 weeks, or we heard the HUD person say in 2 weeks we're going to be rolling this out more fully, you know, they're really on the edge of their seat. They're thinking, "Oh, in 2 weeks, I'm going to get a solution and some help."

So I think I appreciate that, and, you know, I don't know if there's any way that we can tamp down expectations. We want to tell our constituents, as you're doing through HOPE NOW, that there is help out there, but at the same time, you know, there's all kinds of hoops that have to be jumped through.

Did you want to make a comment?

Mr. JOHN. The only comment is that I'd love to come to you and say that I have a solution, but I don't. I'm afraid that it's going to have to be a little bit of honesty that's spoken.

Mrs. CAPITO. Okay. The other—Mr. Jakabovics, you said that you were in favor of benchmark, and I'm afraid I didn't catch quite all your benchmark, but I actually like that idea.

In other words, if we modified a certain amount, in a certain amount of time, or some kind of parameter, is that the theory behind your statement?

Mr. JAKABOVICS. Yes, exactly. The idea, obviously, is that we don't have the time to waste to figure out—I don't want to be back here a year from now saying, "Gee, if only we had done X, Y, or Z," and we wouldn't even have known if, in fact, the program is working.

I think we need to know up front how quickly servicers can build the capacity to modify.

I think moving through systemic modifications as under the program is important, because it creates a level playing field for everybody involved. But we need to keep a close eye on that, in fact.

Mrs. CAPITO. Could I have one more question?

Chairwoman WATERS. Sure.

Mrs. CAPITO. Okay. At the base of this program—well, I don't know if it's at the base, but one of the basic tenets of the program is, we know the folks who are behind, we know the folks who have had—that, you know, you can see on the statements where they're paying either not enough or they're paying late.

But at the base of this is the determination of who is at risk. That's a pretty broad statement, and it's not something that can be answered in a half an hour conversation on the telephone.

What—and I'd be happy to hear whomever wants to answer this—what do you think would be the best way to determine at risk? To set up a top three parameters, if you've lost your job, if your income has gone in half, if you've had a health issue, death in the family? I mean, how do we determine at risk?

Because I can see a whole bunch of people out there now saying, "I'm at risk," but definitionally, they're not going to be at risk.

Yes.

Ms. SCHWARTZ. Well, you bring up some great points, and it's one of the dilemmas we're trying to work through, is that current borrowers, there's now an explicit opportunity to modify people at risk of default, but they're current, and so a servicer doesn't quite know that yet.

You can't solicit a Fannie Mae and Freddie Mac loan that's current, that you think might be at risk, because it violates a security law. So you actually have—the borrower has to call in and let you know.

But if you've lost your job, you also won't get a modification. You might get some sort of forbearance, a 3-month period, or something, to catch up and try to find a job.

So there are a lot of complications on identifying just that issue.

Mr. JAKABOVICS. Just, on top of that, I think that there are certain parameters of loans that exist that we know historically have tended to lead to foreclosure, and so modifying those in advance, for example, a rate reset, or if you have a negatively amortizing loan, those are the types of loans that people may be struggling with, as Mr. John mentioned, struggling to keep up with their payments, because they're determined to keep their house, and to the extent that those are very clearly unsuitable loan products for them, they may not yet be in default, but the legal standard for imminent default, which exists in many of these cases, should be applied to this at risk component.

Mr. QUERCIA. I think it's also important to look at house price trends.

In North Carolina, prices have declined, but not as much as in California or Florida. So I think that's a key issue when we talk about principal reduction.

Mrs. CAPITO. Thank you, Doctor, but I have a problem with you. I graduated from Duke, so I'm really sorry. Anything you say from Carolina has—

[laughter]

Mr. QUERCIA. Congratulations on the championship.

Mrs. CAPITO. Thank you.

Chairwoman WATERS. Thank you. Mr. Green.

Mr. GREEN. Thank you, Madam Chairwoman. I thank the witnesses, as well.

Mr. Jakabovics?

Mr. JAKABOVICS. Yes.

Mr. GREEN. Is that close?

Mr. JAKABOVICS. That's close enough, certainly.

Mr. GREEN. Let me hear you say it.

Mr. JAKABOVICS. "Jakabovics."

Mr. GREEN. Ah, "Jakabovics." Mr. Jakabovics, thank you.

Have we seen the majority of the ARMs that are going to reset from teaser rates to these higher interest rates, have we seen the majority of them reset already, or do we have more ahead of us than we have behind us?

Mr. JAKABOVICS. Sir, the best data that I've seen on this is an older Credit Suisse report that predicts, really, the rate resets on the option ARMs are likely to peak sometime in 2010 or 2011.

The subprime teaser rates have largely already reset, and a lot of those borrowers are now currently in default or in foreclosure, have already lost their homes.

But there's also the fact that, to the extent that rates are now being kept low, because of where Treasuries are or the LIBOR is, that the rate—

Mr. GREEN. Just a moment. I want the chairlady to hear what you just said, because we were at a hearing recently, and our information that was given to us was that those ARMs that were resetting, that were causing the problem, that had already transpired. You might recall that, Madam Chairwoman.

I remember at that hearing, you were amazed, in fact, you were thunderstruck that information was given to us.

So your intelligence is antithetical to what we heard previously?

Mr. JAKABOVICS. That's correct.

The subprime adjustable rate mortgages have largely reset, and many of those borrowers are already in foreclosure, but there is a second pool of borrowers who are likely to face rate resets because of the option ARMs or negatively amortizing loans that then trigger increased payments as a result of the negative balance that they hit.

Mr. GREEN. Do you have any information as to how large this block is?

Mr. JAKABOVICS. I don't have those numbers specifically, but I could certainly find that out for you.

Mr. GREEN. Thank you, if you would.

Yes, sir, do you have—

Mr. QUERCIA. Yes. There are two types of mortgages that have resets. One are 2/28s. They have a 2-year fixed—

Mr. GREEN. Right, 2/28s, 3/27s.

Mr. QUERCIA. And the other ones are 5/25.

Mr. GREEN. 5/35?

Mr. QUERCIA. 5/25.

Mr. GREEN. Explain to me what a 5/35 is, please.

Mr. QUERCIA. No, 5/25.

Mr. GREEN. 5/25.

Mr. QUERCIA. The ones that are going to reset are the 5/25s, the ones that have been teaser and low for 5 years, and in 2010 or 2011, they are going to get back to the regular market rate.

Mr. GREEN. So that's the next wave that we will see?

Mr. QUERCIA. That's the next wave. And by—

Mr. GREEN. The 5/25s?

Mr. QUERCIA. —the analyses I've seen, if you look at the hump, it will be much greater than the one we had already.

Mr. BAKER. If I could just comment quickly on that, I think that may be a little deceptive, because a lot of the option ARMs were owned as investment properties, and in a lot of cases, those have already been foreclosed or walked away from, so I don't think we're going to see the same sort of wave associated with those resets as what you had with subprime.

Mr. GREEN. Thank you.

Let me go to Mr. Geanakoplos. Am I correct, sir?

Mr. GEANAKOPLOS. Absolutely.

Mr. GREEN. Mr. Geanakoplos, how many bond holders are there? You spoke of bond holders earlier. These are the ones that I'm talking about. About how many? And I don't expect you to know the exact number.

Mr. GEANAKOPLOS. You mean bond holders of all mortgages—

Mr. GREEN. Bond holders that you were speaking of earlier who would be involved in this reduction.

Mr. GEANAKOPLOS. Of all deals, there are, you know, hundreds of thousands, probably, tens to hundreds of thousands.

Mr. GREEN. Now, how many have agreed to your concept?

Mr. GEANAKOPLOS. I haven't asked each of them, so—

Mr. GREEN. Well, let's not talk about each, because your concept requires that the bond holders buy into it. They would have to have what I would probably call some sort of enlightened self-interest.

So tell me how many of them are amenable to your concept, because that's the key.

Mr. GEANAKOPLOS. Yes. So they don't have to buy in, in the sense of legally buy in. You're going to take care of that. But what they—

Mr. GREEN. Whoa, whoa, whoa. Did you say I'm going to take care of that? Okay.

Now, I have to ask you, my suspicion is, you're talking about the abrogation of contracts, but I want you to say it. How would I get them to buy in?

Mr. GEANAKOPLOS. All right. I'm thinking that the right way to cope with many of our problems, the problem of outreach and—

Mr. GREEN. I only have a limited amount of time.

Mr. GEANAKOPLOS. Right.

Mr. GREEN. And I have to ask you to go right to the bottom line.

Mr. GEANAKOPLOS. The "right to the bottom line" is, I'm hoping there's legislation that leads the government to hire these community bankers who will modify the loans.

Mr. GREEN. Okay, but how—let's get to the modification.

How does that modification take place such that there's an abrogation of contracts? Because that's what you're talking about.

Do you agree that you're talking about an abrogation of contracts?

Mr. GEANAKOPLOS. The—

Mr. GREEN. Would you kindly say yes or no—

Mr. GEANAKOPLOS. Yes.

Mr. GREEN. —because time is of the essence.

Mr. GEANAKOPLOS. It would move, yes, from the servicers—

Mr. GREEN. How do we abrogate contracts?

Mr. GEANAKOPLOS. You simply legislate it. This happens all the time, as you know, as you told me.

Mr. GREEN. Okay. I know. But tell me how I would do that. You said this is what you want me to do, so I need, for the record, for you to tell me how I do it.

Mr. GEANAKOPLOS. You would pass legislation that transfers the modification power from the servicers to the government-appointed community bankers. The bond holders, it would be nice to—

Mr. GREEN. Okay, the modification power is transferred, but the power to modify is the question.

Mr. GEANAKOPLOS. Yes.

Mr. GREEN. You can transfer what a person has, and if a person has nothing, then you have transferred nothing. So the power is what we must talk about.

Mr. GEANAKOPLOS. Right. The servicers have the power now to make—not the bond holders, the servicers have the power to make the—

Mr. GREEN. The power that the servicers have is the power to do what the bond holders will agree to, so they have to agree—let me just do this, because time is up.

Mr. GEANAKOPLOS. Sure.

Mr. GREEN. Are you saying, sir, that you would have the Congress of the United States of America pass a law that allows the community banks to write down the principal on these loans?

Mr. GEANAKOPLOS. If it maximized the value to the bond holders.

Mr. GREEN. Yes.

Mr. GEANAKOPLOS. Yes, absolutely.

Mr. GREEN. Is that it?

Mr. GEANAKOPLOS. That is it.

Mr. GREEN. Okay. Comparable to what happens in bankruptcy?

Mr. GEANAKOPLOS. Analogous, yes.

Mr. GREEN. Okay. Madam Chairwoman, thank you for being so generous. I apologize.

Chairwoman WATERS. You're certainly welcome.

Mr. Ellison.

Mr. ELLISON. Thank you, Madam Chairwoman.

And let me thank all the panelists, as well. This has been a great, great panel, a great day.

Let me ask you a question I asked before, and it has to do with the large number of people who are renters and tenants who are impacted by bankruptcy when their landlord can't make their mortgage payments and defaults.

Have you all—can you all give us a sense of how serious this problem is in your view, and what do you think we should be doing about it?

Ms. HARNICK. Well, I can respond.

Mr. ELLISON. Yes.

Ms. HARNICK. It is a very serious problem. You have homeowners who are losing their homes, but you also have renters who are being kicked out with no notice because they're, of course, unaware often of the financial straits of the landlord.

And I think what needs to be done about it is, there need to be protections put in place to give renters notice and give them, you know, stability of homeownership under the contracts that they have—I'm sorry, not homeownership, but residence, under the contracts they have.

Mr. ELLISON. Mr. Geanakoplos?

Mr. GEANAKOPLOS. Yes. I agree that it's a serious problem.

And if you prevent the foreclosure, then you'll be saving the renters, and that all too often, we just think about, is the owner in the place or not, when actually, it could be more serious, that he's not in the place, and a bunch of renters in the place are getting thrown out.

Mr. ELLISON. Well, you know, in my district in Minneapolis, about 40 percent of the foreclosures are investment properties, and in one neighborhood in North Minneapolis, about 60-plus percent. So this has really hit in our district.

Mr. Baker, do you have something to add?

Mr. BAKER. Yes. I was just going to comment very quickly.

If we provide protections, if you provide protections for renters, giving them security of tenure, you will substantially reduce the incentives to carry through a foreclosure.

In other words, if I'm the lender and I know that I can't throw all these tenants out, I can't just have the place free and clear, I have much less incentive to carry through with the foreclosure.

So you do start to get rid of the problem, simply by changing—giving renters rights in those situations.

Mr. ELLISON. I have a bill that gives 90 days after foreclosure for people to stay in the property.

It sounds like what you guys are suggesting is that we could even improve on it. Like Ms. Harnick says we could maybe give them—require that there be notice when there's—notice for renters.

Are there any other kind of ways that we can protect renters? Because I'm really trying to think about how we might get a really nice renter protection bill that would help people whose landlords are in foreclosure.

Any other suggestions beyond the one that, the good one that Ms. Harnick made?

Mr. JAKABOVICS. If I might?

Mr. ELLISON. Yes, sir.

Mr. JAKABOVICS. One of the issues I think is that there are two types of renters who fall into problems.

One is, obviously, a renter in a single-family home who has no clue that her landlord is not making the mortgage payments.

But then there are also small multi-family dwellings, four units or smaller, which are eligible under Fannie and Freddie, where you may have an owner in one of the units and then the other two or three units are just paying rent—

Mr. ELLISON. Tenants.

Mr. JAKABOVICS. —and it was structured to be that way, as well.

And I think that if we think about the fact that a long-term lease for the renters is going to be a better way to maintain the value of the property, so that even if the property goes into foreclosure, the right to stay in that property, not with a 90-day notice, but actually with a year's lease, provides a future cash flow that a potential investor who is likely to buy up that property will take advantage of, the fact is that this is already tenanted property, so the returns on that investment are likely to be better than having to go out and find new renters.

And I think that, again, eliminating the period of vacancy does far more for protecting the existing value in the property, as well.

Mr. ELLISON. Any other good ideas before I go to my next question?

[No response]

Mr. ELLISON. Thank you for the ones you've given me. I appreciate it.

My next question has to do with the Neighborhood Stabilization Program. The House had $4 billion in it. The Senate put nothing in it. The compromise is, guess what, $2 billion.

If we were to try to forecast the needs of neighborhoods across America to try to buy up some of these problem properties that nobody is living in, save neighborhoods, stop them from becoming an attractive nuisance, and you know the whole story, what kind of money should we be having in mind going forward?

Mr. Baker, you look like you have a thought.

Mr. BAKER. I do. This is the part that I actually forgot to say in my comments earlier, that when I was saying I would like to see this more carefully target the funding of President Obama's program, it was exactly with this in mind, that where we have areas where the bubble is still deflating, any efforts to stabilize house prices are going to be futile.

On the other hand, if we took that money that might go, basically, throwing good money after bad, and focused on areas where there was a low price to rent ratio, we would have hope of stabilizing prices in those areas, and also, the risk to the government of losing money in that context would be very, very small.

If you have a price to rent ratio, as you do in some areas, of 10 to 1, it's very unlikely it's going to go lower, so you stand a really good chance of actually making a positive return, unlike, say, our investment in TARP.

Mr. ELLISON. Good idea.

So any other thoughts on this issue? I mean, is $2 billion going to do it for the neighborhoods across America at a time when we have record foreclosures, or do we need to be thinking about more money as we go forward?

Mr. Jakabovics.

Mr. JAKABOVICS. Thank you.

I think that, while $2 billion is probably insufficient to deal with the full scope of the problem, you run into capacity issues on the ground, and I think that overwhelming local community development groups and nonprofits that really have a vested interest in maintaining the investments they've made over time in these communities, I think that their ability to spend this money quickly and potentially distorting markets upwards if too much money is sloshing around is real.

So I think that having a larger pool of money, but potentially be able to spend it over the next 5 years, rather than 2 or 3 years, might be a better balance.

Mr. ELLISON. So you say the $2 billion is fine for now, given capacity, but we may be thinking about this into the future?

Mr. JAKABOVICS. I believe that's likely going to be the case.

Mr. ELLISON. Last question: The President's plan has protections for consumers, for example, the waiver of certain—am I done? Am I wrapping up, or am I done?

Chairwoman WATERS. You're done.

Mr. ELLISON. Okay. Well, I guess I want to thank Madam Chairwoman for her forbearance, and I thank the panel.

Chairwoman WATERS. Thank you very much.

And let me thank our panelists for being here today. You have really given us additional information that some of us may be able to use as we try to perfect whatever it is we're doing in order to deal with this foreclosure problem and help some homeowners stay in their homes. I think we heard very good ideas today.

Were any of you sought out to participate in the solution by this Administration on this problem?

[No response]

Chairwoman WATERS. Nobody got invited to give their ideas or share their experience or knowledge?

Mr. GEANAKOPLOS. I communicated with many of the economic advisors to the President, but I haven't been invited to any panel at the White House.

[laughter]

Chairwoman WATERS. All right. Thank you so very, very much.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

The hearing is adjourned. Thank you.

[Whereupon, at 1:14 p.m., the hearing was adjourned.]

A P P E N D I X

March 19, 2009

Testimony of Dean Baker
Before the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee
March 19, 2009

Thank you, Chairwomen Waters for inviting me to testify before the subcommittee and to share my views on the foreclosure crisis and President Obama's Making Home Affordable Program.

I will begin by saying that I think that President Obama's program is a big step forward over prior proposals and will make it easier for millions of homeowners to stay in their homes. In particular, the plan to allow people without 20 percent equity in their homes to refinance mortgages with Fannie Mae and Freddie Mac will substantially reduce mortgage interest costs for up to 4 million homeowners as the President has indicated.

I believe the modification plan that President Obama has put forward is also the most realistic proposal that we've seen. The incentives for servicers to initiate modifications should prompt far more interest than we have seen in prior plans. The target of payments equal to 31 percent of income is also realistic, in that it should make mortgage payments affordable to many families who would otherwise be struggling.

In spite of the many positive aspects of the President's plan, I do still have reservations stemming from the fact that the President's plan does not appear to recognize the underlying cause of the current foreclosure crisis: the housing bubble which caused an explosion in house prices over the decade from 1996 to 2006. In the decade from 1996 to 2006, nationwide house prices rose by more than 70 percent after adjusting for inflation, creating more than $8 trillion in housing bubble wealth. In the century from 1895 to 1995, house prices had just tracked the overall rate of inflation.

It was inevitable that this housing bubble would burst with devastating effects for both homeowners and the economy. While inflation adjusted house prices rose by more 70 percent nationally, in the markets most affected by the bubble (California, Florida, Nevada, and the East Coast from D.C. north) inflation adjusted house prices rose by more than 100 percent. When the bubble burst, tens of millions of homeowners would be left underwater, with mortgages that far exceeded the value of their homes. The loss of wealth would also lead to a plunge in consumer spending as homeowners would have to adjust to the loss of an average of $110,000 in housing equity.

This situation was made worse by the lending practices of the financial industry during the bubble. The industry relaxed standards at exactly the time when it should have been tightening them and it persuaded millions of homeowners to take out adjustable rate mortgages that would reset to monthly payment levels that they could not afford.

It is important to note the centrality of the bubble in this story. Even the worst mortgage does not pose a serious problem in the context of rapidly rising house prices. A homeowner can always refinance or borrow against newly created equity if house prices are rising at double-digit rates. On the other hand, if falling house prices have pushed a homeowner these options do not exist.

Just as policymakers failed to recognize the bubble all through the decade when it was expanding, I am afraid that they still do not fully appreciate its implications, even as it is well on its way to deflating. As à result, plans such as the one that the President forward:

1) Do not help homeowners as much as they could;
2) Waste taxpayer money in many cases; and
3) Do not act to effectively stabilize the housing market.

The basic problem with the President's plan is that it does not distinguish between housing markets in which there either was not a bubble or the bubble has already deflated and the markets in which prices have a substantial amount left to fall. In the former set of markets, the President's plan is likely to be quite helpful, however this is not the case in the latter set of markets.

This point can be demonstrated by considering the price to rent ratio, which is the ratio of the selling price of a home to the annual rent that would be charged for renting a comparable unit. Historically, this ratio has averaged close to 15 to 1 nationwide, although there is some regional variation. At the peak of the bubble this ratio crossed 25 to 1 in many bubble markets, and it is still over 20 to 1 in some of these markets, even after prices have fallen substantially from their peak levels.

In a market where the price to rent ratio exceeds 20 to1, it is easy to show that families would be better off renting than owning even if they are able to get a low mortgage interest rate. To take a simple example, if the sale price on a house is $200,000 and the price to rent ratio is 20, then the annual rent on the same home would be $10,000.

By comparison, if a homeowner is able to get a 5 percent 30-year fixed rate mortgage (for simplicity, assume that the full price is borrowed) then they will pay approximately $12,800 on their mortgage. In addition, taxes, insurance, and maintenance are likely to add at least 2 percent to the annual cost of living in the home, or $4,000. This means that as a homeowner, this person will be paying $16,800 ($12,800 plus $4,000) each year for a home that they could rent for just $10,000.

The difference of $6,800 ($565 per month) is likely to be substantial a burden for most moderate or middle income families. It is effectively raising their housing costs by almost 70 percent compared to what they would pay as a renter. Of course in some bubble markets, where the price to rent ratios exceed 20 to 1, the "ownership tax" would be even larger.

The higher annual housing costs could perhaps be justified if there was reason to believe that homeowners would accumulate equity in their homes; however this is extremely unlikely in the deflating bubble markets. House prices are falling at more than a 20 percent annual rate in the Case-Shiller 20-City index. In some of the most bubble-infected markets, like Phoenix, San Diego, Los Angeles, and Miami, the rate of price decline is closer to 30 percent. By every measure, inventories of new homes, inventories of existing homes, and vacant ownership and rental units, there is an unprecedented excess supply of housing. As a result, it is almost inconceivable that house prices will stop deflating in these markets any time soon.

The implication is that the vast majority of homeowners in these deflating bubble markets, who today have little or no equity in their homes, will almost certainly have negative equity when they sell their home in a few years. (The median period of homeownership in the United States is approximately 7 years. It was less during the bubble years.)

It is difficult to see how we will have helped a family, if we craft a housing plan that encourages them to pay substantially more money in housing costs for several years than they would have paid to rent the same home, and then leave them facing a short sale a few years later when they sell their home. It was a serious failure of public policy that so many people were encouraged to buy into a bubble market, and we compound this failure if we don't carefully consider what would be best for families in designing proposals to address the housing crisis.

The failure to consider price to rent ratios also is likely to increase the costs for taxpayers. There is a much higher risk of future defaults, and much higher expected loss on each default, in the markets that are still inflated by the housing bubble than in markets in which prices have returned to their trend levels. When prices fall further in these bubble markets, homeowners who take part in this program will soon find themselves again underwater in their mortgage, or even further underwater.

The larger the gap between what is owed on a mortgage and the value of the home, the greater will be the incentive for the homeowner to default on their mortgage. If the current rate of price decline continues, a homeowner who has no equity today will be 20 percent underwater at this time next year, and 30 percent in some of the most inflated markets. In the example of the $200,000 home noted above, this translates into shortfalls of between $40,000 and $60,000.

When homeowners find themselves owing this much more than the value of their home, many will no longer struggle to meet monthly payments and simply turn the house back to the bank. This probability of course increases in the event of job loss, which unfortunately will be a likely occurrence over the next year. The result will be that taxpayers will incur substantial losses on these arrangements, even though there may have been little or no real benefit to homeowners. This will show up in the form of larger bailouts that Fannie and Freddie will need to request from Congress.

Finally, the failure to consider price to rent ratios will also undermine effort to stabilize house prices. It would be desirable to pursue policies that prevented the market from overshooting on the downside, with house prices falling below their trend level. It is unreasonable to believe that we could prop up house prices in areas where the bubble has not yet deflated (nor would it be desirable to do so even if we could). Nationwide, housing is almost a $20 trillion market. It would take enormous sums to try to sustain a nationwide bubble.

However, it is reasonable to believe that we could keep prices from falling further in the markets that do not have a bubble. A plan, like the President's proposal, can be effective in sustaining homeownership in these markets and should help to support house prices. It would be desirable to go even further and appropriate additional Neighborhood Stabilization Program funding for states, counties and cities to purchase and fix up foreclosed properties in targeted neighborhoods.

There is little risk that the government would lose substantial sums through investing in real estate in these markets since the sale prices in many cases are extremely low relative to current market rents. It would always be possible to rent out properties and receive incomes that are far greater than interest costs, until the housing market recovered.

The key point is that the government should focus on the price to rent ratio to determine whether it makes sense to commit additional taxpayer dollars to keep a person as a homeowner in their home. This will be best for both the homeowner and the taxpayer. It will also make it more likely that funds are actually committed to areas where they can help stabilize the housing market.

This policy may seem cruel to homeowners in the bubble markets, but the real cruelty was encouraging these people to buy into these markets in the first place. We do these homeowners no favors if we encourage them to incur excess housing costs for several years in the vain hope that they will one day accumulate equity in their home. We should know better than that and we should tell these homeowners the truth.

There is one simple and costless policy that Congress could pursue that would help homeowners in bubble-inflated markets. We can temporarily change the rules on foreclosure to allow homeowners facing foreclosure to remain in their homes as renters, paying the market rent, for a substantial period of time (e.g. 10 years).

This "right to rent" proposal would immediately give homeowners security in their home, so that if they liked the home, the schools, and the neighborhood, they would have the option to stay there for a substantial period of time.[1] This temporary change in foreclosure rules would also give lenders a strong incentive to renegotiate mortgage terms to allow homeowners to stay in their homes as owners, since few lenders will want to become landlords.

A great advantage of this proposal is that it requires no taxpayer dollars or bureaucracy (courts would need a list of appraisers who could determine market rents) and it could begin helping homeowners immediately after the legislation was approved. It also does not create any bonanzas that will be resented by those who do not benefit nor does it create any obvious opportunities for gaming. In short, this right to rent proposal gives people a break who have found themselves in a bad situation due to extraordinary circumstances. That is the most effective type of social policy.

[1] Baker, Dean (2008) "Subprime Borrowers Deserve an Own to Rent Transition," *The Economists' Voice*: Vol. 5 : Iss. 1, Article 5.

Why President Obama's Plan Will Not Work and What Will
Testimony of John D. Geanakoplos[1]

Presented to Subcommittee on Housing and Community Opportunity of House Financial Services Committee
March 19, 2009

The Two Critical Flaws in the President's Plan

The administration's plan to decrease the number of foreclosures will not work for two reasons.

First, it relies on interest reduction when what is needed, for non-prime borrowers whose homes are underwater, is principal reduction. So far 70% of all foreclosures have been from these non-prime borrowers.

Second, it wastes money by paying servicers to modify loans when servicers have perverse incentives that will remain or grow much worse under the administration's plan—incentives that will lead them to modify in a manner that will not help homeowners and will harm bondholders.

Instead of helping homeowners, the administration plan as currently constructed will enrich the servicers by tens of billions of dollars and further diminish the value of the so-called toxic assets, which are at the heart of the financial crisis that is harming the economy as a whole and costing the taxpayer billions of dollars in support for the banks and other financial institutions.

I provide a brief summary of these two critical flaws in the President's plan and then I go through each problem and provide more detail.

The Misguided Focus on Interest Reduction instead of Principal Reduction

The plan relies on interest reduction to stop the avalanche of foreclosures, but all available data shows that principal reduction is critical to stanching the enormous number of defaults yet to come. Interest reduction has been tried and has produced extremely high redefault rates. Moreover, there is a reason it does not work. For the 1 in 5 homeowners predicted in the next few years to have mortgages greater than the value of their homes, paying even reduced interest rates on a home they do not own and cannot sell, is imprudent, particularly in these hard economic times. They can save money by walking away from their negative equity and renting. For all those with non-prime loans, whose credit rating we can

[1] James Tobin, Professor of Economics, Yale University. I am also a partner in Ellington Management, LLC, a hedge fund that trades in mortgage backed securities. The views I express herein are neither those of Yale nor those of Ellington, but my own views. I note for the record that I had only two days notice to prepare this document, and many other obligations. The Committee invited me to appear last week but I was not able to confirm my appearance until two days before this hearing because my appearance required me to give notice to the University of Chicago that I would not be able to fulfill a prior obligation to present a paper there on the date the Subcommittee needed me to appear. As a consequence, I have not had enough time to proofread this document with my normal care. I apologize in advance for any typos, grammatical or other errors that I might have missed due to the pressures of time. I thank Professor Susan P. Koniak of Boston University Law School for her assistance in the preparation of this testimony.

safely assume was already impaired, there is little consequence to walking away from their underwater homes and having more money available to meet other pressing family needs.

There is an irony to all the talk about the need to make homeowners more financially literate. The more financially sophisticated a homeowner is, the more likely she is to realize that it makes little economic sense, given an already impaired credit rating, to throw good money after bad by paying reduced interest on an extended mortgage on a home that is underwater.

Servicers Will Continue to Perform Miserably: Paying them is a Waste of Money and Immunizing Them Leaves Them Even Freer than Now to Serve their Own Interests at the Expense of Both Homeowners and Bondholders

Servicers have interests that are not aligned with homeowners or bondholders. Moreover, paying them, as the Obama plan provides, will not correct this misalignment of interests. Making matters worse, immunizing servicers will just leave them freer to serve their own interests at the expense of both homeowners and bondholders.

Absent the threat of suit by bondholders, servicers would be delighted to reduce interest rates to 1% on every loan, or even to 0%. Servicers get their fees from bondholders, not from interest rates. As long as a loan is being paid according to its terms (new or old – low interest rate or high) and not defaulting, the bondholders must continue to pay fees to the servicers. An underwater homeowner facing very low interest payments is still likely to default, but later, so reducing interest rates gets the servicers more fees. Paying servicers to lower interest rates thus wastes money and postpones defaulting, but will not stop it.

When servicers temporarily reduce interest rates to serve their own interests and without reducing principal, the bondholders take the hit on the value of their bonds. Moreover that "hit" leads to no good end because temporarily reducing interest will not stop underwater homeowners from eventually redefaulting. So, servicers benefit without helping homeowners, or bondholders. And when bondholders suffer the American taxpayer now suffers--through the various interventions by the Treasury and Federal Reserve, the taxpayer is now effectively guaranteeing the value of many of those bonds in the form of the now infamous toxic assets.

Servicers have a further incentive to reduce interest. Today the biggest volume servicers have been acquired by the big banks. These banks own the lion's share of the second mortgages. By reducing interest on the first mortgages, to induce the homeowners to stay a little longer in their houses, but not changing the second mortgages, the big beneficiaries are the second mortgages, who receive their interest in full. Once again the bondholders lose, the homeowners are not helped in the long run, and the servicers (or the big banks that now owner the major servicers) reap billions of dollars.

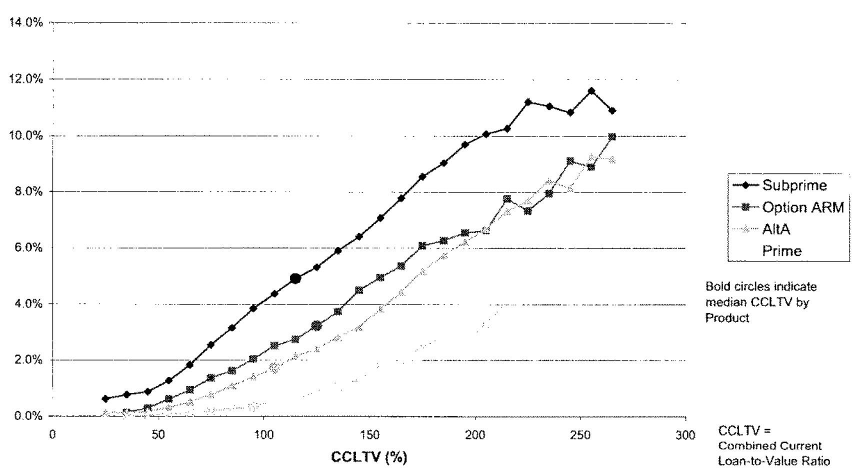
In addition, servicers have neither the staff nor resources to do modifications right; because reducing interest rates is a virtually costless gain to them, they will bank the money we pay them and not reinvest it in hiring people to do modifications right. (As we said, even with the right personnel they would not be the right agents to accomplish effective modifications—the terrible experience most homeowners have had with the servicers to date has caused most homeowners to be quite distrustful of current servicers.) The conflicts between servicers and both homeowners and bondholders are so severe and complex that no amount of tinkering with carrots and sticks will cure the problem. That is why our plan calls for replacing servicers with community banks, government hired trustees, to make the decision to modify or foreclose. [See particularly Geanakoplos and Koniak, NY Times Editorial 10/30/08 and Blind Trustee Outline for Legislation, both provided with this testimony.]

I now turn to elaborating the two major flaws I summarized above

I. Obama's Plan Concentrates on Interest Reduction and Without Principal Reduction Modifications will Fail

- o Principal Reduction is Critical to Prevent Avalanche of Foreclosures, Particularly in Non-Prime Loans that is Still Ahead of Us
  - According to Congressional Oversight Panel's 3/6/09 report to Congress
    - Over next several years 1 in 5 homeowners will have mortgages higher than the value of their homes
  - The default rates for all non-prime loans are stunningly sensitive to whether and how much equity a homeowner has.

Monthly Net Flow (Excluding Modifications)
from <60 Days to ≥60 Days Delinquent
Based on Performance from Nov 08 - Jan 09 for all Deals Issued in 2006



  - Explanation of Chart: It shows the remarkably high rate of default for underwater (CLTV > 100) per MONTH. At CLTV = 160%, every month another 8% default, while at 50% CLTV less than 1% default.

- The above chart is a product of a study done by Ellington Management, LLC.

- How CLTV (Current Loan to Value) was calculated

    - Ellington began with original LTV (loan to value) using original sale appraisals, house by house, for the whole universe of toxic mortgages. For that universe of mortgages, loan level data is typically available. It then added up **all** mortgage loans (1st lien and 2nd lien etc..) to get combined loan total. Next, it updated value of homes by taking the Case-Shiller zip code housing index and updated house values zip code by zip code to get current combined LTV (CLTV in graph above).

- How net default rates were calculated

    - Ellington looked at **monthly** net default rates through January 2009. By "net" we mean any loans once delinquent but that became current during that month were subtracted from the total number of delinquencies and modified loans were not included. So, for example, if in a single month 3% of the current pool becomes >= 60 days delinquent and 0% go from over to under 60 days delinquent, Note that, in that example, the monthly rate of 3%, ignores the, say 1% of loans that may have received modifications. Why? Because people get fooled into thinking the housing problem is getting fixed because current delinquent population is held down by modifications (see quote below from Contgressional Oversight Panel on redefaults under modification plans tried in the past—none of which has concentrated on principal reduction).

    - "For example, the Office of Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) have been jointly gathering data on redefault rates on modified loans in the servicing portfolios of fourteen national banks and federal thrifts. This data shows a high rate of redefaults on modified loans. From this the Director of OTS concluded that modification efforts cannot work. The Comptroller, however, noted that the data shows nothing more than the fact that modifications have not worked; without knowing more about the modifications themselves, we cannot conclude that modifications *cannot* work. Cheyenne Hopkins, *When Mods Fail, What Next?:*

Regulators Split on Implications of Redefaults, American Banker, at 1 (Dec. 9, 2008)" Congressional Oversight Panel, 3/6/09 report, footnote 36, at p. 18.

- The graph above (which covers all loans originated in the 2006) shows that across all mortgage types the default rate is extremely sensitivity to CLTV.

- For example, for subprime (ABX) loans, when CLTV <.60, only 1% default per month. When CLTV >1.60, 9% default per month. And the sensitivity to CLTV is dramatic for every type of loan.

- There are sound economic reasons why the default rate so closely tracks negative equity, particularly for non-prime borrowers.

  - Think of a couple with a combined income of $75,000. They took out a subprime mortgage for $280,000, but their house has depreciated to a value today of $200,000. They've been paying their mortgage each month, about $25,000 a year at a 9 percent rate including principal and interest. But the interest rate is not the problem. The real problem is that the couple no longer "own" this house in any meaningful sense of the word.

  - Selling it isn't an option; that would just leave them $80,000 in the hole. After taxes, $80,000 is one and a half years of this couple's income. And if they sacrifice one-and-a-half years of their working lives, they will still not get a penny when they sell their home.

  - This couple could rent a comparable home for $10,000 a year, less than half of their current mortgage payments — a sensible cushion to seek in these hard times. Yes, walking away from their home will further weaken their credit rating and disrupt their lives, but pouring good money after bad on a home they do not really own is costlier still.

  - President Obama's plan does nothing to change the basic economic calculation this hard-pressed family and millions of others like it must make. The Obama strategy — which involves reducing their interest rate for five years and giving them, at most, $5,000 for principal reduction over five years — will still leave them paying much more than the $10,000 it would cost them to rent.

Comment [tharshaw1]: √

- Given the hard data from all sources (see below for description of other data, which is all consistent with the chart provided above) and the economic rationale for the behavior revealed by the data, it is preposterous to contend that defaults are primarily a function of job loss or a worsening economy. Note too that the loans in the chart above originated in 2006; the loans originated in 2007 were, if anything, of poorer quality than the 2006 loans. That means that even without a worsening economy the default rates to come next year and the year thereafter may be even more severe.

- We provided these findings to the Congressional Oversight Panel, which included the chart above in its 3/6/09 report, where it appears as Chart 12.

- All the other data that the Congressional Oversight Panel was able to collect confirmed Ellington's findings that negative equity is driving default rates to alarming levels and will continue to do so

  - Chart 10 in the 3/6/09 report of the Panel, p. 27 reports data on defaults compiled by Office of the Comptroller of the Currency and the Office of Thrift Supervision. The Panel described this chart as follows:

    - "As Chart 10 shows, negative equity is the single best indicator that a property is likely to enter foreclosure for this data set." COP 3/6/09 report, p. 32.

  - Chart 11 in the 3/6/09 COP report reflects data collected by the Panel from Indy/Mac Portfolio of Loans. As the Panel notes the Indy Mac data shows that negative equity is surpassed only by negative amortization as the best predictor of default and many negative amortization loans "are likely [to have] negative equity." COP 3/6/09 report at p. 32

  - The International Monetary Fund report issued on 2/19/09 also recognizes the importance of addressing negative equity. For example, the abstract at the beginning of that report says: "[T]he key problem is a combination of negative housing equity and unaffordable debt service, and a successful loan modification scheme should address both issues." International Monetary Fund Report: Foreclosure Mitigation Efforts in the United States: Approaches and Challenges, 2/19/09, prepared by the Monetary and Capital Markets and Western Hemisphere Departments (John Kiff and Vladimir Klyuev).

- **Perverse Incentives of Servicers are Exacerbated, Not Cured by President's Plan**

  - It serves servicers' interests, but not homeowners and not bondholders, to reduce interest on every loan in danger of default.

    - Servicers are paid a percentage of principal for each house that is not defaulting. That means reducing interest costs them nothing and gains them much, at least in the short term, i.e., until the homeowner redefaults. But those gains are at the expense of bondholders, who bear the cost of interest reduction and will ultimately bear the even greater cost when these loans redefault. Those gains are also at the expense of homeowners who are encouraged to keep paying on a home they will still not end up owning—pouring good money after bad.

- The threat of redefaults down the road are not enough to dissuade servicers from reducing interest rates because in the current environment, all servicers are driven by their immediate needs (short term goals), not the long term.

    - Small servicers, i.e., those not a subsidiary of a major financial institutions, are cash strapped because they have to pay into the pool in lieu of defaulting homeowners—a huge expense that they can only recoup upon foreclosure (thus many foreclosures take place even when a good modification would yield more money for bondholders, a point we return to later) or when the loan is modified (no matter how unlikely the modification is to last over the long term).

    - The President's plan assumes they are cash strapped primarily because their fee arrangements with bondholders did not contemplate so much work to be done foreclosing and modifying and thus justifies paying servicers a fee for modifying by reducing interest rates, something servicers already have plenty of incentive to do.

    - Indeed, I have seen data showing that the most cash strapped of the small servicers are modifying (by reducing interest rates) at a rate three times that of other servicers. That is no surprise given their desperate need to conserve cash and avoid paying advances on defaulting loans.

    - The large servicers, i.e., those that are subsidiaries of the major banks, are not cash strapped, but for them too, it is all gain and little pain to reduce interest in lieu of reducing principal. The incentives of the major bank/servicers is an important part of this story, which I explain at the end of this section. Here, let it suffice to say that by reducing interest instead of principal, the big bank/servicers can avoid – in the short term-- writing down the loans in their portfolio, thus bolstering, at least temporarily, their balance sheets, while passing the costs of reducing interest on to bondholders. And they too are oriented toward the short term at the moment, a point I return to later, so that the fact that so many of the interest-reduction-modifications will ultimately redefault, and force them to write the loans down much further, is not of primary concern.

- Paying servicers to do what they would happily do for free were it not for the threat of lawsuits from the bondholders (already an insufficient threat to deter the most cash strapped servicers), while **immunizing** these conflicted agents is a recipe for disaster. This encourages quick and dirty modifications aimed at the short term that will do little good. This misalignment of interests between servicers and bondholders is the reason the contracts between bondholders and servicers restricted the number and kinds of modifications servicers could perform.

- Those contract provisions are now imposing enormous externalities on neighborhoods, homeowners and even harming bondholders from getting modifications that would maximize the money they could realize from their mortgage backed securities. But removing those restrictions and leaving the servicers (with their perverse incentives to modify to help themselves and no one else) is not the solution. It will just cause more problems. That is why we proposed getting rid of the contract provisions imposing these enormous costs on all of us, but only in conjunction with replacing the servicers with government hired trustees, community banks. (see Geanakoplos, Koniak, NY Times, Mortgage Justice is Blind, 10/30/09; and the outline for legislation to implement our plan attached to this testimony).

- Servicers have an incentive, and will continue to have an incentive under the President's plan, to foreclose even when reducing principal would yield more money for bondholders and keep homeowners in their homes. The President's plan does nothing to to change this incentive.

  - As noted above, servicers have to pay into the pool in lieu of defaulting homeowners. Servicers get to recoup that money when they foreclose. This gives servicers an incentive to foreclose as quickly as possible on everyone who does not qualify for interest reduction under the President's plan and on all those who are currently seriously delinquent, even when a principal reduction would yield more for bondholders and keep those homeowners in place, thus stabilizing neighborhoods and supporting the value of the so-called toxic assets.

  - The President's Plan only considers whether more money can be realized by a modification of a mortgage than by foreclosure for those homes that meet the rather restrictive requirements of his plan, e.g., no more than 105% under water at the time the loan is considered for the limited kinds of modifications considered legitimate under his plan.

- Whether more money can be realized from modification, including modification by principal reduction, versus foreclosure is, however, the key to an economically sensible result for homeowner, bondholder, neighborhoods and all taxpayers who have an interest in supporting the value of the bonds at the heart of the financial crisis, even if they rent and do not own a home.

- No reasonable "moral hazard" argument can be made against reducing principal for homeowners who become seriously underwater and can reasonably be expected to pay a reworked mortgage. First, the decline in housing values that causes them to go underwater is not their individual doing. Second, no homeowner can force a lender to give her a loan that is worth as much or more than the house. Finally, setting a precedent that in the face of a once in 50 years decline in general housing prices, homeowners could expect principal reductions, would not be a bad idea. That is in fact what should be done in such circumstances. And lenders should take into account that in those circumstances the government might intervene to encourage principal reductions when it improves the cash flows paid by the homeowners. If anything, that should make bondholders more likely, not less likely, to make new loans. Indeed, standardized contracts for future securities might well include or be required to include provisions for principal reductions in the event of a future cataclysmic decline in housing prices like that we are now experiencing.

- The moral hazard that we need to guard against is that of mortgage originators, bondholders and servicers. All of those players need to understand that reckless lending and reckless securitizing costs them money. That is why our plan leaves the cost of principal reduction where it should lay-- on the backs of these actors.

- On the other hand, bondholders--those who invested in the past and those we need to invest in the future in (more safely constructed) securitized loan products so that our credit markets start working again--should not be wiped out by foreclosures that make no economic sense and leave people homeless just because servicers need money or have an interest in artificially inflating their balance sheets in the short term.

- Big bank servicers have an incentive to protect second liens at the expense of first lien holders—something the President's plan encourages

    - Mortgages securitized by the private sector are a huge source of the current problem, and a primary target of the President's plan. But what the plan ignores is that those securitized mortgages are first mortgages and an enormous number of the homeowners with those first mortgages also have second liens on their property. (For example, one category of securitized mortgages were done 80/20 at origination, i.e., 80% first mortgage and 20% second mortgage. By definition, all those people are subject to 1st and 2nd liens.

- The second or junior mortgages, however, that are attached to the securitized first mortgages were generally not securitized. Where are they? They are largely being held as whole assets on the books of the major banks.

- Under the President's plan, a big bank servicer can reduce interest payments on the first without reducing the second (junior) obligations. This flips the priority of creditors on its head: allowing junior interests to collect 100% (interest and principal) while reducing the money owed senior interest holders. It is interesting, to put it mildly, that no one is discussing the "moral hazard" or perverse future consequences on markets of this reversal of creditor position, while we are bombarded daily with talk about the "dangers" of moral hazard and perverse future consequences on the mortgage market of reducing principal for stressed homeowners.

- This hidden feature of the President's program is quite consequential. First, it is hidden.

    - In the guidelines issued by the Treasury, there are only two mentions of junior liens.

    - First, junior liens are to be taken into account (along with all other homeowner debt) in calculating what the plan calls back-end dti (debt to income). Notice that in determining initial threshold eligibility for the program (front-end dti), only the first mortgage is considered, which is consistent with the idea that the loans that the plan contemplates being modified are the first mortgages alone and not the seconds.

    - But we need not guess about the plan's intent to reduce interest on 1st mortgages and not seconds, because the only other mention of junior liens, however, vague and innocent looking on its face, demonstrates that a flipping of creditor priority is contemplated. The guidelines state:

    - "To reduce the borrower's overall indebtedness and improve loan performance, additional incentives will be provided to extinguish junior liens on homes with first-lien loans that are modified under the program." Home Affordable [sic] Modification Guidelines, March 4, 2009, under the Subheading: **Second Lien Elimination Payments**

- The only sensible reading of that elusive paragraph is that the federal government intends to pay off the second lien holders, who just happen to be the major banks—institutions already the beneficiaries of taxpayer largesse with little or no conditions. I want to be clear: I am not here criticizing taxpayer support for the financial system, including the major banks, which is also not to say that I approve of the method in which the government has gone about doing that—that method is simply not the subject of my testimony today.

- What I am saying is that paying off second lien holders while leaving first mortgage holders to take a substantial hit and at the mercy of servicers whose interests are not aligned with those of the first bondholders cannot be justified as economically sound. I am also saying that burying this matter in the guidelines and alluding to vague payments-to-come to second lien holders, not identified as the major banks, as in the interest of homeowners [whose interests are not well served by this overall plan] instead of payoffs to the banks is not consistent with the transparency our government has promised and which it owes the citizens of this country.

▪ What are those 2nd liens worth? And what does the government intend to pay for them? To stabilize our economy—both Main Street and Wall Street—we need to stanch the avalanche of foreclosures that will come from the homes now (and soon to be) underwater. The way to do that is to reduce principal when a homeowner can reasonably be expected to make mortgage payments over time that would yield more money than foreclosing. But if the first mortgage holders are not going to get 100% of the principal repaid, then the second mortgage holders are entitled to nothing. Yet they have somehow managed to get much more than that. How?

  - As the Congressional Oversight Panel says in its 3/6/09 report: "Out of the money junior mortgagees will consent to subordination only if they are paid. Thus, junior mortgages pose a serious holdup for refinancings, demanding a ransom in order to permit a refinancing to proceed.". COP report 3/6/09 at 37.

o Why would the big banks and some bondholders resist writing down principal and support an interest reduction plan when that plan is bound to lead to massive redefaults down the road?

  ▪ There still remains an unanswered question: why do a few bondholders and the major banks, the holders of many securities based on mortgages bound to redefault down the road unless principal reduction is part of the modification plan, vehemently resist principal reduction? If it will make them better off in the long run, why not push for it now? This brings me to the short term time horizon of the banks that I alluded to above.

- The major banks and some bondholders still hope that the federal government will come in and buy up all their bad mortgages and the toxic assets associated with these mortgages. They understand that if that dream comes true and the government decides that such a massive bailout is necessary, the government will not buy the assets at full value, but will insist on some "haircut," reduction from full value.

- A modification plan that reduces interest, but leaves principal untouched, allows the banks to start their hoped for negotiation with the government over what the loans (and other assets are worth) with 100% of the original loan as the starting point. It also allows the banks to carry assets tied to first and 2nd mortgages on their books as if the full principal will someday be paid, no matter the data that says without principal reduction a staggering number of the modified loans will fail.

- These are banks now being put through a "stress test" by the government to determine their future capital requirements and a mortgage plan that required principal reduction and required write of offs of many 2nd liens would reveal a truer picture of the banks financial condition.

- But the banks have little interest in presenting that truer picture. We can only hope that the federal government will come to understand before it is too late that the mortgage plan it has put forth not only will not stop the hemorrhage of foreclosures but also serves to mask the true financial condition of the banks that are so central to our economic future.

- The major banks are a formidable obstacle to sensible modification efforts that includes principal reduction because they want money for their bad investments. Despite the somewhat illusory value of the 2nd liens and the long term prospect of even lower value for 1st liens and the complex securities built upon those 1st mortages, the big banks seem to be calling the tune. The major banks are playing multiple roles—as asset holders, as servicers, as essential lynch-pins to our nation's economic health. Thus, their already strong voices are magnified and drown out data and analysis that demonstrates they are leading us down the wrong path.

- To stabilize Main Street and Wall Street, we need to stanch flood of foreclosures to come from the many homeowners whose mortgages are underwater (or upside down). To do that, we have to bite the bullet and help (first mortgage) bondholders do what is in their best interests—start writing down principal---a solution which rigid contracts and diverging interests prevent bondholders from reaching on their own – a collective action problem that is imposing huge externalities on the rest of the country. The second lien holders have to get out of the way and take their losses; and the servicers (much the same group as the second lien holders) have to be replaced.

- A Plan That Will Work---The Blind Trustee Solution

On October 30, 2008, Professor Koniak and I laid out some of the problems I have detailed more fully here and laid out the broad outlines of a plan to solve the foreclosure problem in a manner that helps both homeowners and bondholders.

This testimony is long enough, so I will not rehash all the details of that plan here, but instead refer to you the October and follow-up March op-eds, which I attach, and the outline of a bill that would implement our plan, which fills in broad strokes provided in the op-eds.

In short, our plan would by legislation remove all restrictions on the number and kinds of modifications permissible in securitized mortgages and transfer the responsibility of deciding whether and how to modify a loan or whether to recommend foreclosure from the servicers to trustees, hired by the government, to do the job free from the perverse incentives of the servicers.

The only cost to the taxpayer contemplated by our plan is the cost of hiring the trustees, which we estimate at 3 to 5 billion dollars over the three years we anticipate they would have to be in place.

The trustees would be charged with modifying all loans, including reducing principal for homeowners underwater, whenever it was reasonable to expect a homeowner to be able to pay more than the home would bring in foreclosure.

The cost of the writing down of principal or other modification terms would be born by the bondholders, not the taxpayers. The problem of moral hazard for bondholders in the future would thus be addressed and taxpayer money would be saved. The servicers would be entitled to whatever payments they are entitled to under their present contracts, but would be divested of the ability to use their powers to drain cash from bondholders by recklessly reducing interest instead of principal or to harm homeowners and bondholders by foreclosing to recoup their money when reducing principal would leave a homeowner in her home and pay bondholders more than they would realize at foreclosure.

Moreover, unlike bankruptcy, our plan builds in an incentive for homeowners now current in their mortgage payments to continue paying until the trustees arrive for a modification review. We provide that anyone now current who defaults before a trustee decides on whether a modification (including reduction of principal) makes economic sense is presumed ineligible for our program unless the person can show a serious unavoidable intervening adverse economic change in circumstance, such as job loss or outsize medical expenses.

This plan would not only help homeowners; it would also help bondholders. There is room to make generous principal reductions, without hurting bondholders and without spending a dime of taxpayer money, because the bond markets expect so little out of foreclosures. Typically, a homeowner fights off eviction for 18 months, making no mortgage payments, no tax payments and no repairs. Abandoned homes are often stripped and vandalized. Foreclosure and reselling expenses are so high the subprime bond market trades now as if it expects only 25 percent back on a loan when there is a foreclosure.

The taxpayers need not and should not be responsible for making up the difference between the payments due bondholders before a loan is modified, and those due after modification. Why? Because the bondholders and the banks, the ultimate beneficiaries of homeowner monthly payments, will be better off if mortgages are modified correctly and foreclosures stopped. They will benefit from the intervention we propose; the government "owes" them nothing more than that.

In the example, we provided above of the homeowner with a $200,000 loan that is underwater, the bond market now values that loan at $70,000 because of the high probability of default and the pathetic amounts realized upon foreclosure. By adopting our program and setting out standards that would allow the bond market to anticipate a write down to $160,000 with a much high probability that the homeowner will not default because she now has equity, the bond market will value that bond somewhere much closer to $160,000 than the $70,000 it now expects.

Thank you for the opportunity to present this written testimony and the material I've attached, which is:

1. John D. Geanakoplos[2] and Susan P. Koniak,[3] Matters of Principal, NY Times, 10/30/08 Mortgage
2. John D. Geanakoplos and Susan P. Koniak, Mortgage Justice is Blind, NY Times 3/05/09
3. George M. Cohen,[4] Susan P. Koniak and John D. Geankoplos Blind Trustee Bill—revised outline
4. David A. Dana,[5] Discussion of Takings Clause of Constitution and the Blind Trustee Plan
5. David A. Dana, The Feudal Mistake
6. Biographical Information on Witness John D. Geanakoplos: brief bio summary and CV
7. The Committee's Required Truth in Testimony Disclosure Form

[2] James Tobin, Professor of Economics, Yale University
[3] Professor of Law, Boston University
[4] Brokaw Professor of Corporate Law, University of Virginia School of Law
[5] Associate Dean, Northwestern University Law School

Matters Of Principal

Sorry, but we simply have to save those who took out bad home loans.

By John D. Geanakoplos

and Susan P. Koniak

John D. Geanakoplos is a professor of economics at Yale and a partner in a hedge fund that trades in mortgage securities. Susan P. Koniak is a law professor at Boston University.

TO stanch the hemorrhage of foreclosures, we don't need another bailout. What we need is a fix — and the wisdom to see what is in our own self-interest.

An avalanche of foreclosures is coming — as many as eight million in the next several years. The plan announced by the White House will not stop foreclosures because it concentrates on reducing interest payments, not reducing principal for those who owe more than their homes are worth. The plan wastes taxpayer money and won't fix the problem.

For subprime and other non-prime loans, which account for more than half of all foreclosures, the best thing to do for the homeowners and for the bondholders is to write down principal far enough so that each homeowner will have equity in his house and thus an incentive to pay and not default again down the line. This is also best for taxpayers, who now effectively guarantee these mortgages because of the various deals we've made to support the banks

For these non-prime mortgages, there is room to make generous principal reductions, without hurting bondholders and without spending a dime of taxpayer money, because the bond markets expect so little out of foreclosures. Typically, a homeowner fights off eviction for 18 months, making no mortgage payments, no tax payments and no repairs. Abandoned homes are often stripped and vandalized. Foreclosure and reselling expenses are so high the subprime bond market trades now as if it expects only 25 percent back on a loan when there is a foreclosure.

The taxpayers need not and should not be responsible for making up the difference between the payments due bondholders before a loan is modified, and those due after modification. Why? Because the bondholders and the banks, the ultimate beneficiaries of homeowner payments, will be better off if mortgages are modified correctly and foreclosures stopped. The government "owes" them nothing more than that.

Why is writing down principal, which the Obama plan rejects, so critical to stopping foreclosures? The accompanying chart, courtesy of Ellington Management, an investment firm in Old Greenwich, Conn., tells the story.

It shows that monthly default rates for subprime mortgages and other non-prime mortgages are stunningly sensitive to whether a homeowner has an ownership stake in his home. Every month, another 8 percent of the subprime homeowners whose mortgages (first plus any others) are 160 percent of the estimated value of their houses become seriously delinquent. On the other hand, subprime homeowners whose loans are worth 60 percent of the current value of their house become delinquent at a rate of only 1 percent per month.

Despite all the job losses and economic uncertainty, almost all owners with real equity in their homes, are finding a way to pay off their loans. It is those "underwater" on their mortgages — with homes worth less than their loans — who are defaulting, but who, given equity in their homes, will find a way to pay. They are not evil or irresponsible; they are defaulting because — for anyone with an already compromised credit rating — it is the economically prudent thing to do.

Think of a couple with a combined income of $75,000. They took out a subprime mortgage for $280,000, but their house has depreciated to a value today of $200,000. They've been paying their mortgage each month, about $25,000 a year at a 9 percent rate including principal and interest. But the interest rate is not the problem. The real problem is that the couple no longer "own" this house in any meaningful sense of the word.

Selling it isn't an option; that would just leave them $80,000 in the hole. After taxes, $80,000 is one and a half years of this couple's income. And if they sacrifice one-and-a-half years of their working lives, they will still not get a penny when they sell their home.

This couple could rent a comparable home for $10,000 a year, less than half of their current mortgage payments — a sensible cushion to seek in these hard times. Yes, walking away from their home will further weaken their credit rating and disrupt their lives, but pouring good money after bad on a home they do not really own is costlier still.

President Obama's plan does nothing to change the basic economic calculation this hard-pressed family and millions of others like it must make. The Obama strategy — which involves reducing their interest rate for five years and giving them, at most, $5,000 for principal reduction over five years — will still leave them paying much more than the $10,000 it would cost to rent.

And five years later, after the Obama plan has run its course, this couple will still not "own" this house. Those who accept an interest modification under President Obama's plan are likely to realize at some point that they are essentially "renting" a home and paying more than any actual renter would. Many of those families will re-default, and see their homes foreclosed.

Bondholders today anticipate making as little as $70,000 on a foreclosed home like that in our example. But consider how much might change simply by writing down the principal from $280,000 to $160,000, 20 percent below the current appraised value of the house. The homeowner might become eligible to refinance the $160,000 loan into a government loan at 5 percent, which would be impossible on the $280,000 mortgage.

Even if the couple couldn't refinance and still had to pay the original rate of 9 percent, the payments would be reduced to $14,400 a year, considerably less than the $25,000 now owed, and no longer wildly more than renting would cost. And the couple would have $40,000 of equity in the house: a reason to continue to pay, or to spruce up the house and find a buyer. Either way, the original bondholders would have a very good chance of making $160,000, instead of the $70,000 expected now. Everybody wins.

If writing down principal is such a good idea, why aren't banks and servicers (the companies that manage the pools of mortgages that have been turned into investment vehicles) doing it now? Many banks are not marking their mortgages down to the foreclosure values the market foresees, hoping instead that we taxpayers will buy out mortgages at near their original inflated value—another government bailout. Reducing principal would force them to take an immediate markdown, but a smaller one. The servicers, meanwhile, are afraid that bondholders, their clients, will sue them if they write down principal — a real prospect because the contracts that allow servicers to modify securitized mortgages put restrictions on the kinds and number of modifications they may make.Moreover, making sound modification decisions is costly; servicers don't want to spend the money and lack the personnel to do the job.

Beyond all that, the servicers have a conflict that all but guarantees they will not modify loans to maximize bondholder value. Once a homeowner is in default, the servicer must advance that homeowner's monthly payments to the bondholders, getting repaid itself only when the house is sold or the loan is modified. So cash-strapped servicers want to foreclose prematurely or do a quick-and-dirty modification (without due diligence and thus without considering principal reduction) to get their money back fast.

Paying servicers, these conflicted agents, $1,000 per mortgage to reduce interest payments, as the Obama plan provides, is a bad use of scarce federal dollars. Last October, on this page, we proposed that Washington pass legislation that would remove the right to modify loans or decide on foreclosure from the servicers and give it to community banks hired by the government. These community organizations would have the power to modify mortgages (including reducing principal) when doing so would bring in more money than foreclosure — particularly loans that are now current but are in danger of delinquency. Those now current would be presumed ineligible if they default before the trustees arrive to modify. Our plan is simple and would require little government spending, somewhere $3 billion to $5 billion over three years, as opposed to the $75 billion or higher price tag for President Obama's plan.

We know there are some who will be outraged at the idea that their neighbors might get a break, while they — so much more responsible — get nothing. To these outraged folks we say, you would benefit too. It is not just your home values and your neighborhoods that will deteriorate if you insist that your underwater neighbors not get relief; it is your tax dollars and that of your children that will be needed to make up for the plummeting value of those toxic assets held by banks, which we taxpayers now guarantee and may soon own outright. It is your job that will be at stake when your neighbors can no longer afford to buy goods and services, causing more companies to cut jobs. So you need to act responsibly again, for your own sake and for the welfare and future prosperity of the entire nation.

Mortgage and Securities Stabilization, Recovery and Modification Program Act of 2009
Drafted by
George M. Cohen*, Susan P. Koniak‡ and John D. Geanakoplos§

Purpose of Bill: To reduce foreclosures and stabilize housing and securities prices by establishing a program for nonconforming securitized mortgages [and conforming securitized mortgages backed by Fannie Mae and Freddie Mac?] that transfers responsibility for mortgage modifications and foreclosure decisions from servicers to government-designated, community-based trustees, and removes any restrictions on those modification and foreclosure decisions found in private pooling and servicing agreements.

The bill would include the following provisions:

- Mortgages Covered by this Program: Covered mortgages include nonconforming [and conforming?] mortgages (including subprime, Alt-A, and jumbos) securitized before date of enactment of this bill.

- Transfer/Expansion of Modification/Foreclosure Decision Rights; Changes to Securitization Documents:

    - Notwithstanding any contract provision to the contrary governing any pool of securitized mortgages covered by this program, all rights to modify and make decisions on whether to foreclose on mortgages will be transferred from the designated servicer (or equivalent party) to the trustee designated by the Office of Mortgage Modification (OMM) established by this bill.

        - The authority to make modification and foreclosure decisions will be transferred away from the servicers to OMM as of the date of enactment of this bill. OMM will then transfer this authority to a designed trustee as soon as possible after the bill's enactment.

    - Once transferred, the trustees will have full power to modify mortgages and to make foreclosure decisions according to the standards discussed in this bill, notwithstanding any contract provision to the contrary governing any pool of securitized mortgages covered by this program, including (but not limited to):

        - any restrictions on the number or type or terms of modifications

        - any prerequisite to modification that mortgages be currently delinquent or

* Brokaw Professor of Corporate Law, University of Virginia
‡ Professor of Law, Boston University
§ James Tobin Professor of Economics, Yale

in default

- any need to get permission from any third party (such as a trustee or holders of mortgage-backed securities)

- any requirements that the modifications or foreclosures be done to maximize the value of a particular securitized pool of mortgages as a whole (as opposed to maximizing the value of an individual mortgage)

  - Once a mortgage is returned to the pool, notwithstanding any contract provision to the contrary governing any pool of securitized mortgages covered by this program, all servicers of such pools (or equivalent parties) must follow the directions of the trustees and OMM concerning modification and foreclosure.

  - Nothing in this act is intended to modify other rights and responsibilities of servicers of pools of securitized mortgages covered by this program, including:

    - rights to fees

    - responsibilities to collect mortgage payments from homeowners (as modified by the trustees)

    - responsibilities to distribute payments to bondholders in accordance with their contracts

    - responsibilities to carry out foreclosures (when directed by the trustees)

    - [what about the right to sell mortgages out of the pool?]

  - Except to the extent that the bondholders are bound by the decisions of the trustees concerning modifications and foreclosures and the effect of those decisions on their payment streams, nothing in this bill affects the rights of bondholders to receive payments in accordance with the securitization contracts.

- <u>Establishment and Responsibilities of Office of Mortgage Modification (OMM)</u>:

  - An Office of Mortgage Modification (OMM) will be established to oversee the program. OMM will be located in an existing agency (e.g. HUD, FDIC, Treasury, FHLBB) to save costs.

  - OMM will collect all necessary mortgage information from servicers and servicers of covered mortgages. Servicers of covered mortgages will be required to provide this information.

- OMM will keep track of which pools the covered mortgages are in but will not pass that information on to the trustees who will rework them, and will establish procedures and take all reasonable and necessary steps to make sure information does not get passed on or acquired by the trustees.

- Similarly, OMM will keep track of which mortgages are assigned to which trustees, but will not pass on that information to the servicers to whom the mortgages will eventually be returned or the holders of securities associated with those mortgages. OMM will establish procedures and take all reasonable and necessary steps to make sure information does not get passed on or acquired by the servicers or securities holders.

- OMM responsibilities will include:

  - dividing the US into appropriate regions

  - identifying community banks and credit unions and taking applications from these organizations to serve as trustees (If feasible, selection of trustees should be done through regular government contracting bidding procedures. If that would process delay program implementation too long, this bill needs to create an exception.)

  - hiring and overseeing (and, if necessary, replacing) trustees in each region who would be responsible for reworking/foreclosure decisions and will be paid by OMM.

  - establishing standards and procedures for trustee decisions

  - collecting reworking or foreclosure decisions from trustees and passing such information on to servicers for implementation of trustee decisions

  - maintaining data on the performance of trustees for purposes of monitoring.

  - auditing servicer and trustee compliance with the provisions of this act

  - collecting information from servicers about all payments made pursuant to modifications made under this plan

  - notifying trustees of all payments made by homeowners and any problems reported by servicers to OMM, such as default or delinquency for appropriate action

- OMM will have the authority to enforce the provisions of this act by appropriate action.

- Eligibility to Serve as and Responsibilities of Government Mortgage Trustees:

  - Community banks, credit unions, other similar institutions, or individuals with comparable experience in local mortgage markets will be eligible to serve as trustees.

  - Effort will be made to insure that trustees include a fair representation of minority-owned and women-owned institutions.

  - Interested institutions must submit an application that includes:

    - relevant experience

    - a staffing plan for hiring and assigning personnel

    - budget proposal

    - disclosure of any ownership of or interest in any mortgage-backed securities by the institution or its personnel (or their close relatives). Conflicts of interest would not necessarily be disqualifying but the institution would have to propose an acceptable plan for mitigating any conflict (e.g. screening).

  - Responsibilities of trustees will include

    - getting current appraisals of covered mortgage properties and maintaining documents of these appraisals

    - acquiring, securing, and maintaining sufficient documentation relevant to homeowners' ability to make sustained repayments

    - evaluating mortgage files sent to them by OMM and deciding which mortgages they should attempt to modify under the established standards

    - taking pro-active steps to locate and make in-person contact (including knocking on doors if necessary) with homeowners holding covered mortgages that the trustees determine are appropriate for modification efforts

    - making all reasonable efforts to create, negotiate, and achieve agreement on modification plans in accordance with the standards detailed in this bill

  - reporting modification, foreclosure, or no-action decisions to OMM
  - for the duration of this act, monitoring payments by homeowners pursuant to approved modification plans
  - taking prompt action upon notice from OMM to respond to delinquencies or defaults occurring under approved modification plans
  - providing homeowners contact information for designated loan officers so that homeowners can contact that person with any difficulties or change in circumstances

- Trustees must take steps to ensure that personnel and operations dedicated to the program are screened off from regular operations.
- Trustees must make their offices available for spot audits of their trustee operations by appropriate government officials.
- Trustees will be treated as independent government contractors, not government employees for purposes of other law.
- Trustee decisions concerning modification and foreclosure are not appealable by servicers or holders of mortgage-backed securities for covered mortgages.
- Trustees must take steps and establish procedures to ensure that they do not acquire any information relevant to securities (or CDS or other derivatives) connected with any covered mortgage. Trustees must report to OMM any improper information they acquire. Any attempt by servicers or securities holders to contact trustees or provide them with improper information or directly or indirectly to interfere with trustee activities will be criminally prosecuted.

• Standards for Modifications of Loans:

  - OMM will establish criteria that trustees must follow in making modification and foreclosure decisions. These criteria will include presumptions based on mortgage debt to income ratios determined by OMM.
  - The basic standard for modification will be that the expected payments from the homeowner pursuant to the modification must exceed the expected recovery from a foreclosure proceeding. The homeowner must reasonably be expected to be able to make and sustain these payments.
  - The standards will be consistent with the overall goals of keeping the homeowners in their homes to the extent possible, and, where possible, converting

nonconforming mortgages into conforming mortgages

- The standards will include a provision stating that the homeowner need not be currently delinquent or in default to qualify for a modification.

- The standards will include a requirement that homeowners must demonstrate the ability to make and sustain payments required under a modification plan.

- The standards will include a presumption that the modification will include reduction in principal when the homeowner has negative equity in the house (appraised value of the house is less than the outstanding mortgage) and holds a subprime or Alt-A.mortgage

- The standards will describe acceptable forms of modifications, including

  - reduction in interest
  - deferral of principal
  - extended time for payment
  - reduction in principal.

- The standards will include a provision that requires a trustee who finds that any loan is not in reasonable risk of defaulting to designate the mortgage as "No Action Required" and return the file to OMM for return to the pool.

- The standards will include a presumption that any mortgage that becomes delinquent between the date of enactment [introduction?] of this bill and 6 months [?] after the date of enactment will not qualify for mortgage modification. The presumption may be overcome if the homeowner demonstrates a significant change in financial circumstances during that time period (e.g. job loss, major illness).

- Trustees may propose revisions to the modification standards either generally or to be applied in specific locations. OMM must approve any changes in standards.

• Congressional and Administrative Oversight:

  - OMM will keep statistics and data and will prepare [quarterly] reports to be submitted to the GAO and Congress. These reports will include not only data supplied by the trustees, but also background data on different regions so that meaningful comparisons can be made among trustees to identify both insufficient and unjustifiable or excessive modifications or re-default rates.

- Efforts to improve performance: Within the first year of the program, the methods and structures of the best performing trustees will be assessed to develop a best practices list, to be implemented by trustees going forward.

- The GAO and Comptroller will produce quarterly reports to Congress [see TARP].

- Spot audits of OMM, trustee offices, [and servicers?] will be conducted by [FDIC?]

- Transparency: OMM will maintain a public website where all reports will be published.

- Ombudsman: OMM will designate an Ombudsman who will handle any complaints from homeowners or servicers. The Ombudsman will prepare separate reports to Congress.

- Termination of Program: The right of trustees under this program to make decisions on modification or foreclosure will terminate no later than three years after the date of enactment of this bill, unless re-authorized by Congress. [Other functions and responsibilities under the program will continue until all covered mortgages are resolved by payment in full, transfer, default and/or foreclosure, unless Congress provides otherwise by appropriate legislation.]

- Establishment of Task Force for Regulation of Future Mortgage and Other Private Securitizations:

  - A Task Force will be established to consider regulations to govern the securitizations of mortgages, with an emphasis on promoting efficient loan modification and foreclosure decisions, increasing transparency and oversight, clarifying fiduciary duties of agents of entities holding securitized assets, and preventing excessive leverage throughout the system.

  - The Task Force will also consider regulations of credit default swaps (CDS), with an emphasis on eliminating the ability to "overinsure" assets and increasing transparency and oversight.

  - [If new mortgage securitizations are created after the date of enactment of this bill and before Congress enacts new regulation, the task force/OMM should make a recommendation to Congress about whether it is advisable to expand the mortgages covered by this bill.]

- Funding for Program: [identify funding source and how money gets appropriated to

OMM for hiring of trustees.]

- Effect on Other Law [and accounting standards?]

  - Nothing in this act shall affect any previously existing tax status (i.e. REMIC) for entities holding securitized mortgages.

  - Nothing in this act is intended to affect any accounting treatment of securitized mortgages or the entities holding them (FAS 140).

  - The bill shall include any additional provisions necessary to preserve the tax and accounting treatment of securitized mortgage pools.

- Immunity:

  - Servicers of securitized pools of covered mortgages will be immune from liability only for transferring mortgages rights to OMM/trustees and accepting the modification/foreclosure decisions made by trustees under the program.

  - Servicers remain legally responsible for any actions or omissions taken before the enactment of this bill or for any actions not required by this bill.

  - Trustees will be immune from private suits in connection with decisions made in connection with the program [or immune to the extent that government contractors or other government agents are immune?]

Why the Takings Clause is not a Problem for the Blind Trustee Servicing Plan—A Quick Explanation

David Dana, Northwestern University

As Oliver Wendell Holmes explained over a century ago, government could "hardly go on" if every change in value of every property interest had to be compensated when the government implemented new regulation affecting market values.[1] Indeed, the Takings Clause guarantee of just compensation has been largely limited to intrusions on core indicia of land ownership -- notably the right to be free from permanent physical occupations. In the realm of commercial or economic regulation of personal property, as the United States Supreme Court has explained, private individuals and entities have no reasonable basis for expecting constancy in regulatory treatment. It is against that background – and not the background of cases involving zoning of land -- that a plan for mandatory transfer of mortgage servicing to blind trustees must be assessed. Moreover, even if we apply the land use cases regarding Takings to the blind trustee servicing plan ("servicing plan"), it is doubtful any investors could succeed on any Takings claims.

The starting point in any Takings Clause analysis is the identification of the relevant "property" that it is at issue. The Supreme Court has adamantly rejected "conceptual severance" – the severing of an investment into discrete elements, so as to isolate some element that has been wiped out by new government regulation. Instead, the Court has held that the economic investment as a whole must be considered in evaluating how much new government regulation has resulted in a loss in fair market value. Viewed from this vantage, the relevant property that could be affected by the servicing plan is a given investor's financial interest in a pool of mortgages. If the servicing plan were to result in an investor receiving nothing from an investment in a pool when it otherwise would have received a significant sum of money, we could characterize the plan as resulting in the elimination or cancellation of an interest in property. But the servicing plan is likely to instead result in investors sometimes receiving more from their investment in the pool, and perhaps sometimes receiving less than they otherwise would have. But investors could not establish –and under clear doctrine it would be their burden to establish – that their financial interest in a pool was "wiped out" by the servicing plan. Indeed, it seems unlikely they would be able to carry their burden of proof of quantifying any financial losses they incurred at all as a result of the servicing plan.

Even if the investors could indeed show some partial losses or reduction in the value of their property as investment in the mortgage pool, that would decidedly not mean that a Taking had occurred. Under the applicable *Penn Central Transportation v City of New York*[2] framework, partial reductions in value of a property have generally not been found compensable. In deciding whether such partial losses are compensable, key factors for the court to consider are: (1) the extent to which the character of the government regulation infringes on a traditional core aspect of property ownership, such a the right to physically exclude, (2) the property owner's "reasonable expectations", (3) the degree of "average reciprocity of advantage" – that is, the extent to which the affected property owner may benefit from as well as be burdened by the new regulation, and (4) the breadth or narrowness of the class or persons or entities affected by the new regulation, with the idea being that narrowly applied regulation warrants more concern because of the possibility of unfair discrimination against a vulnerable small minority. All of these *Penn Central* factors argue against a finding of any Taking as a result of the servicing plan. The servicing agreements underlying the pool investments generally allow for reworking of mortgages by the servicer, so investors in mortgage pools could not have any firm, reasonable expectation mortgages would not be reworked. Moreover, the residential housing market and mortgages in particular as a historical matter been the subject of intensive regulation and often massive new

[1] ***Pennsylvania Coal v. Mahon*, 260 US 393 (1922).**

[2] **438 U.S. 104 (1978).**

regulation during housing market downturns, and investors in mortgage pools reasonably would have known as much. The servicing plan does not affect at all traditional indicia of property ownership, such as the right to physically exclude. There is clear average reciprocity of advantage, because investors will benefit from the overall stabilization of the housing market and hence the economy (and may indeed benefit from some share of the mortgage restructurings). Finally this plan would apply to a broad range of property owners, and would apply "blindly," so the equal protection concerns that are expressed in the Takings Clause jurisprudence would not be implicated. Like the adoption of a more progressive tax to raise revenue to decrease a federal deficit that threatens economic stability, the servicing plan would be broad-based, public-need-driven economic regulation of the sort the courts have held is a matter best left to democratic politics and not properly the subject of claims for just compensation under the Takings Clause.

The Feudal Mistake

David A. Dana, Northwestern University Law School

In recent years, mortgages have been carved up into so many pieces that the re-working of mortgages – and the saving of homes from foreclosure - is not happening even when there are responsible homeowners who are willing and able to make reasonable payments. History provides a clear lesson as to what Congress should do about this mess. In feudal England, trade in land was burdened by a legal system that recognized a myriad of current and future interests that could lay claim to any parcel. English and American judges created and used legal doctrines to undo the excessive fragmentation of ownership interests in land. Right now, Congress should take that legal history as inspiration and enact reforms that would allow the re-working of mortgages without the consent of all the owners of the securities that are in some way "backed" by or "derived" from troubled mortgages.

From the Seventeenth Century onward, English and American law encouraged the holding of land in what is called a "fee simple" - a kind of ownership where all the interests in the land are held by a single entity that can make economically rational land use decisions (including whether to sell the land to someone else who values it more). The judges promoted unified ownership of land through aggressive means, in some cases plainly rewriting wills and contracts to remove contingent or uncertain claims on land.

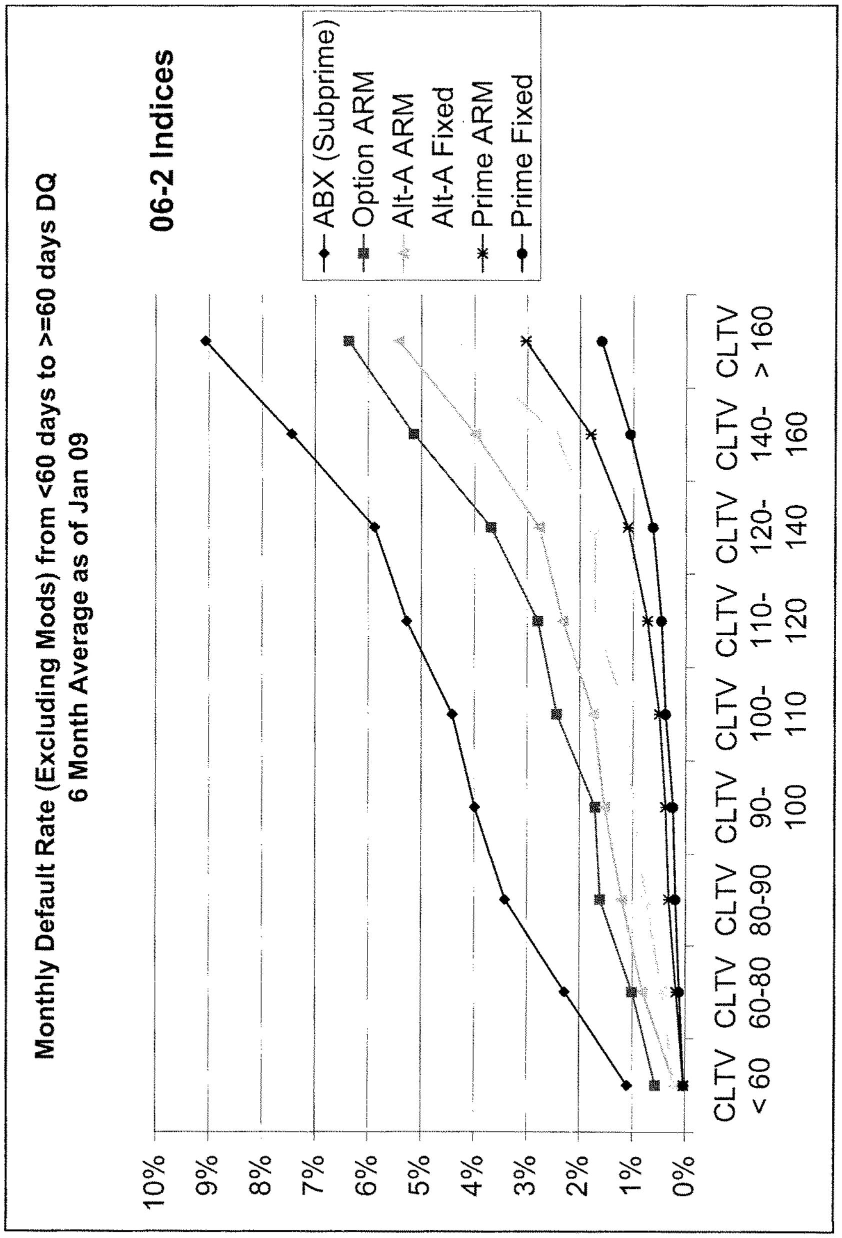
The recent developments in the mortgage-backed securities and derivatives markets prove the wisdom of the English and American judges. The structure for mortgage-backed securities that has been used in recent years makes re-working of mortgages a near impossibility. Some mortgage-backed securities holders benefit more if the mortgages do not go into default and the properties do not enter foreclosure, while others benefit more if the mortgages do go into default and the properties do enters into foreclosure. Because many mortgages are pooled in each security, hundreds or even thousands of investors may gain a tiny advantage from any single mortgage not going into default or instead going into default. Under these circumstances, it is not feasible to obtain the consent for a re-working of a mortgage from of all the investors who may have some kind of financial stake.

Congress should follow the path of post-feudal property law by eliminating any requirement that all investors in a mortgage consent to the re-working of the mortgage. Instead, government-appointed trustees should be authorized to employ the same criteria for re-working that a community bank traditionally would use when it holds a 100% stake in the mortgage. One of the criticisms of this plan to facilitate the re-working of mortgages has been that doing so may infringe upon the "property rights" of some of the investors in mortgage-backed securities and derivatives. But facilitating rational economic decisions by limiting the effects of fragmentation of ownership interests is consistent with - indeed central to -- the traditions of property law in England and America.

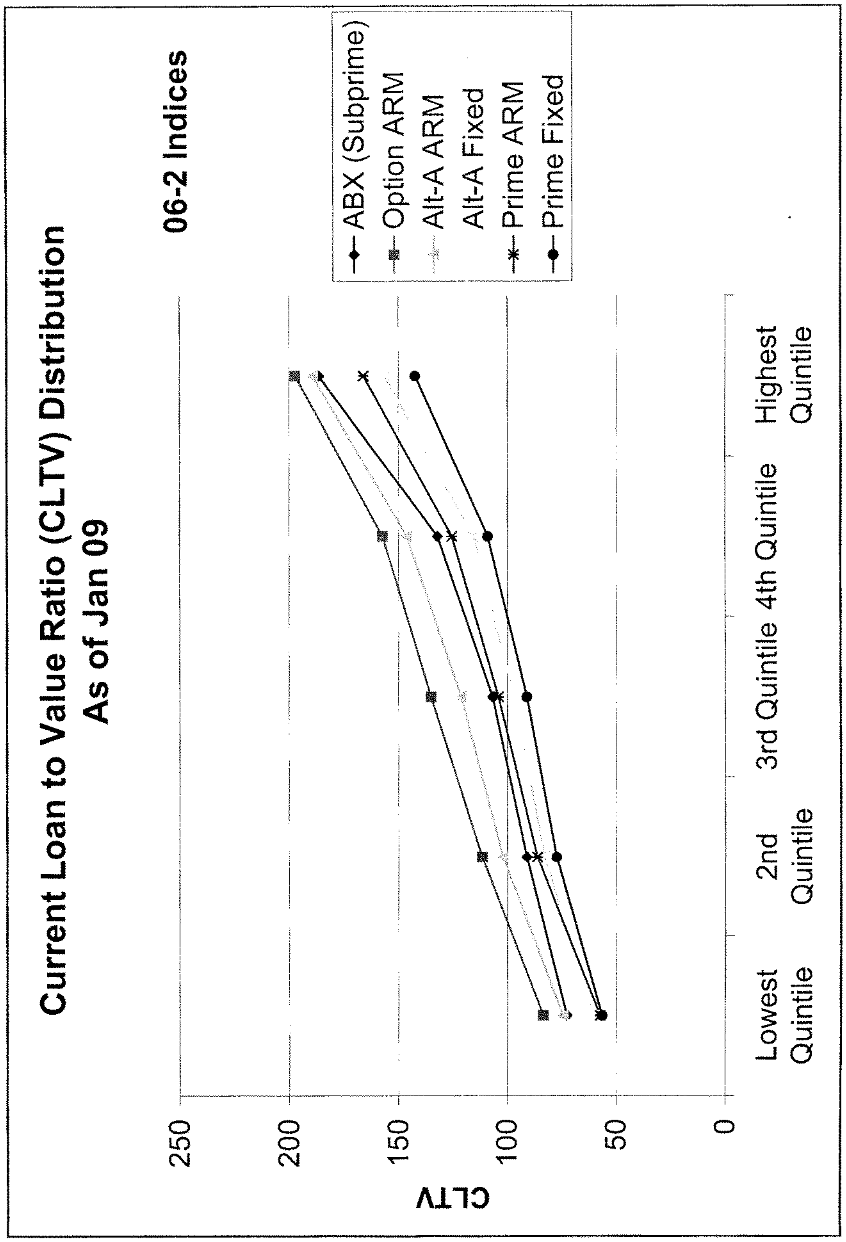
Moreover, since the New Deal, the courts have embraced the general principle that Congress can adopt economic or business regulation that modifies and limits private behavior and privileges so as to advance the public interest without triggering any government obligation to make adversely affected private parties whole.

In any case, the holders of interest in mortgage-backed securities and derivatives will not be wiped out by any government plan that facilitates the reworking of mortgages. The market in these securities is already in such disarray that the institutions that hold them have marked them down to cents on the dollar. Indeed, by placing the decision to rework or foreclose in the hands of agents capable of making economically sensible choices, the great uncertainty about the value of these securities will be eliminated, allowing trading in them to resume. Even more important, by bringing more closure and certainty to a chaotic landscape, government measures to promote mortgage reworking would stabilize the housing market.

Every major financial institution probably would benefit on net from the stabilization of the market in mortgage backed securities as well as the improvement in economic conditions more generally. As the late Justice Brennan explained, regulation that promotes what he called an "average reciprocity of advantage" is precisely what our government is supposed to aim for, and does not implicate the constitutional requirement of just compensation for the government taking of private property.



Monthly Default Rate (Excluding Mods) from <60 days to >=60 days DQ
6 Month Average as of Jan 09
06-2 Indices
10%
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
CLTV < 60
CLTV 60-80
CLTV 80-90
CLTV 90-100
CLTV 100-110
CLTV 110-120
CLTV 120-140
CLTV 140-160
CLTV > 160
ABX (Subprime)
Option ARM
Alt-A ARM
Alt-A Fixed
Prime ARM
Prime Fixed



Current Loan to Value Ratio (CLTV) Distribution
As of Jan 09
06-2 Indices
ABX (Subprime)
Option ARM
Alt-A ARM
Alt-A Fixed
Prime ARM
Prime Fixed
CLTV
250
200
150
100
50
0
Lowest Quintile
2nd Quintile
3rd Quintile
4th Quintile
Highest Quintile

Corrections to Testimony Sent to Subcommittee 3/17/09
of John D. Geanakoplos
Corrections Sent 3/18/09
Testimony to be Delivered 3/19/09

Date: 3/18/09

The first footnote of the testimony I sent you yesterday to meet your deadline noted that there might be errors because I had so little time to prepare it, two days.

I have already found two errors and one ambiguity and wanted to notify the Subcommittee of them.

Page 9, paragraph beginning: The President's plan only considers.... The example is wrong. The President's plan is restrictive, but it does not impose any maximum or minimum loan to value ratios, so, in theory, someone with a home deeply underwater (150%, for example) could qualify for the plan. The main point, however, remains the same: the plan is built on interest reduction (and loan extension), not principal reduction, which is "permitted," although the government's "pitch-in" is based on debt to income, (government contributes to get debt to income ratio from 38% to 31%) even if principal is reduced.

Page 10: Beginning with the paragraph "The second or junior" mortgages .... ." Most second liens connected to non-prime loans **were** securitized, just as first mortgages were. Nonetheless, the basic point about the second liens remains; the second lien holders and the servicers of the second liens are holding up sensible modification plans, see p. 12 of my testimony, quoting Congressional Oversight Panel.

Page 2: I point out that immunizing servicers makes matters worse. It does. But my testimony is ambiguous on the source of this potential immunity. The President's foreclosure mitigation plan does not offer servicers immunity. But immunity for servicers was considered as part of the bankruptcy bill and there are various other proposals that push immunizing servicers as a solution to the foreclosure problem. My testimony explains why immunity would make matters worse. See section on servicer incentives.

The President's plan instead of offering servicers immunity affirms the restrictions built into servicer contracts that limit their ability to modify. Those provisions, as I state, on p. 8 of my testimony were designed to control servicer self-dealing at the expense of bondholders. But, as I also point out, they are now imposing mass externalities on homeowners, neighborhoods and the general economy. That is why I advocate removing them, but simultaneously transferring the power to modify away from servicers – otherwise the servicers will be unrestricted and free to serve their own interests at the expense of both bondholders and homeowners.

Testimony of Ellen Harnick, Center for Responsible Lending
Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Program"

March 19, 2009

Good morning Chairwoman Waters, Ranking Member Capito, and members of the Subcommittee. Thank you for inviting me to testify about the current state of home mortgage foreclosures and the Administration's "Making Home Affordable Program."

I serve as Senior Policy Counsel at the Center for Responsible Lending (CRL), a nonprofit, 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, a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund. For close to thirty 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 affordable home loans. Self-Help's lending record includes a secondary market program that encourages other lenders to make sustainable loans to borrowers with credit blemishes. In total, Self-Help has provided over $5.6 billion of financing to 62,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.

Summary of Administration's program

The Administration's Making Home Affordable Program represents a significant step forward, one that is essential and long overdue. It includes concrete and pragmatic measures to counter the perverse incentives that severed the interests of servicers from those of the borrowers and investors, and led servicers to pursue foreclosure even where the homeowner could afford a loan modification that would produce greater returns for investors as a whole. The program recognizes that, without government action, relying on servicers and investors to voluntarily modify troubled loans does not work.

In particular, Making Home Affordable does the following to re-align misplaced incentives, bring relief to struggling families, and get the housing market back on track:

- It sets a standard to establish the basic requirements of a sustainable loan modification for troubled mortgages. Among other things, the modification must be set so that the homeowner's first mortgage debt-to-income ratio (DTI) is no higher than 31% based on the homeowner's documented income. This goes a long way to making sure that the loan is affordable, thus protecting both the homeowner and the investor (and the taxpayer) by lowering the risk of re-default. It incents servicers and investors to meet this standard by sharing the cost with investors to move the borrower from a 38% DTI to a more affordable 31% ratio.

Servicers get a $1,000 up-front payment for each qualifying loan modification. An additional "pay for success" fee rewards homeowners for five years that the loan remains current and servicers for three years that the loan avoids default. Investors also get payments to compensate them for property value declines. These incentives will both encourage sustainable loan modifications and compensate servicers for the costs entailed.

- The program encourages lenders and servicers to work with at risk borrowers *before* they default, by providing bonus payments to both the investor and the servicer for modifying loans where default is imminent while the borrower is still current.

- The program also provides mechanisms for transparency and audits to ensure that modifications and refinances, another important part of the program, are implemented properly.

- Finally, the program calls on Congress to permit courts to implement an economically rational loan modification where the servicer or lender cannot or will not do so. The Bankruptcy Code has long empowered courts to perform this function for all manner of debt, including mortgages on commercial real estate, investor properties and vacation homes, but currently excludes the mortgage on the primary residence alone. We applaud the House of Representative for passing H.R.1106, the Helping Families Save Their Homes Act of 2009, to accomplish this objective. This legislation is an important component of the program and is necessary to any effort to meaningfully arrest the flood of foreclosures that have so impaired the housing and financial markets and the real economy.

Over two years ago, CRL forecast that 2.2 million families with subprime loans would lose their home to foreclosure.[1] Since that time, industry's response has been consistently behind the curve.[2] We are approaching the second anniversary of the Homeownership Preservation Summit at which the nation's largest lenders and loan servicers got together "to ensure that all that can be done on behalf of borrowers facing foreclosure is being done."[3] However, only a tiny proportion of troubled homeowners were offered any form of modification at all, and the number of modifications that actually *reduced* the homeowner's monthly payment was miniscule.

All the while, more and more families have fallen from the middle class into economic catastrophe. As we sit here today, every 13 seconds another home falls into foreclosure, to the tune of 6,600 new foreclosures every day, for a total of over 2 million new foreclosures this year alone, according to Credit Suisse projections.[4] It is now universally recognized that these foreclosures spread misery, far beyond the people immediately affected, to the economy as a whole, and that unless a substantial proportion of these foreclosures are prevented, our economic crisis will deepen and spread.

In this testimony I make the following points:

- The Program is strong. The Making Home Affordable Program is a comprehensive, well-thought-out and targeted plan with important tools for breaking through some of the main barriers precluding meaningful loan modifications on a scale sufficient to stabilize the housing sector of the economy.

- Evaluation will be key. The success of the program will ultimately depend upon investors' and loan servicers' willingness and capacity to participate and to modify qualifying loans with the diligence and speed that the times require. With foreclosures progressing at the rate of almost 200,000 each month, we do not have time to lose. Servicer and investor performance under the program must be closely monitored so that the program can be adjusted, or additional measures can be taken, if modifications do not occur at a rate appropriate to the scale and speed of the crisis. Take-up rates should be monitored to identify barriers to successful participation, such as the presence of second mortgages. Re-default rates should be similarly monitored to ensure that the program's prioritization of loan modification tools is effective. Unduly high redefaults could militate in favor of including principal write-downs as a required element of a qualifying modification.

- Consumer protection compliance is important. Treasury will need to carefully monitor lender and servicer compliance with the program's consumer protection rules and generally ensure that no abuses, such as requiring homeowners to waive existing rights, find their way into the process. Treasury should maintain an adequately staffed and well publicized hotline that consumers can use to report concerns.

- Public loan-level reporting will be important. Treasury should also require participating lenders and servicers to provide loan-level detail on the terms of the modifications they offer, both within the plan and outside it, as well as on outcomes for homeowners rejected for modification. This data should enable Treasury to measure servicer participation, evaluate success of modifications, identify areas for improvement, account for government obligations, provide a basis for informing state and local policymakers of mortgage-related trends in their jurisdiction, and ensure compliance with fair lending and other consumer protection laws. To build confidence in the program, Treasury should publicly disclose participation, modification, and success rates by servicer and also should make loan-level data available to independent researchers under common-sense protocols.

- The program's plan to deal with second liens is crucial. The program plans to address the ongoing problem posed by second mortgages. We look forward to the release of Treasury's schedule of the payments it will make to buy off second mortgages at a steep discount to their face value. While many of these mortgages are virtually worthless, it is necessary to offer second lien-holders some incentive to cooperate in the modification of the first mortgage.

- Judicial modification is an essential part of the Administration plan. We commend the House for passing H.R. 1106, the Helping Families Save Their Homes Act of 2009, and hope the Senate will quickly follow suit. By providing an alternative to foreclosure for homeowners whose servicers or lenders will not or cannot agree to economically rational modifications, the court-supervised loan modification provision will both provide an important last resort for homeowners with no other option, and increase the incentives for timely participation by servicers and lenders. The provision also would supplement the "servicer safe-harbor" provision of the bill by providing "cover" for servicers, as investors could not recover damages for a modification that recovers at least as much as a court would order in bankruptcy.

- The House should exempt principal forgiveness from taxation. We must not allow arbitrary tax rules to undermine the success of loan modifications. As it stands today, when a lender forgives part of a mortgage debt, some homeowners are required to pay taxes on the forgiven amount, while others are exempt. Specifically, mortgage debt forgiven on loans used for refinances, debt consolidation or relatively minor home repairs do not qualify for the exemption from taxes. This restriction is ironic, given that so much of the current foreclosure crisis was driving by refinancing and push-marketing that urged homeowners to take out mortgages for credit consolidation or home repairs. Loan modifications that come with a significant tax burden are likely to sabotage homeowners who are already struggling—meaning that all the time and expense invested in modifying the loan will be wasted. We therefore urge Congress to simplify the existing tax rules and to eliminate adverse tax consequence for all mortgage debt that is forgiven.

I. Background

A. Today's mortgage market.

While statistics seem almost unnecessary to illustrate what everyone here knows, every part of the mortgage origination system is in deep trouble. Overall mortgage activity has plummeted. For 2008, residential loan production cratered: $1.61 trillion compared to $2.65 trillion in 2007, and industry projections suggest that 2009 production will total just $1.09 trillion.[5]

Furthermore, originations of subprime, Alt A, and other non-prime mortgages all but stopped in 2008. Only an estimated $64.0 billion in such mortgages was originated last year, according to an analysis by Inside B&C Lending.[6] At its high point in 2006, nonprime lending constituted 33.6% of all mortgage production. By the fourth quarter of 2008, it had fallen to 2.8%.[7] These loans are not being originated in large part due to the collapse of the secondary market for these mortgages, which was driving the demand and facilitating the production, and analysts predict that 2009 will see "little or no non-agency securitization."[8] Tens of thousands of mortgage brokers have lost their jobs, and more are positioned to lose their jobs as lenders stop using independent brokers, mortgage insurers place additional restrictions on loans originated by brokers, and banks increase net worth requirements on third-party lenders.[9]

On the demand side as well, every major indicator is down. Between 2006 and 2008, existing home sales dropped 24 percent,[10] while new home sales and new construction starts plummeted by 54 and 58 percent, respectively.[11] In February, mortgage applications for the purchase of homes hit their lowest levels since April 1998.[12]

Our most recent report on subprime mortgages shows that over 1.5 million homes have already been lost to foreclosure, and another two million families with subprime loans are currently delinquent and in danger of losing their homes in the near future.[13] New projections of foreclosures on all types of mortgages during the next five years estimate 13 million defaults from 2008Q4 until 2014, across all segments of the market, from subprime to prime.[14] Right now, more than one in ten homeowners is facing mortgage trouble.[15] Nearly one in five homes is underwater.[16]

The flood of foreclosures we see today goes beyond the typical foreclosures of years past, which were precipitated by catastrophic and unforeseen events such as job loss, divorce, illness or death. The current crisis originated in losses triggered by the unsustainability of the mortgage itself, even without any changes in the families' situation, and even where the family qualified for, but was not offered, a loan that would have been sustainable.

The most common subprime loan marketed during the past four years is a highly risky loan called a hybrid adjustable-rate mortgage (ARM), often known as a 2/28 or 3/27 because the interest rate is fixed for either 2 or 3 years, and then the is adjustable, typically every six months, for the balance of the 30 year term. The three particularly tricky aspects of this loan are: first, that the rate jumps up, often sharply, at the end of the initial period, and often without regard to whether interest rates in the economy stay the same or even decline; second, lenders typically made these loans fully understanding that the borrower could not afford the rate increase, and would have to refinance before the rate reset; and third, refinancing before reset entails the payment of a steep "prepayment" penalty – typically equaling three to four percent of the loan balance.[17]

Sadly, many of the borrowers who are losing their homes to foreclosure qualified for better loans that they would be sustaining today. An investigation 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."[18] And even those borrowers who did not qualify for prime loans could have received sustainable, thirty-year fixed-rate loans, for at most half a percentage point to eight-tenth of a percentage point above the initial rate on the unsustainable exploding ARM loans they were given.[19] Had these borrowers received the sustainable loans they qualified for, we would not be facing the foreclosure crisis we are in today.

Unfortunately, the failure to protect borrowers from needlessly risky and unsustainable loans was followed by the failure to head off the crisis by implementing decisive measures to avert preventable foreclosures. We missed the opportunity to mitigate the crisis before its spillover effects reached neighboring homes, communities, and the housing and financial system itself. As a consequence, a crisis that started in the subprime market has now spread to the "Alt A" and prime markets as well.

The spillover costs of the foreclosure crisis are massive. Tens of millions of homes – households where, for the most part, the owners have paid their mortgages on time every month – are suffering a decrease in their property values that amounts to hundreds of billions of dollars in losses.[20] These losses, in turn, cost states and localities enormous sums of money in lost tax revenue and increased costs for fire, police, and other services. As property values decline further, the cycle of reduced demand and reduced mortgage origination continues to spiral downward.

B. A brief explanation of the recent meltdown.

A misalignment of incentives lies at the heart of today's mortgage meltdown.[21] Back in the days when families went to their local savings and loan to get a mortgage and the thrift held that loan among its own investments, the interests of borrowers and lenders were perfectly aligned: if the borrower did not pay the mortgage, the lender did not make money. But the proliferation of independent brokers and the growth of the secondary market upset that core alignment of interests between lender and borrower by creating a system where each actor was compensated early in the loan transaction, often within the first month of the loan term, thereby reducing or even eliminating the incentive to worry about how the borrower would fare later on.[22]

At the height of the housing bubble, independent mortgage brokers originated the vast majority of subprime loans, receiving their compensation from lenders immediately upon brokering the loan. Those lenders then sold the loan into the secondary market within weeks, where it was bundled together with other mortgages and sliced and diced into mortgage-backed securities (MBS). The facilitators of this process – the investment bankers, lawyers, and ratings agencies involved – were all paid their fees regardless of the performance of the MBS. Those securities were then sold to investors. At the same time, even more derivative products were layered on top of them, with credit default swaps at the top of the pyramid – what Warren Buffet identified as early as six years ago as "financial weapons of mass destruction."[23]

Stabilizing the housing sector requires effective measures to avoid unnecessary foreclosures – meaning those foreclosures resulting from the homeowner's inability to afford the current monthly loan payments, where the homeowner is willing and able to remain in the home if the loan is modified on an economically rational basis to make it affordable to the homeowner, and financially at least as beneficial to the investors as a foreclosure sale.

II. Current voluntary modification efforts have failed to stem the tide of foreclosures due to structural and legal barriers and distorted incentives.

A. The limits of voluntary modification efforts to date.

Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, voluntary efforts undertaken thus far by lenders, servicers and investors have not yet been sufficient to stem the tide of foreclosures. Moreover, servicers still face significant obstacles in making modifications.

Seriously delinquent loans are at a record high for both subprime and prime loans.[24] All available data consistently indicate that continuing foreclosures far outpace total loss mitigation efforts and that only a small share of loss mitigation efforts result in true loan modifications that are likely to result in sustainable loans.

In October, Credit Suisse reported that only 3.5 percent of delinquent subprime loans received modifications in August 2008.[25] Similarly, the most recent report from the State Foreclosure Prevention Working Group of Attorneys General and Banking Commissioners, which covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans, confirms that progress in stopping foreclosures is "profoundly disappointing."[26] Their data indicate that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report.[27] Even the homeowners who receive some kind of loss mitigation are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.[28]

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners and financial institutions in an even worse economic position than when they started. According to an analysis by Valparaiso Professor of Law Alan White, a national expert on foreclosure policy, of more than 3.5 million subprime and alt-A mortgages (all securitized), only 35% of modifications in the November 2008 report reduced monthly payments below the initial payment, while 20% left the payment the same and 45% increased the monthly payment.[29] Similarly, data through September 2008 indicate that the large majority of HOPE NOW efforts rely on repayment plans,[30] which typically require financially burdened households to add previously unpaid debt to their current mortgage payments.

In view of the foregoing, the recent report by the Office of the Comptroller of the Currency (OCC) regarding high loan modification redefault rates is unsurprising.[31] This report demonstrates is what we already suspected, which is that the modifications being made are not sustainable, affordable modifications. It is only common sense to predict that if a homeowner in default is given a higher rather than a lower monthly payment, there is a high probability of redefault.

In fact, other studies tracking the results obtained by different types of modifications show that certain types of modifications are much more successful than other types. According to a recent Lehman Brothers analysis, rate reduction modifications result in a more significant improvement in performance than principal and interest capitalizations that add past-due amounts onto the balance of the loan.[32] Credit Suisse reports that when interest rates or principal are reduced, the re-default rate is less than half of those for these other modifications.[33] In a January 13 paper, Goldman Sachs concluded, "Principal writedowns are always more effective in reducing default rates than note rate reductions."[34] And the OCC report suggests that modifications of mortgages held by a lender, rather than ones pooled into a mortgage-backed security, have been defaulting at lower rates, which further supports the notion that sustainable modifications can be made if obstacles to doing so can be overcome.[35]

B. Obstacles to modifications.

A recent Federal Reserve Staff Working Paper identifies a number of obstacles that limit the scale of modifications.[36] These obstacles help explain why voluntary loss mitigation has not kept up with demand.

- *Servicer Incentives:* The way servicers are compensated by lenders creates a market-distorting bias for moving forward with foreclosure rather than engaging in foreclosure prevention. Servicers are often not paid for modifications, but are reimbursed for foreclosure costs.[37] The Federal Reserve concludes, "Loan loss mitigation is labor intensive and thus raises servicing costs, which in turn make it more likely that a servicer would forego loss mitigation and pursue foreclosure even if the investor would be better off if foreclosure were avoided."[38]

- *Limited Servicer Staff and Technology:* With few but welcome recent exceptions, servicers have continued to process loan modifications through a labor-intensive, case-by-case review. While they have added staff and enhanced systems, the lack of transparent, standardized formulas has limited the number of modifications that have been produced.[39] Even when a servicer has a uniform methodology, the lack of transparency in the inputs to its net present value analysis, such as its selection of an appropriate discount rate, prevents borrowers and the public from properly evaluating modification decisions.

- *Second Liens:* Additional liens on a property pose a structural obstacle that is often impossible for servicers of the first lien to overcome. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,[40] and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, "it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications," thereby dooming the effort.[41]

- *Investor and PSA Concerns:* Servicers may shy away from modifications for fear of investor lawsuits.[42] While some Pooling and Servicing Agreements (PSAs)

> provide adequate authority to modify loans, these modifications may cause disproportionate harm to certain tranches of securities over other classes. Other PSAs include serious impediments to modifying securitized loans. For example, some limit the number or percentage of loans in a pool that can be modified.[43] Some impose modification costs on the servicers.

These obstacles must be addressed for any voluntary loan modification program to succeed.

III. The Making Home Affordable Program is a great improvement over earlier efforts to encourage loan modifications.

The Administration's program reflects the lessons learned from the failure of voluntary loan modification programs to meet the demands of the crisis to date. First, the program sets ground rules to specify what qualifies as an acceptable modification under the program. "Modifications" that just capitalize arrearages or increase monthly payments will not count.

Second, the program goes a long way toward addressing the obstacles posed by misaligned servicer incentives. The program will pay servicers $1,000 for each qualifying loan modification, plus an additional $1,000 per year for each year (up to three) that the modification is successfully sustained. And it will pay servicers an additional $500 for qualifying modifications made while the homeowner is at risk of default, but has not yet defaulted.[44] These payments should exceed the actual cost of the modification, turning Making Home Affordable modifications a profit center for the servicer. It is reasonable to hope that this will enable servicers to hire and train staff and invest in other infrastructure necessary to meet the demand.

So far, servicers have expressed support for the program, and the Chairman of the Mortgage Bankers Association, whose members include the major servicers, has expressed the view that servicers will participate.[45]

The program also provides for payments to investors of $1,500 per qualifying loan modification made before the at-risk homeowner has defaulted. This may prove helpful to servicers in addressing some investor concerns. The enactment of HR 1106 should go a long way toward addressing servicer concerns about lawsuits by investors. The bill's "safe harbor" provision shields servicers from liability for loan modifications for failing mortgages where the servicer reasonably believes that the principal recovery under the modification has a net present value that will exceed the principal to be recovered through foreclosure.[46] The bill's court-supervised loan modification provisions will render worthless any claim for damages against a servicer for a voluntary modification of a failing loan that yields more for investors than could be obtained in bankruptcy or foreclosure. We commend the House of Representatives for passing this bill, and its prompt enactment by the Senate is for these reasons important to ensuring the program's effectiveness.

Finally, while the details have yet to be made public, the program proposes to provide a schedule of payments for second-mortgage-holders to incent them to relinquish their claims. We look forward to Treasury's implementation of these second mortgage buyouts. The payments will be at a steep discount to face value, as these mortgages are frequently virtually worthless. But they are necessary to break through the barriers that the holders of these notes have imposed.

All of this depends, of course, on servicers' willingness to participate, and the promptness with which they modify loans under the program. This will have to be carefully monitored so that the program can be fine-tuned or supplemented by stronger measures as appropriate.

IV. Suggested steps to maximize the program's effectiveness.

A. Transparency.

Treasury should require participating lenders and servicers to provide loan-level detail on the terms of the modifications they offer, both within the program and modifications made by participating servicers outside the program. Participating servicers should be required to report on the outcomes for homeowners rejected for modification under the program. This data should enable Treasury to measure servicer participation, evaluate success of modifications, identify areas for improvement, account for government obligations, provide a basis for informing state and local policymakers of mortgage-related trends in their jurisdiction, and ensure compliance with fair lending and other consumer protection laws.

Transparency and openness with the public are essential. Treasury should publicly disclose participation, modification, and success rates by servicer and also should make loan-level data available to independent researchers under common-sense protocols.

B. Monitoring.

The success of the program will turn on: (1) the extent of servicer and lender participation; (2) the speed with which they modify loans under the program, (3) compliance with consumer protection standards – both by complying with limits expressly articulated in the program rules, and by not gaming the system to unfair advantage, such as by billing excessively large amounts for those fees that have not been prohibited – and complying with fair lending norms; and (4) the sustainability of modifications under the program.

Treasury will need to closely monitor the program with these four concerns in mind, and be prepared to intervene early to correct any problems that appear, or make adjustments to enhance effectiveness and fairness. Treasury and Congress should be prepared to act quickly to provide any additional mechanisms needed in the event that voluntary participation by servicers and lenders falls short of the substantial participation needed to stabilize the housing sector. They should be prepared also to take further measures to prioritize reductions in loan balances should other modification tools prove insufficient to generate modifications that are sustainable.

C. Tax Fix.

Finally, even the most carefully structured loan modifications can be seriously undermined if struggling homeowners must treat the forgiven mortgage debt as taxable income. Congress has already recognized this problem, and partially addressed the issue by passing the Mortgage Forgiveness Debt Relief Act of 2007, which was intended to prevent adverse tax consequences for homeowners.

Unfortunately, because of the way that legislation was written, many homeowners are not covered by the Mortgage Forgiveness Debt Relief Act. That legislation defined "qualified mortgage debt" to include only that debt that was used to purchase a home or make major home improvements. In calculating the tax, any unqualified debt is first subtracted in its entirety from the amount of forgiven debt (not on a pro rate basis). In many cases, the amount of unqualified debt will equal or exceed the amount of debt forgiven, leaving the homeowner to pay tax on the entire forgiven debt—and even in those cases where the amount forgiven exceeds the amount of unqualified debt, the homeowner will still owe a large tax bill.

The fact is, a large majority of homeowners in trouble have at least some "unqualified" debt, because so much of the current foreclosure crisis was driven by refinancing rather than initial home purchase and because predatory mortgages were push-marketed to people encouraging them to use the new loan for home repair or credit consolidation. More than half of all subprime mortgages were refinances.

What's more, expanding the definition will make it easier for everyone, even those homeowners already fully covered by the Mortgage Forgiveness Debt Relief Act, to take advantage of this exclusion. To take advantage of the mortgage debt exclusion, a homeowner now has to file a long-form 1040, along with a Form 982, a very complicated and difficult form. Unfortunately, most lower and middle income taxpayers are not accustomed to using these forms, and taxpayers filing long-form 1040s are not eligible to use the various tax clinics offered by the IRS and others for lower-income taxpayers.[47] If the definition of qualified mortgage debt is expanded as described above, the IRS can take steps through its tax forms to simplify the process for taxpayers claiming the mortgage debt exclusion.

Because one in six homeowners with mortgages is underwater, it is clear that the tax consequences of forgiveness in the context of short sales and principal write-downs from modifications will become an increasingly significant problem.[48] Significantly, solving this tax problem has been flagged as a priority by the IRS's Office of the National Taxpayer Advocate.[49]

Conclusion

There is no single solution to the challenges facing us today, but the Making Home Affordable Program is a significant step forward that has the potential to meaningfully mitigate the foreclosure crisis. Careful monitoring will be necessary so that any needed changes to the program can be identified and implemented promptly so that the crisis does not deepen. We hope the Senate will quickly pass the Helping Families Save Their Homes Act of 2009 to amend the Bankruptcy Code to enable judges to accomplish economically rational and sustainable modifications as called for by the program, and implement a "safe harbor" for services. We also urge Congress to fix the gap in the Internal Revenue Code that can undermine the most effective loan modification tool available.

---

[1] Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, "Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners," Center for Responsible Lending (Dec. 2006), available at, http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.

[2] For example, as late as 2007, the Mortgage Bankers Association continued to assert that subprime foreclosures would not damage the broader economy. In May 2007, the Association's then-Chairman John Robbins asserted: "As we can clearly see, this is not a macro-economic event. No seismic financial occurrence is about to overwhelm the U.S. economy." (Statement of John M. Robbins, CMB, Chairman, Mortgage Bankers Association at the National Press Club's Newsmakers Lunch, Washington, DC (May 22, 2007)).

[3] John M. Robbins, Chairman, Mortgage Bankers Association, Homeownership Preservation Summit, *available at* http://dodd.senate.gov/index.php?q=node/3870.

[4] Credit Suisse Fixed Income Research, "Foreclosure Update: Over 8 million Foreclosures Expected," (Dec. 4, 2008) at 3, *available at* www.credit-suisse.com/researchanalytics.

[5] *National Mortgage News* (March 9, 2009).

[6] *Inside B&C Lending* (February 27, 2009).

[7] Id.

[8] *Inside Mortgage Finance MBS Database.*

[9] *National Mortgage News* (March 9, 2009).

[10] National Association of Realtors, http://www.realtor.org/research/research/ehsdata.

[11] US Census Bureau, http://www.census.gov/const/quarterly_sales.pdf and http://www.census.gov/const/www/quarterly_starts_completions.pdf.

[12] Based on the Mortgage Bankers Association's Weekly Mortgage Applications Survey for the week ending February 27, 2009. The four-week moving average for the seasonally adjusted Purchase Index reached its lowest level since April 1998. *See* www.mortgagebankers.org/NewsandMedia/PressCenter/67976.htm.

[13] Center for Responsible Lending, *Continued Decay and Shaky Repairs: The State of Subprime Loans Today*, p.2 (Jan. 8, 2009) [hereinafter "*Continued Decay*"], *available at*

http://www.responsiblelending.org/issues/mortgage/research/continued-decay-and-shaky-repairs-the-state-of-subprime-loans-today.html.

[14] Goldman Sachs Global ECS Research, Home Prices and Credit Losses: Projections and Policy Options (Jan. 13, 2009), p. 16; *see also* Credit Suisse Fixed Income Research, Foreclosure Update: Over 8 Million Foreclosures Expected, p.1 (Dec. 4, 2008).

[15] Mortgage Bankers Association National Delinquency Study (March 5, 2009).

[16] First American Core Logic (March 4, 2009).

17 Additionally, subprime lenders generally did not escrow for taxes and insurance as prime lenders do, which left many families reeling when those bills came due. This practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs. A study by the Home Ownership Preservation Initiative in Chicago found that for as many as one in seven low-income borrowers facing difficulty in managing their mortgage payments, the lack of escrow of tax and insurance payments were a contributing factor. Partnership Lessons and Results: Three Year Final Report, p. 31 Home Ownership Preservation Initiative, (July 17, 2006) at www.nhschicago.org/downloads/82HOPI3YearReport_Jul17-06.pdf.

18 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).

19 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.

20 Continued Decay, p. 3.

[21] For a much longer discussion of the roots of today's crisis, see Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008), *available at* http://www.responsiblelending.org/pdfs/senate-testimony-10-16-08-hearing-stein-final.pdf [hereinafter "Stein Testimony October 2008].

[22] Chairman Bernanke makes this point in a recent presentation: "Housing, Housing Finance, and Monetary Policy," remarks by Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System at the Federal Reserve Bank of Kansas City's Economic Symposium – Jackson, Hole, Wyoming (August 31, 2007), pp. 16 – 17.

[23] Berkshire Hathaway Annual Report (2002).

[24] *See* HOPE NOW Data for all periods, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf.

[25] Credit Suisse Fixed Income Research, *Subprime Loan Modifications Update*, October 1, 2008, p.2, *available at* http://www.credit-suisse.com/researchandanalytics [hereinafter "Credit Suisse Update"].

[26] State Foreclosure Prevention Working Group, *Analysis of Subprime Servicing Performance*, Sept. 2008, at 2, *available at* http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachment1.pdf.

[27] Id. at 6.

[28] Id. at 7-9.

[29] Alan White, *Deleveraging American Homeowners: December 18, 2008 Update to August 2008 Report*, Valparaiso University School of Law (December 2008), p.2.

[30] *HOPE NOW Loss Mitigation National Data July 07 to September 08*, p.9 HOPE NOW Alliance (October 2008) *available at* http://www.hopenow.com/upload/data/files/HOPE%20NOW%20Loss%20Mitigation%20National%20Data%20July%2007%20to%20September%2008.pdf.

[31] *See* OCC and OTS Mortgage Metrics Report (Third Quarter 2008), *available at* http://occ.gov/ftp/release/2008-150a.pdf [hereinafter "OCC Report"]. One of the many concerns about this report is that meaningful, sustainable loan modification efforts did not become active until the third and fourth quarters of 2008, long after the OCC's data was collected, including the streamlined modification programs being used by the FDIC for IndyMac Federal Bank and by Fannie Mae and Freddie Mac.

[32] Lehman Bros. U.S. Securitized Products Fixed Income Research, *The Loan Modification Story So Far* (Sept. 11, 2008), p. 2.

[33] Credit Suisse Update, p.1.

[34] *Home Prices and Credit Losses,* p. 19.

[35] OCC Report, pp. 5-6. We hope that the OCC will release disaggregated data, which we anticipate would show that when modifications reduce monthly payments and are made in accordance with the homeowner's ability to pay, these modifications are much less likely to redefault than modifications that do not reduce or even raise monthly payments.

[36] Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang and Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities*, (Federal Reserve Staff Working Paper, Finance and Economics Discussion Series, 2008-46) [hereinafter *Myths and Realities*].

[37] *See* Testimony of Stein Testimony October 2008 at fn 30.

[38] *Myths and Realities*, p 15.

[39] Id. at 3, 9, 23.

[40] Credit Suisse, *Mortgage Liquidity du Jour: Underestimated No More*, March 12, 2007 at 5.

[41] Credit Suisse Update, p. 8.

[42] *See* Bajaj, Vikas and Meier, Barry, *Some Hedge Funds Argue Against Proposals to Modify Mortgages*, New York Times, October 23, 2008.

[43] *See* Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Apr. 5, 2007 (noting specific examples of PSAs with various modification restrictions, including 5% by balance, 5% by loan count, limits on frequency, and limits on interest rate).

[44] The refinance portion of the program also reflects the Administration's recognition that it is important to help borrowers take advantage of historically low interest rates who would otherwise be shut out of the refinance market due to property price declines. Thus, the program's refinance provisions permit borrowers whose loans are held or guaranteed by Fannie Mae and Freddie Mac, who have current loan to values over 80% and less than 105%, to refinance. This will help qualifying borrowers to stabilize their finances, reduce the possibility that they will default in the future, and stimulate the economy b/c of hundreds of dollars of savings per year. We believe that the Administration should investigate the possibility of increasing the eligible loan to value to 125% to help borrowers more severely underwater,

and therefore more at risk of default, although we recognize that there are issues related to securitization to be considered and worked out.

[45] See statements of Mortgage Bankers Association President and CEO John Courson, NewsHour with Jim Lehrer, "Public, Bankers, Analysts Debate Merits of Obama's Foreclosure," (Feb. 19, 2009), *available at* http://www.pbs.org/newshour/bb/business/jan-june09/foreclosures_02-19.html

[46] Helping Families Save Their Homes Act of 2009, sec. 201.

[47] Apparently comparatively few Form 982s were filed for the 2007 tax year, which suggests that there is already widespread failure either to take advantage of the exception or to pay the COD tax owed.

[48] See Zillow, http://zillow.mediaroom.com/index.php?s=159&item=103; see also First American Core Logic http://www.housingwire.com/2008/10/31/76-million-borrowers-underwater-on-mortgages-study/

[49] National Taxpayer Advocate, 2008 Annual Report to Congress, p. 341, 391-396.

Testimony before the House Committee on Financial Services
Subcommittee on Housing and Community Opportunity
Hearing entitled "Examining the Making Home Affordable Program"

Andrew Jakabovics, Associate Director for Housing and Economics
Center for American Progress Action Fund

March 19, 2009

Madame Chairwoman, Ranking Member Capito, and distinguished members of the subcommittee, it is an honor to be here today to discuss with you the President's recently announced Making Home Affordable Program and several proposals for Congress to consider to ensure the new program meets its projected goal of keeping up to nine million American families in their homes.

My name is Andrew Jakabovics. My testimony today is based on my work as the Associate Director for Housing and Economics at the Center for American Progress Action Fund, and ideas developed in consultation with members of the Mortgage Finance Working Group convened by the Center for American Progress. Shortcomings, of course, are my own.

Housing experts know that in most cases the highest and best occupants of a property are its current residents, but until last month there was no far-reaching, comprehensive, systematic, or standardized effort to offer already delinquent or at-risk homeowners' opportunities to save their homes from foreclosure. The Making Home Affordable Program has three elements: $200 billion for preferred stock purchases in Fannie Mae and Freddie Mac with the aim of keeping interest rates low for the mortgage market in general; the Home Affordable Refinance Program, which relaxes loan-to-value ratios for Fannie Mae and Freddie Mac to allow slightly underwater borrowers to take advantage of those same low rates in refinancing; and the Home Affordable Modification Program, or HAMP, which moves the servicing industry to make sustainable loan modifications at an anticipated cost of $75 billion. My remarks this morning will focus on the modification program.

HAMP is based on the simple truth that foreclosures are costly for nearly all involved: homeowners, mortgage lenders and investors, and communities across the country. The beauty of the program is that it requires servicers to do what is in the best interest of their customers—lenders and investors—by requiring them to offer modifications in a consistent manner on all loans for which they are responsible when modification maximizes the net present value of a mortgage compared to foreclosure.

The program, in short, aligns the interests of borrowers, lenders and investors when foreclosure is clearly not preferable to loan modifications for any of them, and helps stabilize housing prices in communities nationwide.

Success, however, is not guaranteed, which is why Congress, in your oversight capacity, and the administration, in drafting the contract with servicers and as a prerequisite for incentive payments, must put in place appropriate tools to measure success. Both the Bush administration's weak efforts and the more serious yet unsuccessful attempt initiated by Congress under the Hope for Homeowners program serve as reminders that it is not entirely predictable how such a large and diverse market involving many different financial institutions and millions of borrowers in a variety of circumstances will respond to a program encouraging modifications.

The Making Home Affordable program is thoughtfully designed and has every prospect of succeeding, but constant evaluation should be built into the program from the beginning so that if it isn't working—or even if some aspects are and some are not—then we will know these things quickly and take corrective action. As the program gets underway, now is the critical time to establish clear reporting requirements and benchmarks for servicers to meet.

HAMP is predicted to provide 3 million to 4 million homeowners with mortgage modifications over the next two years. Working off the low end of that range, it seems reasonable to set a performance benchmark of 750,000 modifications within six months. Or calculated another way, mortgage servicers should be expected to modify 25 percent of their troubled portfolios in the same timeframe. Because we do not have the luxury of waiting before evaluating the new program's success or failure—absent a concerted effort to modify loans, an estimated 9 million families will lose their homes over the next four years—basic metrics for success both for individual mortgage servicers and the program as a whole must be established.

I would also encourage Congress to take additional actions now, well in advance of our recommended six-month evaluation date, to provide the administration with the authority necessary to implement the suggested next steps should it become clear that the mortgage-modification benchmarks are not being met, either by the program as a whole or by servicers individually.

Program strengths

Turning first to the program's strengths, HAMP establishes a clear industry standard for mortgage modifications which, in addition to helping keep borrowers in their homes, helps servicers fulfill their legal obligations to maximize value for their customers, the home mortgage lenders and investors. Moreover, the servicing industry can safely make more modifications knowing they are protecting the long-term value of individual mortgages and the overall value of the mortgage-backed securities in which they were often bundled.

It is crucial to remember that the landscape in which we are operating is one in which servicers have a clear fiduciary duty, that is, a legal obligation under the terms of their contracts with the trusts, to maximize net present value. It is far from certain that to this point servicers have been meeting that obligation when they have chosen to foreclose rather than modify loans, even though their own financial incentives favor foreclosure, namely their recapture of costs and fees off the top of any proceeds from the sale of the property. Nevertheless, the payments offered to servicers under the program may help realign servicers' incentives with their existing obligations and provide needed funds to build capacity to do the modifications.

In contrast to the direction offered to servicers under the Hope Now Alliance's June 2008 Mortgage Servicing Guidelines, which stressed loss mitigation, the modification program now in place is predicated on maximizing net present value. While this may seem like a semantic quibble—my sustainable modification might be your loss mitigation strategy—the two approaches are fundamentally different and lead to what we hope are radically different outcomes. Under the new program, sustainable modifications based on 31 percent debt-to-income are forward-looking, focusing on the borrower's ability to manage the debt service and protecting the long-term value to investors, whereas loss mitigation is effectively backwards-looking, entirely about narrowing the gap between what was owed and what was paid, often resulting in short-term gains that are ultimately wiped out by longer-term losses. It is inconceivable under HAMP that modification would lead to a rise in payments, as it did in 34 percent of Hope Now's modifications, as Alan White found in his recent study.

Establishing a clear industry standard is beneficial to homeowners as well as servicers because of the certainty it can provide. For many families seeking mortgage relief, it is the uncertainty of the outcome of their entreaties that can be most stressful. Housing counselors can tell you about the palpable relief that can come with a firm "no" as families can begin to make preparations to find new living accommodations. Standardization is beneficial to borrowers able to get help under the program as well, offering them the ability to approach a servicer with the necessary documentation and an understanding of the transparent calculations that makes them eligible. In that vein, servicers' contracts with Treasury should recognize borrowers as third-party beneficiaries.

With that in mind, I would urge the creation of a publicly available eligibility calculator, available at www.financialstability.gov or www.hopenow.com, to be used independently or with a housing counselor that would mimic the calculations done by participating servicers.

Measuring success: Setting clear program benchmarks

There is no single performance metric that unequivocally would determine an individual servicer's success or failure, and by extension, that of the program as a whole. For this reason, we suggest a range of measurements that might be appropriate, including comparing a servicer's modification and redefault rates to those of Fannie Mae and Freddie Mac. In short, we need both absolute and relative measures of modifications and redefaults.

There may be legitimate reasons servicers can't achieve the same rates of modifications as for loans guaranteed by Fannie Mae and Freddie Mac, but an initial test should be to make that comparison. The burden of proof should fall on the servicers to provide compelling evidence—based on their specific portfolios—of why they fell short of this baseline.

In exchange for the incentive payments to servicers—as much as $4,500 per mortgage—we have a right to demand a far greater level of transparency in reporting than is currently available. Either the treasury or the Congressional Oversight Panel should collect and publish monthly performance reports by participating servicer.

Knowing what is happening is obviously the first step, but the bigger question remains: Is it any good?

The number of modifications and percentages of serviced loans constitute simple baseline metrics to compare across servicers, but the deeper analytics I would like to see reported would include comparisons within serviced portfolios of loans owed by borrowers with high back-end ratios compared to those whose total indebtedness is lower. Those borrowers with high levels of indebtedness are more likely to redefault, so their modifications should be closely monitored to alert us of a possible need for program adjustments.

A crucial measurement of the program's success must be its ability to protect low-income and minority families from foreclosure. Congress and the administration should demand strict adherence to fair housing laws and should monitor individual servicers closely to ensure that all eligible borrowers receive assistance. Given the servicers' ability to choose an interest rate reduction or a principal reduction under the program, I would urge reporting the types of modifications offered by race and income as well.

Beyond individual servicers, the whole program as currently conceived may not serve low-income and minority borrowers properly, and if we see them disproportionately continuing to lose their homes, program rules must be changed.

Many live in communities hard hit by the foreclosure crisis, with significant declines in home values off the peak. Because of the high cost of proceeding to foreclosure, particularly the costs of securing and maintaining the homes, long holding periods, and steep discounts necessary to attract buyers, borrowers in those communities may be more likely to be offered modifications than in places with fewer foreclosures or other homes for sale whose property values have remained relatively stable.

Yet, minorities also have significantly higher unemployment rates than whites, and income is a crucial factor in determining eligibility for modifications. Assuming servicers do not voluntarily modify to a sustainable 31 percent of income without the incentive payments, families whose incomes would require reductions in interest rates below 2 percent to reach a 31 percent debt-to-income ratio would not be helped under the program.

It remains to be seen how house price trajectories will intersect with income trends, particularly as they relate to low-income and minority borrowers. The paucity of available data makes it difficult to predict which communities, both geographically and demographically, will be helped. I am hopeful that direct and indirect effects of the funds from the American Recovery and Reinvestment Act flowing to states and localities in short order will be successful in both preventing additional job losses as well as spurring new job creation. But recognizing the very real possibility that borrowers who receive help today may suffer future unemployment spells, preventing a second modification as the program currently does may limit the program's effectiveness when we measure redefault rates.

Creating additional tools and mandatory mechanisms to reduce foreclosures

This reporting and evaluation process outlined above may uncover significant barriers to modifications that are difficult to remedy within the existing context. One serious potential barrier may be servicer capacity, as many, including the Mortgage Bankers' Association, have recognized. If that proves to be the case, then the logical next step is to take mortgages out of their hands. The capacity of mortgage servicers to modify mortgages has been a problem since the foreclosure crisis first dawned over a year ago. Even with incentive payments to servicers, they may not have the necessary manpower and remain unwilling to invest in technology to handle the volume of calls we expect them to achieve.

If within a reasonable period of time—say three months or certainly no more than six months—it becomes clear that individual servicers are failing to meet the reasonable levels of modification activity expected, the time will have come to move from carrots to sticks. Similarly, if the HAMP effort does not meet the level of modification activity set out from the beginning, then more aggressive modification policies should be implemented across the board. These next steps are not without controversy, but they are specifically intended to increase the number of modifications.

These action-forcing mechanisms potentially include:

- Principal reduction.
- The exercise of the government's right of eminent domain on mortgage-backed securities.
- Changes to rules that govern so-called Real Estate Mortgage Investment Conduits in which individual mortgages have been bundled up, sliced into pieces, and sold to investors.
- Expanded bankruptcy provisions to help at-risk homeowners.

All of these mechanisms are complex, but I will touch upon them briefly here and refer those who want more information to the report I have submitted in conjunction with today's written testimony.

Principal reductions

If we find that over time a significant number of modifications end in redefaults, then principal reductions might be better as a first step in the modification process rather than the last. The HAMP effort relies heavily on interest rate reductions to quickly create sustainable mortgages, but principal write-downs and interest-rate reductions offer identical net present valuations over the full life of the loan. More aggressive action to offer relief to borrowers whose loans are held by servicers with poor redefault track records should therefore include principal write-downs to the current value of the property in conjunction with adjusting mortgage payments to the 31-percent debt-to-income ratio.

Similarly, if HAMP as a whole results in high rates of redefaults, then principal write-downs to the current value of the property should become the new modification standard. The propensity for borrowers to walk away from severely underwater loans improves the net present value calculation for principal balance write-downs compared to interest-rate adjustments for the same monthly payment. The reason: Calculating in the cost of foreclosure means it is probably better for lenders or investors holding these mortgages to go for principal reduction as a way to lessen redefault risk.

Applying eminent domain

If mortgage servicers are simply too slow to offer modifications, then the government can break the logjam by acquiring entire pools or individual whole loans contained in such pools via eminent domain, which allows the government to acquire private property for a larger public purpose. Under eminent domain, property holders are entitled to receive just compensation for their losses and have the right to sue the government if they believe the payment they received was less than fair market value of the property. In this context, existing investors would get paid out based on a fair market value of any individual mortgage or of the pool as a whole.

While eminent domain is most often used to purchase real estate outright, the power has also been extended to taking other forms of interest in real estate such as leases. Given that mortgages—and by extension, pools of mortgages—are also considered to be interests in real estate, the use of eminent domain should apply to them as well. After acquisition, the Treasury Department as sole owner of the mortgage or the pool would then be able to unilaterally modify loans by whatever means they choose, including writing down principal to the current value of the property. Subsequent Treasury-funded acquisitions of mortgages and mortgage-backed securities under eminent domain could be funded by resecuritizing modified mortgages through Ginnie Mae.

Eminent domain is unquestionably a powerful tool, and I recognize the potential political pitfalls in promoting it, but if we focus on what makes it attractive—getting mortgages or entire pools out of the hands of entities unable or unwilling to modify them and the opportunity for quick price discovery based on the standard net-present-value analysis—

then we may be able to fashion an equally sharp policy lever. Because the authority to purchase mortgages already exists under TARP, one possibility would be congressional action to explicitly create a safe harbor for participating servicers and defining the sale of an individual mortgage out of a pool as the legal equivalent of a short sale, which servicers have the authority to accept.

Using REMIC rules for a public purpose

There are at least three ways in which the regulations that govern Real Estate Mortgage Investment Conduits, or REMICs—which are tax-advantaged trusts that issue bonds backed by mortgages that have been pooled and sold into the trusts—could be modified to increase modifications. The simplest change would be to modify the REMIC rules that govern the treatment of the trusts holding securitized mortgages such that trusts with contracts that limit modifications would no longer be eligible for tax-advantaged REMIC status. Investors and trustees would probably restructure their contracts with servicers to eliminate restrictions on modifications to maintain REMIC status, and consequently, we should expect modification rates to rise accordingly.

Taking the idea of rescinding REMIC status for trusts whose contracts with servicers limit modifications one step further, REMIC status could also be revoked for mortgage pools that exceed a certain default or foreclosure rate. Just as above, where the threat of lost status will trigger modifications, this more aggressive regulatory change will provide strong impetus to minimize redefaults as well.

A variation on this concept would be to implement regulatory changes to make REMICs behave more similarly to pools of credit card loans and other asset-backed securities, which include an early amortization trigger that forces the issuer of the asset-backed securities to repurchase the pool. In the case of REMICs, however, instead of passing the mortgage pool back to the issuer, the pool could be passed to Fannie Mae or Freddie Mac for modification. Investor payouts in those instances would be based on calculations of pool value as under the eminent domain scenario, again with investors retaining the right to litigate perceived damages.

Expanded bankruptcy provisions

If mortgage servicers' efforts to modify loans prove to be weak, with a demonstrated lack of good faith efforts being made, then expanded access to relief in bankruptcy court for homeowners should be considered.

Should the House-passed bankruptcy bill return to the House or go to conference, I would urge consideration for amending the bill to sunset the five-year claw-back provision that would allow note holders to recapture up to 90 percent of profits generated on sale created by a judge's write-down of principal balance six months after enactment if modifications fail to meet the program's benchmarks.

Conclusion

In keeping with the Obama administration's belief in transparency and accountability, reporting requirements and benchmarks in its Home Affordable Mortgage Program should be established in short order. Should either mortgage servicers individually or the HAMP program fail to meet the suggested levels of modifications—750,000 modifications in the aggregate or 25 percent of individual servicers' mortgages within six months—then the need for additional tools and mandatory mechanisms will be clear. Now is the time to put those additional measures in place so that they can be rapidly implemented should the need arise.

The Heritage Foundation
LEADERSHIP FOR AMERICA
214 Massachusetts Ave. N.E, Washington D.C. 20002 (202) 546-4400 www.heritage.org

CONGRESSIONAL TESTIMONY

The Making Home Affordable Program

Testimony before Subcommittee on Housing and Community Opportunity Committee on Financial Services United States House of Representatives

March 19, 2009

David C. John
Senior Research Fellow
Thomas A. Roe Institute for Economic Policy Studies
The Heritage Foundation

My name is David John. I am Senior Research Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

On February 21, 2009, President Obama released his Homeowner Affordability and Stability Plan, now known as Making Home Affordable, to help stabilize the deeply troubled housing finance market by providing several forms of assistance to as many as 7-9 million borrowers who may be at risk of defaulting on their mortgages. The broad outlines of February were filled in by detailed guidelines for the implementation of the program that were issued by the Treasury Department in early March.

Two of the initiative's three key components are designed to provide subsidies and benefits primarily to homeowners who are still current in their payments. The first The Home Affordable Refinance program will assist those who may not be able to take advantage of attractive refinancing opportunities at lower interest rates because the value of their home has declined beyond the loan-to-value ratio permitted by rules governing mortgage investments made by Fannie Mae and Freddie Mac. The second, The Home Affordable Modification program would provide taxpayer and investor subsidies to mortgage borrowers who have taken on more debt than they could safely manage including, in some cases, credit card and automobile debt. An extremely dangerous third component of the plan, which is beyond the scope of this hearing, encouraged the enactment of legislation allowing bankruptcy judges to alter the terms of certain mortgage loans, a practice that to date has been prohibited by federal law.

The Obama plan suffers from 12 specific weaknesses and risks:

1. The plan's Home Affordable Modification program bestows new and costly benefits on those who took on more debt than they could handle, including credit cards, automobile loans, and mortgages (including refinancings and seconds). Worse, the value of the benefits will vary in direct proportion to the degree of borrower financial irresponsibility, and the intensity of community land regulations. Homeowners with a first mortgage as large as $729,750 are eligible for the initiative, meaning that the well-to-do will receive more financial benefits than those of modest means. And as analysts at one nationwide financial firm noted: "The modifications would go disproportionately to borrowers who overstretched and who lied about their income." This moral hazard sends a clear message to the American people: The worse the behavior the greater the reward.

2. Under this program borrowers with a ratio of mortgage debt service to income greater than 31 percent can have their mortgage interest rate reduced to as little as 2 percent if that is what it takes to achieve the 31 percent ratio—with government paying half the subsidy and the investor/lender surrendering the other half. If this concession is insufficient to reach 31 percent, then the servicer (as opposed to the lender/investor holding the mortgage) can lengthen the term of the loan and/or reduce the principal amount owed to achieve the 31 percent. Eligibility appears to be based solely on the debt-to-income ratio with no apparent minimum or maximum loan-to-value ratio.

3. Borrowers under the modification program with a ratio of debt service payment to income as high as 55 percent—because of combined mortgage, credit card, and automobile debt—will be eligible to receive temporary payment reductions if they merely agree to HUD-approved counseling. Such borrowers may then be eligible for permanent payment reductions.

4. One of the most absurd provisions of the initiative is why consumers who have their loan modified, and thus save thousands of dollars a year in reduced payments, should also receive an additional $1,000 a year in principal reduction for the first five years of the program in return for keeping their payments current. The amount is too low to be much of an incentive since in most cases it would be less than one month's mortgage payment, and in any case only goes to reduce the principal. Why homeowners who have received so much with taxpayer assistance should be eligible for yet more assistance is a mystery.

5. Because the investor/lenders will be responsible for a portion of the mortgage rate reduction, this program will deter private sector investment in all but the best mortgages. Combined with the proposed "cram down" bankruptcy proposals, the net effect will be to require a substantial and permanent federal presence in the housing finance market to accommodate those many potential borrowers who are not highly qualified.

6. The plan also includes a formal endorsement by the President of a bankruptcy provision that allows judges to alter the terms of certain mortgages. While as noted, this legislation is beyond the scope of this hearing, its passage would make it even harder for the rest of the initiative to succeed. This provision will increase the risk to lenders of all mortgages. The industry is already treating this as a permanent measure. Increased risk requires higher costs to compensate lenders, and either down payments or interest rates would have to rise, while potential borrowers with checkered credit histories would be denied access to credit. However, these costs would not rise evenly for all borrowers: Higher risk borrowers (first-time buyers and moderate-income workers) would see costs increase more and have fewer opportunities to buy a house.

7. The Home Affordable Refinance program creates a new right for American borrowers now current in their mortgage payments: the right to refinance their home at a lower interest rate even if the quality of the loan—as measured by the

loan-to-value ratio—would otherwise pose a risk to the lender. As such this proposal establishes the act of being highly leveraged or slightly "underwater" (the amount that a borrower owes on his or her mortgage is more than the value of the house) as a legitimate reason to default, and as a policy problem worthy of taxpayer support and federal intervention. The creators of this new right fail to recognize that many other consumer credit markets operate comfortably, successfully, and safely despite the fact that many borrowers are underwater the minute they sign the contract, notably home improvements, mobile homes, automobiles, RVs and HDTVs. Though those borrowers do expect to be "underwater" for these kinds of purchases, it raises the question of whether future legislation will extend this concession to car loans and credit card debt, which are also experiencing significant levels of default?

8. Only borrowers with loans held or repackaged by the federally-controlled and subsidized Fannie Mae and Freddie Mac will be eligible to exercise this new right to refinance. Borrowers whose loans are held by private investors are denied this right, further distorting the housing markets with government-selected winners and losers.

9. To date, the several, federal loan modification programs that have been put in place have had very limited success, and the rate of failures exceeds that of successes, especially for loans where one or more payments have been missed. For loans that were four months past due at time of modification the recidivism rate is 80 percent after 12 months. For loans one month past due, the recidivism rate after 12 months is 60 percent. With the nationwide decline in house prices accelerating in recent months, the risk of recidivism under the new program could remain at high levels.

10. The overall initiative will cost $275 billion ($75 billion for problem mortgages and $200 billion for Fannie Mae and Freddie Mac).

11. The initiative will take a great deal of time to implement. A recent MarketWatch.com article notes that loan refinancing applications are up 47 percent at a time when a substantial portion of the loan originating infrastructure has disappeared due to bankruptcy and bank consolidation. The prospect that a shrunken mortgage lending system could expeditiously accommodate the 7-9 million borrowers expected by the Obama plan is wishful thinking. The result will be long waits for refinancing that will come too late for some borrowers, and may also crowd out efforts by unsubsidized borrowers to refinance due to the generous financial incentives offered to servicers participating in the new federal program.

12. Perhaps the most troubling part of the plan is the increased reliance being placed on the now federally-controlled Fannie Mae and Freddie Mac, whose lax and corrupt behavior over the past decade was an important contributing factor to the present economic crisis. Although nominally privately-owned, both are now run by the U.S. Treasury, whose massive holdings of preferred shares in both give it a huge implicit ownership stake. As is clear from the refinancing plan—which will

> reduce Fannie and Freddie's earnings and thus weaken them further—the two GSEs have become little more than the federal government's captive mortgage financing banks to be used at will for any housing policy initiatives that the President and/or Congress wish to pursue. And with the plan's many provisions discouraging the private sector from getting involved in mortgage finance, this plan substantially advances the de facto nationalization of America's housing finance system for all but the "jumbo" mortgages that exceed conforming limits.

While I am critical of the President's initiative, I am very aware of the pain and disruption that losing a home causes a family. Several of my neighbors in my West Virginia neighborhood have lost their homes to either foreclosure or the scavengers who offer to help homeowners in trouble and end up with their houses. However, I can find little justification for extending assistance to people who bought a home that was well beyond their ability to afford, refinanced homes in order to draw down equity to finance an extravagant lifestyle, or abused the system by lying. Despite the best of intentions, congressional efforts to deal with foreclosures have had moral hazard problems, have greatly failed to reach the number of people intended, or both.

While the guidelines for the overall initiative will weed out certain of these people from benefiting from the Making Home Affordable initiative, there will still be many instances where homeowners who have sacrificed in order to keep their mortgages current will see their neighbors who have acted irresponsibly treated the same way that they are. The moral hazard created by this situation is equally unfair to those who have paid off their mortgages and to those who rent. The message that is sent to homeowners, and especially our children and grandchildren – that they will not have to face the consequences of their decisions – will result in lasting damage and almost certainly calls for yet more bailouts the next time the economy turns sour.

A Proposal for the Future

However, let me take this opportunity (since I rarely appear before this subcommittee) to suggest a way to make it simpler for future generations to build savings for items such as down payments on housing. It is clear that foreclosures and defaults rise when a homeowner has not made any sort of major down payment. On the other hand, many assets initiatives such as Individual Development Accounts show that workers at all income levels are interested and willing to save. These efforts are even more successful when such assets programs include both matching deposits and financial education.

President Obama's budget includes both a universal employer-based retirement savings program, part of which is based on the Automatic IRA proposal developed by Mark Iwry or Brookings and me. It also includes changing the savers credit so that it becomes a match that goes directly into the account. It would be relatively simple to develop an workplace-based payroll-deduction savings account that starts when a worker enters the workforce and includes both a retirement section and a linked savings account that could be used for the down payment for a first home or similar use. When the worker is young, most of the money would go to the savings account and less to retirement, but as the worker ages, the proportion would gradually and automatically shift so that eventually all of that money goes to retirement savings. Such a plan would make it easier for millions of Americans of all income levels to save for a home.

This concludes my testimony, and I look forward to any questions.

****

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(C)(3). It is privately supported and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2008, it had nearly 400,000 individual, foundation, and corporate supporters representing every state in the U.S. Its 2008 income came from the following sources:

Individuals	67%
Foundations	27%
Corporations	5%

The top five corporate givers provided The Heritage Foundation with 1.8% of its 2008 income. The Heritage Foundation's books are audited annually by the national accounting firm of McGladrey & Pullen. A list of major donors is available from The Heritage Foundation upon request.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own and do not reflect an institutional position for The Heritage Foundation or its board of trustees.

Statement of

Patrick J. Lawler, Chief Economist

Federal Housing Finance Agency

Before the House Financial Services Committee

Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Plan"

March 19, 2009

Statement of
Patrick J. Lawler, Chief Economist
Federal Housing Finance Agency
House Financial Services Committee,
Subcommittee on Housing and Community Opportunity
March 19, 2009

"Examining the Making Home Affordable Plan"

Chairman Waters and Ranking Member Capito, thank you for the opportunity to testify before this committee on the *Making Home Affordable* plan. This is an important topic and FHFA is happy to contribute to the dialogue. My name is Patrick Lawler, and I am FHFA's Chief Economist.

Today, the country faces an enormous challenge to stabilize the housing market. FHFA and the housing GSEs are actively working on foreclosure prevention to help homeowners in trouble through the *Making Home Affordable* plan. This is a major component of FHFA's efforts to ensure the housing GSEs fulfill their mission of providing liquidity, stability, and affordability to the housing market.

The *Making Home Affordable* plan is a critical component of President Obama's financial stability plan. The affordability plan reaches out to millions of American homeowners who are trying to keep their homes in these difficult economic times to help them refinance or modify their mortgages so that they will have more affordable mortgage payments. My testimony today will summarize the prominent role of Fannie Mae and Freddie Mac in this plan and progress made in implementing the plan.

Market Conditions

In late 2006 and 2007, rising delinquency and default rates on recently-originated subprime mortgages made investors aware of the extent of poor underwriting in subprime lending. In the second half of 2007, these factors led to a virtual collapse of the primary and secondary markets for subprime and nontraditional mortgages. These issues have extended to the primary markets and, combined with the economic downturn and reduced house prices, have created a serious problem with millions of American homeowners potentially facing foreclosure.

Over the past two years, serious delinquencies of 90-days or more have risen across the board. For subprime mortgages, serious delinquencies are 23 percent, and for subprime ARMs, 34 percent. Serious delinquencies are far lower at Fannie Mae and Freddie Mac at about 2 percent, which is even lower than the rate for all prime loans at 3.7 percent or the rate for all loans at 6.3 percent. Delinquencies in all categories are continuing to rise.

While Fannie Mae and Freddie Mac own or guarantee almost 31 million mortgages, about 56 percent of all single-family mortgages, the mortgages they own or guarantee only represent 20 percent of serious delinquencies. Private-label mortgage-backed securities represent 15 percent of the mortgages but 50 percent of the serious delinquencies. This is the problem we face in foreclosure prevention. If we are going to stabilize the housing market, we have to address that 50 percent, which comprises mostly subprime and alt-A loans. We believe Fannie Mae and Freddie Mac must be leaders in improving, promoting, and enforcing industry standards and best practices for all mortgages, and their roles in *Making Home Affordable* reflect that.

Overview and Expected Impact of the Homeowner Affordability and Stability Plan

FHFA was pleased to work on the development of the Administration's plan, announced in February and published in detail on March 4, 2009. It is a major step forward in reducing preventable foreclosures and stabilizing the housing market. It aggressively builds on the FDIC's and our streamlined mortgage modification programs. The key elements of the plan involve Fannie Mae and Freddie Mac.

1. *Making Home Affordable* refinance plan. Fannie Mae and Freddie Mac will provide access to low-cost refinancing for loans they own or guarantee. This will help homeowners reduce their monthly payments and avoid foreclosure. It is designed for borrowers who are current in their payments and seek to refinance at a lower rate or into a safer mortgage but who have experienced difficulties due to declining home values and limited availability of mortgage insurance.

2. *Making Home Affordable* modification plan. A $75 billion program will establish a national standard for loan modifications. Treasury will share a portion of the costs, which will provide financial incentives to borrowers, lenders and servicers. The Enterprises will monitor servicer compliance with the plan's rules, and for those loans owned or guaranteed by Fannie Mae or Freddie Mac, the Enterprise will bear the full costs of the modifications.

3. Treasury will support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac. The Treasury Department doubled the size of its Preferred Stock Purchase Agreements to $200 billion each. This increase should remove any possible concerns that investors in debt and mortgage-backed securities have about the strong commitment of the U.S. Government to support Fannie Mae and Freddie Mac. In addition, the Treasury Department will continue to purchase Fannie and Freddie MBS, and increased each GSE's allowable mortgage portfolios by $50 billion to $900 billion, along with corresponding increases in allowable Enterprise debt outstanding.

Taken together, these three elements are extremely important steps toward achieving a recovery for housing markets and the entire economy.

Before going further, let me stress that a lot of work remains ongoing to operationalize these programs. So, my testimony today is a status report on those activities and there will be further details and information rolled out to servicers and to the public in the days and weeks ahead.

<u>FHFA's Role in the Design of the *Making Home Affordable* Plan</u>

During the last two months, FHFA has been working with Treasury and other agencies to help develop the details of the *Making Home Affordable* plan, first announced in February of this year. Drawing on the loan modification experience of Fannie Mae and Freddie Mac, and their Streamlined Modification Program (SMP), we have provided expertise and information to structure the new affordability plan to make it most effective.

Director Lockhart announced the Streamlined Modification Program in November. It was developed jointly with the U.S. Treasury, HUD, Fannie Mae, Freddie Mac, and HOPE NOW's members. More than 90,000 solicitation letters and modification agreements were sent to eligible borrowers. We have been carefully monitoring the success of the program, but it is clear that the program needs to be more aggressive to reach more troubled borrowers. The Making Home Affordable loan modification program is designed to meet that need. Fannie Mae and Freddie Mac have taken many additional steps to help avoid preventable foreclosures. They suspended foreclosures and evictions and developed programs to protect renters living in foreclosed properties. They are pulling loan files for a "second look" before foreclosures, and they are working with credit and housing counselors.

The new loan modification plan is based on our experience with SMP in a number of ways and builds on that success. For loan modifications, the SMP set a 38% debt to income ratio, which would lower the borrower's mortgage payment to no more than 38% of their income. We intended this to become a minimum standard across the industry, and for servicers to be able to go even lower. However, we have found that this is not always enough to provide an affordable payment to borrowers and help them avoid foreclosure. The *Making Home Affordable* modification plan lowers the debt to income ratio to 31%, with the government paying half the cost between 38% and 31%. We expect that with this lower ratio and payment, many more homeowners will be able to remain in their homes.

SMP was targeted toward borrowers who were most at risk – those who were 90 days behind in their mortgage. It is critically important to get to troubled borrowers as soon as possible, before they are significantly behind on their payments in order to keep more people in their homes. The *Making Home Affordable* modification plan goes even farther and includes homeowners who are facing reasonably foreseeable or imminent default, but are still current on their mortgage.

Implementation of the Making Home Affordable Plan

The *Making Home Affordable* plan is in the implementation stage. Both Fannie Mae and Freddie Mac will participate in the *Making Home Affordable* modification program both for the loans that they own or guarantee and as administrators on behalf of the Treasury Department for all other loan modifications under this program. Fannie Mae and Freddie Mac are the only participants in the *Making Home Affordable* refinance program, which includes new refinancing flexibilities for homeowners whose loans are owned by each of the Enterprises. The Enterprises have already issued guidance for their participation in these programs.

As an administrator of the modification program, Fannie Mae is working on guidance to seller/servicers that would address loans owned by Fannie Mae and Freddie Mac, and those owned by investors in private-label securities. Many of these securities have pooling agreements that require that servicers can modify loans only if they follow industry standards. Fannie Mae will be issuing new standards for servicers of private label securities, setting these new standards. This overcomes a major obstacle to loan modification. We expect these developments, along with the incentives offered to servicers to modify loans instead of foreclosing on homes, will motivate servicers, especially those related to private-label securities, to help American homeowners.

Each Enterprise has other key roles in the implementation of this program. Fannie Mae also has a paying agent role to provide the incentive payments to servicers who have modified loans. Incentives for modifications on loans that Fannie Mae and Freddie Mac already own will be paid out of their funds, while incentive payments on loans owned by other investors will be paid with TARP funds. In addition, Fannie Mae will be required to maintain data and report on how many loans are refinanced or modified, as well as relevant statistics about those loans.

Freddie Mac has an important audit and compliance role with the modification program. It will take a lead role in reviewing servicers' compliance with the program guidelines and ensuring that noncompliance is reported and handled, including required reporting, documentation and on-site visits to the servicers. Both Enterprises are hiring or transferring the necessary staff to conduct their respective roles in the program. And both Enterprises are developing appropriate systems, confidentiality standards and firewalls to ensure that this program has the highest integrity. FHFA is confident that both Fannie Mae and Freddie Mac have fully embraced their roles and are on track in developing the necessary infrastructure to ensure that the *Making Home Affordable* plan is a success.

The modification plan requires that servicers modifying loans use a Net Present Value model to determine if the borrower is eligible. FHFA has been working with experts from Fannie Mae, Freddie Mac, the FDIC and Treasury to put this model in place. The model includes acceptable discount rates, property valuation methodologies, house price appreciation assumptions, as well as foreclosure costs and timelines and borrower cure and redefault rate assumptions. This underwriting process will help reduce the possibility of redefault and mortgage fraud, which are concerns to everyone.

<u>Monitoring and Oversight of the *Making Home Affordable* Plan</u>

While I have described the plans that have been made and the progress in implementing them, what really count are the results. We have several ways of tracking the impact the plan is having on foreclosures and the economy through required reporting described above. In our role as the Enterprises' regulator, we are in a unique position to oversee the implementation of this plan and monitor its results.

Beyond continuing with our regular comprehensive examination work, FHFA will also be establishing a special team of trained examiners with expertise in key areas to pay careful attention to the implementation and results of the plan. This team will focus on the data used and created by the program, anti-fraud efforts, servicer registration, human resources, system development, and Freddie Mac's compliance function and internal controls over Fannie Mae's paying agent role.

As I mentioned earlier, Fannie Mae has a critical reporting role in this program and will be systematically collecting data, which FHFA will also review, about the loans made under this program, including re-default rates. We are hopeful that this information can be used to improve the program. For example, information on the performance of the loan made under this program could be used to improve the underwriting standards and the NPV model. Statistics on servicer participation could be used to address other challenges that the servicers of loans bundled in private-label securities are facing.

In addition, FHFA will publish information related to Treasury's and the Federal Reserve's purchase of senior preferred stock and mortgage-backed securities, and use of the GSE credit facility on regular basis starting this month. In September, FHFA began publishing *Foreclosure Prevention Reports*, which are transparent reviews of key performance data on foreclosure prevention efforts. These monthly and quarterly reports present data from more than 3,000 approved servicers on 30.7 million first-lien residential mortgages serviced on behalf of Fannie Mae and Freddie Mac, of which 84 percent are prime. FHFA will continue to release these reports and monitor the progress and results of the *Making Home Affordable* plan.

<u>Next Steps for Homeowners</u>

I've described the challenges we face in foreclosure prevention and the solutions we are implementing through the *Making Home Affordable* plan. Let me provide you with some next steps for American homeowners to take advantage of the plan.

I would encourage everyone to visit the website financialstability.gov or <u>makinghomeaffordable.gov</u>. At these websites, homeowners can learn more details about the plan and the options we have discussed. If they are current on their mortgage payments, they can learn if Fannie Mae or Freddie Mac owns their loan and the steps to apply for the refinance program. If they are behind on their mortgage, they can identify who to contact and what information they need to apply for the modification program. There is also a self-assessment tool for homeowners to determine if they are eligible. For those homeowners with questions or unsure of their situation, I would urge them to call 1-888-995-HOPE, the HOPE Now hotline to reach a free HUD-approved housing counselor to help them with the new program. Everybody who is struggling with their mortgage payment should look into how the *Making Home Affordable* plan can help them.

FHFA understands the nation's deep concern over the human tragedies of the foreclosure crisis. We believe that the *Making Home Affordable* Plan is the best way to help both the American homeowners and the economy in the long run. Thank you for the opportunity to offer this testimony. I will be happy to answer questions.

WRITTEN STATEMENT OF VANCE T. MORRIS

Director for Single Family Asset Management
U.S. Department of Housing and Urban Development

Hearing before the Subcommittee on Housing and Community Opportunity
Committee on Financial Services
United States House of Representatives

"Examining the Making Home Affordable Program"

March 19, 2009

Chairwoman Waters, Ranking Member Capito, and members of the committee, thank you for the opportunity to appear before you today.

Many homeowners and communities throughout the country have been severely hurt by the current economic crisis. This includes many responsible families that are making their monthly payments but have experienced falling home values that disqualify them from opportunities to refinance with today's low interest rates. Millions of American workers have been laid off, or forced to accept lower paying jobs, and are significantly challenged to produce the income to make their mortgage payments.

If we refuse to act, over 6 million families could face foreclosure in the next few years, with millions more struggle to stay above water. We have seen the detrimental effects that diminishing home values have had on our neighborhoods, communities and the national economy. Millions of families are left unable to refinance into lower more affordable loans, pushing more lenders to foreclosure on thousands of properties, and in the end perpetuating this vicious cycle. Now is the time to act.

With the President's comprehensive strategy to rebuild the housing market and revive the economy, many of these homeowners will have a fighting chance to stave off foreclosure and keep the American dream of homeownership within reach. The Making Home Affordable program is targeted to reach as many as 7 to 9 million homeowners who are at risk of foreclosure and struggling to stay in their homes. While this program supports a recovery in the housing market, it will not provide money to speculators. The Program is, and will be, utilized for the benefit of owners that have made good-faith efforts to make their mortgage payments on time and can continue paying off their mortgages. The program not only helps responsible homeowners at risk of losing their homes, but helps to stabilize neighborhoods by slowing the rate of foreclosures that fuel falling home values.

The Making Home Affordable program has two key components: the comprehensive Home Affordable Refinance Program and the $75 billion dollar Home Affordable Modification Program, further details of which were just announced by the Department of Treasury on March 4, 2009.

The Home Affordable Refinance program is expected to help approximately four to five million borrowers who have an existing mortgage held by Fannie Mae or Freddie Mac. This initiative is specifically designed for borrowers with a solid payment history on their mortgage, but due to a decline in home prices or where mortgage insurance (MI) is not available, have been unable to refinance to obtain a lower payment, due to home price declines that have pushed their current loan-to-value ratios above 80%. Under the Home Affordable Refinance program, many of them will now be eligible to refinance into a better loan, either by reducing their interest rate or by refinancing out of a loan with high risk features such as interest only or balloon payments.

As noted, mortgage rates are currently at historically low levels. But under current rules, only families with conforming loans owned or guaranteed by Fannie Mae or Freddie Mac who owe less than 80 percent of the value of their homes are eligible to refinance to these low interest rates. This initiative expands the maximum loan-to-value (LTV) ratio for refinance mortgage loans owner or guaranteed by Fannie Mae or Freddie Mac from 80% to 105% without adding any new mortgage insurance requirements.

Unfortunately, given the recent decline in home prices, millions of responsible homeowners who made down payments and timely mortgage payments are unable to access these lower rates. To help, Fannie Mae is eliminating the existing streamlined refinance options and introducing two new refinance options available only for existing Fannie Mae loans. Fannie Mae is providing two new options that include new flexibilities for refinances of existing Fannie Mae-owned or -securitized loans that will allow borrowers the opportunity to take advantage of lower interest rates.

To help keep mortgage rates at lower levels and promote stability and liquidity in the marketplace, the Treasury Department will continue to purchase Fannie Mae and Freddie Mac mortgage-backed securities. In addition, the Treasury Department will increase its funding commitment to Fannie Mae and Freddie Mac to ensure the strength and security of the mortgage market and to help maintain mortgage affordability. This backing will bolster confidence in the mortgage market, allowing Fannie Mae and Freddie Mac to continue to facilitate the extension of affordable mortgage credit to responsible homeowners.

For certain borrowers that cannot afford their mortgage payment, the Home Affordable Modification Program provides an opportunity to modify existing loans to an affordable and stable monthly payment. In the current economy, millions of hardworking families have seen their mortgage payments rise 40 to 50 percent of their monthly income or are experiencing a reduction in income that that makes it very difficult to stay current on their mortgages. FHA, together with the Department of Veterans Affairs, the Department of Agriculture, the Federal Housing Finance Agency, and the Department of the Treasury, are working with the banking and credit union regulators to implement standard industry practices that allow for sustainable mortgage modifications. This initiative will be ongoing in each of the distinct housing programs administered by these agencies. For our part, FHA will coordinate these efforts with an expanded and improved Hope for Homeowners program.

These homeowners may be eligible for a loan modification as long as their home mortgage does not exceed the national GSE conforming loan limit, which is $729,750 for a one unit house, the loan was originated prior to January 1, 2009, they occupy the property as a primary residence and their mortgage debt is greater than 31% of their gross monthly income.

Significantly, this program will not require homeowners to be delinquent in their payments to qualify for eligibility. Loan modifications are more likely to succeed if they are made before a homeowner becomes delinquent; thus, the program will include households at risk of imminent default despite having not yet missed a mortgage payment.

Borrowers with large non-housing debts can qualify, but only if they agree to enter HUD-certified counseling. Specifically, homeowners with total "back end" debt (which includes not only housing debt, but other debt including car loans and credit card debt) equal to 55% or more of their income will be required to agree to enter a counseling program as a condition for a modification.

The Home Affordable Modification Program is expected to help up to three to four million at-risk borrowers in all segments of the mortgage market avoid foreclosure by modifying into and affordable loan payment. The program has several key components:

- First, the government will partner with lenders to reduce the homeowner's monthly payment to an affordable level. The lender is solely responsible for interest rate reductions and other changes necessary to lower the borrower's monthly mortgage payment to 38 percent of his or her income. From that point, the government will match, dollar-for-dollar, additional reductions the lender makes to lower that ratio to 31 percent. These adjustments could mean a monthly mortgage payment lowered by more than $400 for a borrower with a $220,000 mortgage. The lower interest rate arrived at must be kept in place for five years, at which point it can be gradually increased to the conforming loan rate in place at the time of the modification. Lenders will also have an option of decreasing monthly payments by reducing the principal owed on the mortgage. The lower interest rate arrived at must be kept in place will be fixed for five years, at which point it can be gradually increased. At no time however, can it exceed to the conforming loan rate at the time of the modification, thus assuring the borrower of long term stability.

- Second, servicers will receive $1,000 for each eligible modification meeting initiative guidelines. They will also receive fees to reward them for continued success – earned monthly as long as the borrower stays current on the loan – of up to $1,000 each year for three years.

- Third, to encourage borrowers to stay current, the initiative will provide a monthly principal balance reduction payment. As long as a borrower stays current on his or her loan, he or she can get up to $1,000 each year for five years.

- Fourth, because loan modifications are more likely to be successful if they are made before a borrower misses a payment and to keep lenders focused on reaching borrowers who are trying to stay current on their mortgages, an incentive payment of $500 will be paid to servicers, and an incentive payment of $1,500 will be paid to mortgage holders, if they modify at-risk loans before the borrower misses a payment.

- Fifth, Treasury is working with industry to develop an approach to modifying and extinguishing second liens that will compliment the program as announced and help create more sustainable modifications under the program and refinancing via Hope for Homeowners.

- Finally, to encourage lenders to modify more mortgages and enable more families to keep their homes, the Administration – together with the FDIC – has developed an innovative home price decline reserve payment. Resources allocated for this purpose – which may total as much as $10 billion – will provide holders of mortgages modified under the program with an additional payment to offset potential home price declines – and therefore mitigate the risk of losses in cases of if defaults is are higher than expected.

The program offers a number of incentives to encourage both families and servicers to avoid the costly foreclosure process and minimize the damage that foreclosure imposes on financial institutions, borrowers and communities. This program aims to protect taxpayers through sound modifications. No payments will be made unless the borrower completes a three month trial period, and most payments are designed around the principle of "pay for success."

Fannie Mae and Freddie Mac will be responsible – subject to Treasury's oversight and the Federal Housing Finance Agency's conservatorship – for administering the program and monitoring compliance by servicers. Every servicer participating in the program will be required to report standardized loan-level data on modifications, borrower and property characteristics, and outcomes. Treasury will meet quarterly with the FDIC, the Federal Reserve, the Department of Housing and Urban Development and the Federal Housing Finance Agency to ensure that the program is on track to meet its goals.

In a joint effort, FHA, the Veterans' Administration, the United States Department of Agriculture, the Federal Housing Finance Agency and the Department of Treasury will work with banking and credit union regulators to implement standard industry practices that allow for sustainable mortgage modifications. This program will work in tandem with an expanded and improved Hope for Homeowners program.

Despite these significant efforts, not every foreclosure can be avoided. For borrowers whose income was grossly overstated when they purchased their home or who are facing long term unemployment, moving to less expensive housing is the appropriate alternative. The Department of Treasury will soon announce a plan to assist borrowers make this difficult transition with dignity and in a manner that preserves the value of the real estate so that damaged and abandoned properties do not further devalue neighborhoods. The plan will include borrower and servicer incentives for short sales and deeds in lieu of foreclosure as well as options for more effectively transferring some of these properties to nonprofit housing agencies with the ability to rehabilitate and return them to productive use.

As part of the American Recovery and Reinvestment Act, the Department of Housing and Urban Development will award $2 billion in competitive Neighborhood Stabilization Program grants for innovative programs that mitigate the impact of foreclosures by supporting new strategies to address the problem of vacant, foreclosed properties. Additionally, the Act includes an additional $1.5 billion to provide assistance to renters facing displacement, reducing homelessness and avoiding entry into shelters. HUD announced the allocations of that $1.5 billion of homelessness prevention funding to recipients on February 25th, as part of our successful allocation of three quarters of Recovery Act funds for HUD programs only a week after President Obama signed the Act into law.

In addition to the already mentioned efforts, the President's overall economic recovery plan will seek careful changes to personal bankruptcy provisions. The Administration will continue to work with Congress to ensure that legislation works well in conjunction with our voluntary modification approach.

With the proposed "Helping Families Save their Homes Act of 2009", the Hope for Homeowners and the enhanced partial claim programs offer alternatives for struggling borrowers to refinance their mortgages. In order to ensure that more homeowners participate, we support changes to the products that will reduce fees paid by borrowers, increase flexibility for lenders to modify troubled loans, permit borrowers with higher debt loads to qualify, and allow payments to servicers of the existing loans

The Department of Housing and Urban Development and its partners look forward to helping millions of homeowners stay in their homes and keep the American dream of homeownership accessible and affordable. Through refinancing and loan modification, we can make a difference.

Thank you, and I look forward to answering any questions you may have at this time.

Testimony of Roberto G. Quercia
Center for Community Capital
Department of City and Regional Planning
University of North Carolina at Chapel Hill

Before the U.S. House Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Plan"

March 19, 2009

Good morning Madame Chairwoman, Ranking Member Moore-Capito, and distinguished members of the Subcommittee. Thank you for holding this hearing on President Obama's Making Home Affordable Plan and for inviting me to testify.

INTRODUCTION

I serve as Director of the Center for Community Capital and Professor of City and Regional Planning at the University of North Carolina at Chapel Hill (www.ccc.unc.edu and . www.planning.unc.edu).

For over a decade, the Center for Community Capital has conducted research and analysis into the transformative power of capital on the economic health of households and communities in the U.S. Our multidisciplinary team of academics, practitioners, economists and social scientists brings broad perspective and expertise to the work of examining how financial capital flows through communities and impacts homeownership, household financial security, and local economies. The center's in-depth analyses help policymakers, advocates and the private sector find sustainable ways to expand economic opportunity to more people, more effectively.

In my remarks, I will summarize the findings of our recent study on loan modifications, co-authored by Lei Ding and Janneke Ratcliffe. On the basis of the study findings, I will derive implications for key aspects of President Obama's Making Home Affordable plan ("the plan"). Attached to this written testimony is the complete text of the study.

First, I will highlight our top findings and policy implications:

1. Our study finds that modifications that reduce mortgage payments significantly reduce foreclosure.
2. These findings support the plan's primary features: Systematically modifying and refinancing mortgage loans to reduce payments will prevent many foreclosures.
3. In our view, reducing rates will provide substantial relief to many homeowners, but those who owe more than their house is worth will remain vulnerable to default. A more explicit use of principal reduction in appropriate situations should help save more homes.

LOAN MODIFICATIONS AND REDEFAULTS

The foreclosure crisis shows no sign of abating. Over 2.3 million homeowners faced foreclosure in 2008, an 81 percent increase from 2007. Almost 900,000 properties were repossessed by lenders nationally in 2008, almost double the figure in 2007 (Aversa and Zibel 2009). The foreclosure crisis has mushroomed into a full-fledged national and global recession. Payroll employment has declined by 3.6 million since December 2007 and over one-half of this decline occurred between November 2008 and February 2009 (Bureau of Labor Statistics 2009). Job losses lead to more foreclosures, which, when added to the already oversupplied real estate market, further reduce home values, leading to even more foreclosures. The $2.8 trillion loss in household real estate wealth from 2006 to the third quarter of 2008 has further weakened households, ultimately leading to less spending and more job loss (Board of Governors of the Federal Reserve System 2008).

Thus, what began with defaults of poorly structured mortgages has led to job losses and economic contractions that further exacerbate the delinquency, foreclosure and devaluation cycle. The Obama Administration has recognized the urgency of addressing the root cause of the problem. We concur that actions to reduce the rate of preventable foreclosures would promote economic stability for households, lenders, our communities, and the nation's economy.

One strategy to deal with mounting foreclosures is to modify mortgage loans - changing the loan terms so that borrowers can remain in their homes. To date, however, modification activity has been voluntary, non-standardized, and inconsistent. While the servicing industry reports a growing number of modifications, they are not keeping pace with the increasing number of new delinquencies. Further, there is scant evidence about the effectiveness of loan modifications, and what evidence does exist suggests a high rate of recidivism.

At the same time, studies have found that many loan modifications do not reduce mortgage payment, and in fact, many increase either the balance and/or the payment. In fact, so-called "traditional modifications" take the late fees and payments due and add them to the loan amount, thus *increasing* the burden and often resulting in higher payments Alan White 2008). It is important to recognize that all modifications are not created equal.

Our study examines the relationship between post-modification redefault rates and different types of loan modifications. For this analysis, we use data from a large sample of recently modified loans (10,000 loans that were modified in the second quarter of 2008 to prevent default). These modified loans came from a pool of more than 1.3 million mostly subprime and adjustable-rate mortgages made during the peak of the mortgage boom (2005-2006). We examined the redefault rate of the modified loans as of December 2008, about six months after the modifications.

Not surprisingly, we find that the key to sustainable loan modifications is to reduce the payments so they are truly affordable to the borrowers. Six months after receiving a modification, homeowners whose modification led to a payment reduction has a relatively 60 percent lower rate of delinquency than those who got traditional modifications with an increased payment. However, nearly a half of the sample received no payment reduction. Supplemental analysis shows that a full third of *delinquent* borrowers received a modification that increased their mortgage payments. This is like throwing a rock to someone who is drowning.

Moreover, the findings show an even lower level of redefault when payment reduction is accompanied by principal reduction. A payment relief can be the result of a reduction in interest rate, extension of the loan term, or forbearance or forgiveness of principal. The results suggest that among the different types of modifications examined, the principal forgiveness modification has the lowest redefault rate. We believe that this is because it addresses both the short-term issue of mortgage payment affordability and the longer-term problem of underwater homeowners (those who owe more than the house value). When confronted with a crisis, underwater borrowers pose a greater default risk because they will not be able to sell their home to terminate their mortgage obligation.

Even after controlling for such factors as credit scores, delinquency status and market conditions, homeowners who obtained a rate reduction were about 13 percent less likely to redefault than similar borrowers in similar situations who did not receive such a reduction. Those whose rate reduction was accompanied by a principal reduction were even less likely to redefault, 19 percent less likely.

We also find that there are significant differences in redefault risks on the basis of the timing of the modification. Early intervention works best as it is associated with lower redefault risks. Thus, the findings suggest that waiting for borrowers to be 90 days delinquent before intervening may not be the best approach as the probability of redefault is much higher at that point in time.

As expected, we find that local economic conditions play a key role on the success of loan modifications: a one percent rise in local unemployment leads to a 1.4 percentage point increase in the probability of redefault. As the economy continues to deteriorate, it may be increasingly difficult to disentangle these macro-factors from loan-related risk factors. Even if modifications are successful in the short term, for instance, by lowering the loan rate to increase affordability, redefault may occur if borrowers later experience job loss due to a deteriorating local economy.

Finally, the results underline the importance of finding more innovative approaches to help borrowers who have negative equity in their homes. The results indicate that households with negative home equity are more likely to redefault over time, even when a modification has initially lowered mortgage payment. For these loans and loans that were poorly underwritten at origination, more significant loan restructuring or refinancing may be needed to minimize redefault risks.

MAKING HOME AFFORDABLE PROGRAM

The "Making Home Affordable" program recently announced by President Obama incorporates the key findings from our study. Namely, it relies on making home mortgages more affordable by lowering payments, using a systematic and consistent framework. As such, we expect it should help prevent many foreclosures.

The mortgage refinance option will be available to more homeowners who have solid payment history on an existing mortgage owned by Fannie Mae and Freddie Mac. Normally, many of these borrowers would be unable to refinance because their homes have lost value, pushing their current loan to value ratios above 80 percent (up to 105%). The Obama administration estimates that 4 to 5 million homeowners will be able to refinance to benefit from lower, fixed interest rates and extended terms. Although not comprehensive, as it excludes non GSE loans and higher LTV loans, this aspect of the administration program is consistent with our findings that suggest the benefits of reduced payment burdens, even before delinquency sets in.

With regard to modifications, servicers are expected to follow a series of steps in order to reduce monthly payment to no more than 31 percent of gross monthly income. We see this as a crucial element of the program as our findings indicate that reducing mortgage payments is the key to lower future redefault risks.

Lenders are required to base the decision to modify a loan on a net present value test. On the basis of this test, lenders need to estimate the cost of doing a modification compared to the cost of doing nothing. Modifications are expected to occur if the net present value of the expected cash flow is greater with a modification than without it, adjusted for an assumed rate of default under each scenario.

The modification sequence requires first reducing the interest rate (subject to a rate floor of 2%), then if necessary extending the term or amortization of the loan up to a maximum of 40 years, and then if necessary forbearing principal. Under the program, principal forgiveness or a Hope for Homeowners refinancing are mentioned as acceptable alternatives.

An important aspect of the President Obama's program is to focus on homeowners at risk, not just on homeowners that are already delinquent. This is consistent with our study findings indicating that early intervention works best as it is associated with lower default risks.

To sum up, on the basis of our study, these two components of President Obama's program should be able to minimize default risks among many homeowners now at risk. The sharp reduction in mortgage payment, to 31percent of household income, should have the greatest impact in minimizing short term redefault risks.

ADDITIONAL INTERVENTIONS TO BE CONSIDERED

Our research suggests the importance of principal reduction. Modifications that resulted in a mortgage payment reduction accompanied by a principal reduction exhibited the lowest redefault risks. When an estimated 20 percent of all homeowners with a mortgage are "underwater," it is important to find more innovative approaches to deal with negative equity. In fact, lack of equity home has long been considered a strong predictor of default. Our analysis suggests that households with little or no equity in the home are more likely to redefault but they usually would not enter serious delinquency or foreclosure unless they have negative equity.

Allowing borrowers with high loan-to-value ratios to refinance or modify into lower-rate loans can only partly solve the problem for underwater borrowers. We believe that more consideration needs to be given to incorporating principal forgiveness in loan modification, particularly if the plan bars second chances. Although principal reduction is permissible under the proposed program, the lack of guidelines and standards for principal reduction may limit or discourage the use of this important tool in situations where it may be appropriate and necessary.

Further, success of the plan depends on the willingness and ability of servicers, lenders and investors to cooperate. Alternatively, our study findings support the use of the bankruptcy courts as an avenue for modification that can lead to appropriate principal reductions.

The plan aims to standardize the modification process, allowing troubled borrowers to get fair access to timely and consistent help. It is also important to develop guidelines to tailor modifications to the particulars of individual borrowers with specific loan products in unique housing markets. To do so, more data and more research are needed in the public domain.

We commend President Obama and the administration for proposing guidelines to streamline the modification process, allowing troubled borrowers to get timely and consistent help. However, we believe that more structured guidelines may be needed in other areas, for instance, with regard to principal forgiveness. The data to develop such guidelines exist in the shared databases and within mortgage servicers' own portfolios. We also understand that many government agencies are collecting detailed information on loan modifications. We encourage these agencies to make the data publicly available to researchers. This would allow for a broader array of insights and views in developing any additional policy steps needed.

In closing, I applaud this subcommittee for examining these important issues. Thank you.

LOAN MODIFICATIONS AND REDEFAULT RISK

An Examination of Short-term Impact

By
Roberto G. Quercia
Lei Ding
Janneke Ratcliffe

Working Paper: March 3, 2009

Center for Community Capital
The University of North Carolina at Chapel Hill

Author Email: Quercia@unc.edu
Phone: 919-843-2493

Prepared with financial support from The Ford Foundation

Loan Modifications and Redefault Risk

An Examination of Short-term Impacts

Roberto G. Quercia, Lei Ding, and Janneke Ratcliffe *

Abstract

One promising strategy to stem the flood of home foreclosure is to modify mortgage loans so that borrowers can remain in their homes. However, a primary concern of loan modification efforts is the seemingly high rate of recidivism. We examine the relationship between redefault rates and different types of loan modifications based on a large sample of recently modified loans. We find that the key component to making modified loans more sustainable, at least in the short run, is that mortgage payments are reduced enough to be truly affordable to the borrowers. The findings also show an even lower likelihood of redefault when the payment reduction is accompanied by a principal reduction. Unfortunately, we also find that to reduce redefault for modified loans that are currently underwater (those with negative equity) or were poorly underwritten at origination, more significant loan restructuring or refinancing may be needed.

1. Introduction

The foreclosure crisis shows no sign of abating. Over 2.3 million homeowners faced foreclosure in 2008, an 81 percent increase from 2007. Almost 900,000 properties were repossessed by lenders nationally in 2008, almost double the figure in 2007 (Aversa and Zibel 2009). The foreclosure crisis and the resulting credit and financial turmoil have now become a full-fledged national and global recession. Payroll employment has declined by 3.6 million since December 2007 and over one-half of this decline occurred between November 2008 and February 2009 (Bureau of Labor Statistics 2009). Job losses lead to more foreclosures, which, when added to the already oversupplied real estate market further reduce home values, leading to even more foreclosures. The $2.8 trillion financial losses in household real estate wealth from 2006 to the third quarter of 2008 further weaken the overall economy, leading to more income loss (Board of Governors of the Federal Reserve System 2008).

With the large number of foreclosures and the increasing numbers of delinquencies, actions to reduce the rate of preventable foreclosures would promote economic stability

* Roberto G. Quercia is Professor of City and Regional Planning and Director of the Center for Community Capital at the University of North Carolina at Chapel Hill. Lei Ding is Senior Research Associate at the Center for Communicty Capital. Janneke Ratcliffe is the Associate Director at the Center for Community Capital. We are grateful to Alan White for helpful advices and comments.

for homeowners, their communities, mortgage lenders, and the nation as a whole. To date, government initiatives appear to have been unable to fix the problem as foreclosures continue to mount. The expectation is that the new Obama administration and the new Congress will focus on policy proposals to assist homeowners directly. Tools being considered include more aggressive loss mitigation programs (Inside Mortgage Finance 2009). Lawmakers want to expand access to FHA refinancing, the HOPE for Homeowners program (H4H), and other initiatives, such as the loss-sharing modification program of the Federal Deposit Insurance Corporation (FDIC).

Borrower inability to meet mortgage payments is the core of the foreclosure problem, and loan modifications are seen as a means to reduce the payment burden. By providing troubled homeowners with relief, modifications can be regarded as a tool for foreclosure avoidance. For instance, under the FDIC's streamlined loan modification program, mortgages that meet certain criteria can be modified to decrease the borrower's payment by 10 percent or more and help borrowers achieve sustainable payments by lowering their housing payments to 38 percent of their gross income (FDIC, 2008). As recently announced by President Obama, the Homeowners Affordability and Stability Plan creates a $75 billion program to subsidize loan modifications that would reduce the monthly mortgage payment of a troubled homeowner to as low as 31 percent of monthly household income (Stolberg and Andrews 2009).[1] In practice, OCC and OTS (2008) documented that about 133,000 loans were modified in the third quarter of 2008, a 16 percent increase from the second quarter of 2008, but the number of modifications continued to fall further behind the number of new delinquencies.[2]

A primary concern with loan modification efforts is the seemingly high rate of recidivism. Within six months, over half of all modified loans were 30 days or more delinquent and over a third were 60 days or more delinquent (OCC and OTS 2008). Do these high rates of re-default imply that loan modifications are failing?

Unfortunately, the complexity of the many factors involved in loan modifications makes this question less straightforward than it appears. Modifications do not necessarily reduce mortgage payments, only some do. Loan modifications can lower monthly payments by extending the loan term, or by reducing the interest rate or the mortgage's outstanding balance, or by a combination of practices. However, traditional modifications only add the delinquent payment to the unpaid principal, thus increasing the amount of debt and often resulting in higher monthly payments (White 2008). This type of modification is

[1] Under this plan, a mortgage lender needs to reduce a borrower's payments to 38 percent of monthly income and the federal government would provide additional incentives, such as a $1,000 upfront payment per modification and more payments if the borrower keeps current (Stolberg and Andrews 2009). The government would also match additional reductions to bring the payment to as low as 31 percent of monthly income. The payment can be reduced via a waterfall of options, typically beginning with interest rate reduction.

[2] During the same period, the number of 60+day delinquencies increased by 17 percent and the ratio of the number of loan modifications to the total number of 60+day delinquencies was only 7.2 percent of in the third quarter 2008.

likely to lead to higher redefault risks in the long run, especially when higher debt burdens are accompanied by declining house prices.

There is also an important temporal aspect to loan modifications during an extended period of economic downturn. A loan modification may be successful in addressing the initial problem, for instance, by reducing the monthly payment to address a lack of affordability after an interest rate reset. However, as a result of the deepening financial and economic crisis, borrowers can easily face new problems shortly after a loan modification, such as loss of a job, that can lead to another mortgage delinquency and redefault. Thus, it is important to examine the short- and long-term implications of loan modifications.

Using data from a large sample of recently modified nonprime loans, we examine why some loan modifications are more likely to redefault than others. More narrowly, we examine the types of modifications that are more likely to redefault in the short run. In a companion study, we will examine loan modifications and the dynamics of principal reduction over a longer period of time.

The paper proceeds as follows. Section 2 reviews the current practices of loan modifications and the literature. Section 3 discusses the data and outlines the logistic models of the redefault behavior of borrowers with modified loans. Section 4 presents and discusses the results, and the final section concludes.

2. Literature Review

Implementing loan modifications

In early 2007, the majority of modifications involved a capitalization of arrears for seriously delinquent loans and/or a principal forbearance, according to Inside B&C Lending (2008). In late 2007 and early 2008, the pre-reset modifications (interest rate freeze or reduction) on subprime adjustable rate mortgages (ARMs) increased significantly. More recently, modification activity has focused on interest rate reductions and less seriously delinquent borrowers. But the category of principal write-down is still largely theoretical and has not been used to any significant degree (White 2008). As a result, some loan modifications have lowered the mortgage payments but they generally are not reducing the total mortgage debt.

The federal government has relied primarily on encouraging lenders to voluntarily modify the terms of existing mortgages. In October 2007, the HOPE NOW program, a coalition of mortgage servicers and housing counseling agencies formed to stimulate a voluntary effort to restructure mortgages. In June 2008, the HOPE NOW alliance members issued guidelines for a streamlined foreclosure prevention process for committed servicers. In June 2007, American Securitization Forum (ASF) also issued guidelines for the modification of securitized subprime residential mortgage loans (ASF, 2007). In August 2008, the FDIC, which took over the former IndyMac Bank, launched the first streamlined loan modification program for struggling mortgage borrowers meeting certain criteria. This program is designed to help troubled borrowers achieve a sustainable 38 percent HTI ratio in the mortgage and decrease the borrower's payment by 10 percent or more.[3] To reach affordable levels, mortgage modifications combine interest rate reduction, extended amortization, and partial principal forbearance. In December 2008, government-sponsored enterprises (GSEs) started a streamlined modification program applying many of the features of the FDIC loan modification program.[4] As mentioned early, the recently announced Homeowners Affordability and Stability Plan encourages lenders to bring the mortgage payments to as low as 31 percent of monthly income by providing incentives to lenders, servicers and borrowers.

The current loan modification programs aim to standardize the modification process, allowing troubled borrowers to get timely and consistent help. Servicers can examine readily available loan criteria, such as loan-to-value ratios, loan amount, credit scores and payment history, and debt ratios, to make a quick determination of qualifications. While the number of completed loan modifications steadily increased in 2008, a number of barriers and concerns have impeded the wider adoption of loan modifications, and the number of modifications continues to fall further behind the number of new delinquencies (OCC and OTS 2008).

Barriers of loan modification

Eggert (2007) summarized several barriers to loan modifications and indicated that servicers' costs and self-interests are the primary hurdles. Loan modifications have been labor intensive and usually very expensive for servicers, with costs estimated at between $500 and $600 per modification (Eggert 2007). Because of the high cost of the loan modification, servicers may want to save money by doing nothing, in the hope that the loan can cure by itself without any action (Mayer and Gan 2006). Furthermore, since subprime servicers derive substantial income from late fees, and can expect to be reimbursed for the costs of foreclosure, they may have little interest in helping borrowers cure the delinquency. As a result, many servicers have more incentive to allow a loan to proceed to foreclosure than to resolve the delinquency. Finally, since some servicers, especially subprime servicers, have been accused of abusive practices designed to increase their income to the detriment of borrowers, their internal policies may discourage loan modifications (Eggert 2004). Of course, servicers are not interested in keeping borrowers in long term delinquency so much because in many cases it involves a lot of work which they do not get paid much for in the current market. For example,

---

[3] If the initial modification at a 38 percent of HTI does not decrease the borrower's payment by 10 percent or more, the HTI ratio can be lowered to 35 percent and then to 31 percent to achieve the 10 percent savings. In cases where a 10 percent reduction can not be achieved, the 31 percent HTI ratio is used for affordability. FDIC (2008) provides the technical details about the loan modification program.

[4] The underwriting criteria include missing at least three mortgage payments, proof of financial hardship, not in active bankruptcy, and payment on first-lien mortgage not exceeding 38 percent of a borrower's gross monthly household income (Inside Mortgage Finance, 2008). Servicers are expected to begin actively soliciting eligible borrowers with owner-occupied mortgages and loan-to-value ratios of 90 percent or more. Servicers will be compensated $800 for each successful loan modification under the program.

servicers have to advance monthly payments on loans that are not paying and that will be a negative to them.

For securitized loans, the Pooling and Servicing Agreement (PSA), a legal document that outlines the responsibilities of the servicer, restricts the extent of loan modifications allowed. Bound by the PSAs, it is not easy for servicers to work with investors of securitized mortgages to achieve loan modifications, and usually it is not clear what is legally permissible (Eggert 2007). The differences in the type and scope of modifications that are explicitly permitted among different trustees raise operational compliance costs and litigation risks. So securitization seems to affect servicers' incentives and slow or reduce their propensity to modify loans – even when such action would be in the collective interests of investors and borrowers.[5] One recent study suggests that frictions due to the securitization preclude efficient loan modifications and increase the foreclosure rate: Conditional on a loan becoming seriously delinquent (60+day), the likelihood of a portfolio loan default is lower in absolute terms than that of a securitized loan default (19 percent to 33 percent, respectively, relative to the mean foreclosure rate) (Piskorski, Seru, and Vig 2008).

By introducing foreclosure alternatives like a loan modification that likely have a lower cost for the borrower, the lender/servicer encounters an implicit moral hazard issue: the willingness to negotiate a less costly solution can itself lead to more defaults (Ambrose and Capone 1996). In other words, providing a less costly option by modifying the terms of a mortgage may signal to other borrowers that the costs associated with default have declined sufficiently, which would result in more defaults than otherwise would have occurred. To limit the moral hazard problems associated with lowering borrower default costs, Ambrose and Capone (1996) suggested that lenders or servicers should restrict foreclosure alternatives to liquidity-constrained borrowers. In practice, the moral-hazard problem has been addressed by the requirement of full financial disclosure by defaulted borrowers; only true hardship cases will receive assistance (Inside Mortgage Finance 2008).

Significant redefault risk may remain if modifications are not significant enough. Many of the current modifications may not effectively help troubled borrowers, most likely because the modifications did not bring mortgage debt in line with declining home values or reduce the mortgage payment to an affordable and sustainable level. Other factors—such as the high debt burden, increased unemployment rate, the continuing decline in property value—also may contribute to high redefault rates. In one review, 38 percent to 40 percent of borrowers with modified mortgages redefaulted (Credit Suisse 2007), indicating that servicers often have not modified the loans enough to allow some borrowers to make their payments. About 53 percent of mortgages modified in the first quarter of 2008 redefaulted in six months (OCC and OTS 2008). As the subprime market worsens and housing prices continue to decline, more innovative solutions that can effectively help troubled borrowers will need to be considered.

[5] The ASF (2007) indicated that modifications were allowable to the extent they improved the NPV for the "aggregate investor." Despite this statement, however, investors and servicers are still sending mixed signal.

The impact of loss mitigation efforts

Why would some borrowers with modified mortgages redefault? Broadly, there are two complementary theories to explain why borrowers stop making their mortgage payments: the "option" theory and the "trigger-event" theory. According to the option theory, the borrower exercises the put option when he has a negative equity in the property (Foster and Van Order 1984; Vandell and Thibodeau 1985; Kau, Keenan, and Kim 1993). When the property value has fallen below the amount owed on the loan, the borrower has the incentive to default and to let the lender take the property. The trigger-event theory focuses on "life-changing" events that affect the homeowner's ability to make mortgage payments, because of either a sudden drop in or loss of income or an unforeseen increase in expenses (Vandell 1995). Income disruptions typically are associated with a loss of employment or adverse change in family circumstances, such as an illness, death or divorce. In addition, some environmental factors, such as local economic conditions and changes in underwriting standards, also influence a borrower's decision to default (Cutts and Merrill 2008). Since most borrowers with modified loans were delinquent to some degree before the loan modifications, most if not all of them should have had disruptions in income or unforeseen expenses. As a result, payment relief through a loan modification should help them keep current with required mortgage payments. Of course, the level of equity in the property is also important, because if there is sufficient equity in the home, borrowers can simply sell the property or refinance it if they cannot make the mortgage payment. In these cases, income disruptions are usually insufficient to cause severe default. More simply put, loan to value has always been the most important determinant of default. The conventional wisdom is that the trigger events explain delinquency while the option theory explains default; in this way, they are not really competing, but complementary, explanations.

One group of studies has examined whether loss mitigation efforts including loan modifications prove helpful to borrowers. For FHA loans, Capone and Metz (2003) found that loss mitigation programs successfully lowered the foreclosure rate; the probability of a loan reaching foreclosure is dramatically reduced when the loans goes through a forbearance agreement (from 77.6 percent in 1998 to 14.5 percent in 2002). Cutts and Green (2005) provided an excellent review of servicing literature and Freddie Mac's innovations in loan servicing and loss mitigation. Using Cox's hazard model to investigate the impact of repayment plans on foreclosure incidence they found that borrowers who enter a repayment plan have a much lower probability of loosing their home (80 percent lower for borrowers overall and 68 percent lower for low- to middle-income borrowers). They also found that borrowers who had previously had a loan modification but were again in default were significantly less likely to fail than those who had not previously been through a loan modification, perhaps because of the borrower's willingness to work with the servicers to reach a positive resolution. Pennington-Cross and Ho (2006) found that differences in servicing practices affect the probability of default to a strong degree and the prepayment risk to a lesser, but still significant, degree. Cutts and Merrill (2008) also documented that the success rate of modified loans varies by the amount of arrearage capitalized into the loan modification; not surprisingly, there is a direct relationship between a lower arrearage and a lower failure rate.

However, there is scant evidence about the effectiveness of different types of loan modifications. Credit Suisse (2008) documented that rate-freeze modifications and principal reduction modifications have lower redefault rates than traditional modifications, but the analysis does not control for borrowers' risk characteristics. For example, the data found that reset modifications (primarily rate freeze) only exhibited a15 percent delinquency rate 8 months post-modification, thus out-performing the other categories. But about 10 percent of the loans that received a reset modification were delinquent prior modification, compared to the much higher delinquency rates (usually 80-85 percent) for loans modified by other means. This illustrates the need for more precise analysis of performance of modifications, taking into account borrower, loan and market factors.

Data on recent modifications are available from a number of sources, including the OCC and OTS Mortgage Metrics Report, the Foreclosure Prevention Report from Federal Housing Finance Agency (FHFA), the HOPE NOW coalition of mortgage servicers and counselors, the Mortgage Bankers Association, and the Mortgage Servicing Report by the State Foreclosure Prevention Working Group. These studies and reports provide important evidence as to the effectiveness of the voluntary restructuring approach. However, few of them specify the kinds of modifications implemented or attempt to understand the impact of the modifications beyond blunt statistics. In this analysis, we examine the short-term impact of different loan modifications by identifying which kinds of modifications are more sustainable than others, and under which circumstances. The data and methods used to examine these issues are described below.

3. Data and Methodology

Data

Loan-level data on individual mortgages are available for a national sample of private-label securitizations, known as Columbia collateral file (White 2009). The data is available through remittance reports produced by the trustee on several mortgage pools, altogether representing more than four million outstanding mortgages. During the 2007–2008 reporting period, the pools were serviced by many of the leading mortgage servicing companies.[6] The monthly performance reports provide loan-level details on loan characteristics, defaults, foreclosures, bankruptcy, and losses on foreclosed homes. The reports also have information about the loan balance, mortgage payment, and interest rate, both before and after modification, which allows us to identify whether total mortgage debt, interest rate, or mortgage payments are reduced for individual homeowners.

This analysis focuses on a sample of mortgage loans derived from remittance reports for 2006 securitizations, which covers about 1.3 million loans mostly originated in 2005 and 2006. We chose to examine the 2006 deals because it is generally accepted that recent

[6] As documented by White (2008), a subset of this dataset includes seven of the top ten subprime originators in 2006 and six of the top fifteen subprime servicers in 2007.

nonprime vintages, especially subprime ARMs, have performed worse than earlier ones, as a result of relaxed underwriting criteria, higher combined loan-to-value ratios, and the popularity of risky loan terms (Immergluck 2008). Although our sample is national in scope, about half of the mortgages are concentrated in California, Florida, and a few other high-growth states. As of April 2008, the top five servicers of the 2006 deals—Wells Fargo Bank, Countrywide Home Loans Servicing LP, Aurora Loan Servicing Inc., Ocwen Loan Servicing LLC, and Bank of America—accounted for about 47 percent of all the loans.

Generally, the data do not allow us to explicitly identify the loan types for all the loans (59 percent have missing values for the loan type variable). As Table 1 shows, the credit quality of the loan types as measured by the average FICO scores differ from 629 for subprime loans, to 698 for conventional loans, to 702 for Alt-A loans. However, after excluding a very small share of FHA/VA and commercial loans (0.85 percent), we are confident that a vast majority of the loans in this sample are nonprime loans because most of them have at least one risk characteristic that is more common in the subprime sector.[7] Of course, restricting the analysis to modified loans alleviates this concern to some degree. As Table 1 shows, the average FICO score, average loan-to-value ratio, and average interest rate of modified loans do not differ much across loan types. If lenders can classify borrowers into different loan types based on an assessment during the origination process of the likelihood of default, differences in the redefault of modified loans cannot be attributed to selection on unobservables at the time of origination.

Of course, this sample of loans does not represent a statistically random sample of all mortgage loans or all nonprime mortgage loans. The loans are securitized loans, and servicers of securitized loans may have different incentives than lenders who retain ownership of mortgage loans. So this sample of voluntary loan modifications may not be representative of loan modifications by portfolio lenders. Nevertheless, given that nonprime mortgages account for more than half of all foreclosures,[8] and that the vast majority of nonprime loans that led to the crisis were securitized, this sample provides important insights as to what voluntary loan modification programs have yielded to date in the nonprime market.

---

[7] It is safe to assume at least a vast majority of these private-label securitizations as nonprime loans. About 36 percent of those for which data on the loan type variable are available were labeled as subprime or Alt-A loans. About 40 percent were classified as conventional and the rest, 24 percent, were labeled as conforming or non conforming loans. However, many of those loans listed as conventional or with missing value are not typical prime loans. As suggested in the literature, it is reasonable to assume the following characteristics significantly increase mortgage credit risk: 1) borrower FICO score less than 620; 2) interest-only loan; 3) negative amortization; 4) limited or no documentation; 5) original loan-to-value ratios higher than 90 percent (Foote, Gerardi, Goette, and Willen 2008; Immergluck 2008). A vast majority of conventional loans and those with missing values (86 percent and 90 percent, respectively) have at least one of these risky loan features. In this sense, most of them should be considered subprime or Alt-A mortgages, although they were coded as conventional, conforming, or with missing values.

[8] Without including Alt-A loans, subprime loans alone accounted for 48 percent of all foreclosure starts in the second quarter of 2008 (Mortgage Bankers Association 2008).

Characteristics of modified loans

As Figure 1 shows, the number of loan modifications among this sample increased sharply in 2008, from about 4,800 in March 2008, to about 6,200 in May 2008, and then to almost 9,000 in November 2008. This pattern is consistent with the national trend, which saw loan modifications increase in 2008 (Evers 2009). We restricted the analysis to modifications in one quarter only to alleviate concerns that policy environment and macroeconomic conditions might have changed substantially during the study period. During the second quarter of 2008, there were 17,592 loan modifications in the sample—a large number considering that in the same quarter OCC and OTS (2008) reported 114,439 modifications based on a sample representing over 60 percent of all outstanding mortgages and FHFA (2008) reported 15,372 modifications by the GSEs.

After excluding second-liens, originations before 2005, loans with missing data, non-owner occupied loans, and those whose final outcomes could not be identified, we have a total of 9,693 loan modifications reported. The number of monthly modifications increased from 2,280 to 4,011 between April and June 2008. The data also provide rich details on individual mortgage delinquency and foreclosure, allowing us to track the performance of the modified loans through December 2008. Although the majority of the modified loans had experienced some delinquency, 37 percent had never experienced any delinquency during the 12 months before the modification. So the borrowers holding modified loans can be divided into two basic groups: those with loans that were already past due under the current terms; and those that remained current but were considered to be in "imminent default", for example as a result of pending interest rate resets.

Descriptive statistics of the modified loans are listed in Table 2. Borrowers holding modified loans generally had quite low origination FICO scores, with an average of about 614. More than a half the loans were refinance loans (54 percent). Most of these loans were adjustable rate mortgages with a 30-year amortization period. About 24 percent of them were interest-only mortgages and a small percentage (4 percent) negative amortization loans. Over one-third of them had limited or no documentation at origination. About two-thirds originated in 2006; the remainder in 2005.

Just over a half of the modifications (54 percent) led to reduced monthly principal and interest (P&I) payments (with at least one percent reduction in mortgage payment; see Table 3). But 23 percent of reported modifications resulted in payment increases, likely a product of recasting arrears. The remaining 23 percent of modifications had roughly the same P&I payment (less than one percent change). On average, the monthly payment was reduced by $173 for all modified loans. But the reports do not disclose whether the payment changes and rate reduction are permanent or temporary for this sample.[9]

These loan modifications actually increased the aggregate outstanding mortgage debt. The amount owed on the modified loans went from $2.31 billion before modification to $2.33 billion after modification. A small share of modified loans (8.4 percent) did have

[9] The reports started to identify whether a loan modification is temporary or not from November 2008 but the variable is not well populated.

their principal balance reduced, but only 299 (3 percent) reduced principal by more than 20 percent.[10] The news is slightly better regarding the reduction in interest rates. More than half (about 59 percent) experienced an interest rate reduction. Because of the rate reduction, the average interest rate of modified loans dropped from 8.84 percent to 7.16 percent after modification, significantly higher than the prevailing 30-year fixed rate on prime mortgages during the period of a little higher than 6 percent.

As Table 4 summarizes, the most common modifications were either interest reduction only (53 percent), in which the interest rate was cut but the principal remained the same or increased slightly, or a traditional modification (39 percent), in which the interest stayed the same but principal balance and mortgage payment increased slightly. These increases were likely because of capitalization of unpaid interest or other charges. For loans modified in the second quarter of 2008, about 44.7 percent were foreclosed or 30+days delinquent as of December 2008, slightly lower than the 55 percent six-month redefault rate reported by OCC and OTS (2008). Over 25 percent were 90+days delinquent or in the foreclosure process.

However, redefault rates varied by type of loan modification. As Figure 2 shows, modifications with a reduced mortgage payment have a lower redefault rate than those with the same or a larger mortgage payment (38 percent, 46 percent, and 60 percent respectively). A similar pattern can also be found for the interest rate reduction modifications (Figure 3).

Modeling

Why are some loan modifications more sustainable than others, which redefault quickly? In our empirical analysis, we want to identify the kinds of loan modifications that are more successful than others. The simplest approach to do this is to use the following specifications:

$$\Pr(Y_i = 1 | Modify) = f(\alpha + \beta * Modify_i + \gamma * X_i + \eta * S_i + \kappa * \delta_i + \varepsilon_i) \qquad (1)$$

The dependent variable is an indicator variable for a modified loan i that takes a value of 1 if the loan redefaults. A loan is considered in default if it was foreclosed or it was in delinquent status (including foreclosure post-sale or REO status) as of December 2008. X_i is a vector of factors that may influence the outcome of a modified loan.

Specifically, we controlled the following loan and borrower characteristics: FICO score at origination, documentation type, adjustable interest rate, interest-only, loan amount (in log), loan purpose, and the estimated current loan-to-value (LTV) ratio[11] when modified.

---

[10] White (2008) suggests some of these large principal reductions may have resulted from litigation.

[11] Of course, consumers usually do not observe home equity in static terms and recent movement (trends and volatility) matters as much as absolute changes. However, the trend (house price appreciation rate) and volatility variables are highly correlated with the estimated LTV variable. In fact, the estimated current LTV ratio is determined by the original LTV ratio and recent house price changes. We decided not to

We estimate the current LTV ratio by dividing the unpaid balance when the loan was modified by the estimated house price in the second quarter of 2008, using the original house price and the house price index (HPI) at the metropolitan statistical area (MSA) level provided by the Office of Federal Housing Enterprise Oversight (OFHEO). If the property is located outside an MSA, we used the state HPI. We used the county unemployment rate as of October 2008 to represent local economic conditions.

This approach makes the following identification assumption: conditional on observables, there is a random assignment of troubled loans to different types of modifications. It is nevertheless possible that after conditioning on a host of observables, the assumption of a random assignment into different modifications at the time of modification may be violated, making the estimate biased. If servicers decide the types of modification based on unobservable private information about the borrower quality at the time of modification, the differences in redefault rates among modified loans might simply reflect different conditions of these loans. Consequently, our results could be driven by selection on unobservables at the time of modification and the estimated value of β may be biased because of the selection bias.

We alleviated this concern by controlling for the delinquency status and prior delinquency history of the borrower *at the time* of modification. We expect the delinquency severity represented by the delinquency status at the time of modification and the number of months in delinquency during the preceding 12 months to capture some of the information regarding quality of the borrower that is revealed *between* origination and modification. On the one hand, being late for many months would incur a significant increase in principal debt (recasting arrears). On the other hand, prior delinquency behavior should be a good predictor of future performance of the same borrower. These variables are hypothesized to be important factors when servicers decide the type of modifications and to be the predictors for redefault.

As suggested in the literature, servicers have a significant impact on the performance of delinquent loans (Pennington-Cross and Ho 2006; Stegman, Quercia, Ratcliffe, Ding, and Davis 2007). We expect that the unobservable soft information of the practices of servicers has a significant impact on the performance of modified loans. We further controlled the dummies (S_i) of major servicers to capture unobservable information of different servicers. We also included dummies for two major states (δ_i, California and Florida) to account for variation of socioeconomic conditions across regions and controlled a time dummy for all originations in 2006. These controls should reduce the bias in the estimation.

Modify is a set of indicators of different types of loan modifications. In this specification, β measures the impact of different types of loan modifications on the performance of modified loans. Specifically, we tried two sets of loan modification variables. The first set of variables focuses on the level of payment relief induced by the loan modification.

include the house price movement variables in this analysis, but we are interested in considering this factor in a dynamic model in a companion study.

We are interested in testing how the mortgage payment reduction affects the redefault probability of modified mortgages. By using a set of variables capturing the level of payment relief after the modification, we can determine the sensitivity of the redefault risk to the change in mortgage payment. The second set of variables focuses on the different changes in loan terms. By considering two features of loan modifications—interest rate change and principal change—we constructed four mutually exclusive dummy variables for the combinations of these two characteristics. These are *r0p0* for "*rate reduction and principal write-down,*" *r1p0* for "*principal write-down only,*" and *r0p1* for "*rate reduction only.*" The category *r1p1*, "*no rate reduction and no principal write-down,*" which can be roughly regarded as the traditional loan modification, is set as the reference group.

To illustrate the effect of loan modifications on a borrower's monthly mortgage payment obligation, following Cutts and Merrill (2008) we assume a borrower who is N months into his 30-year fixed-rate loan with monthly interest rate r and who has missed interest payments of amount i along with associated monthly escrows for taxes, T, and insurance, I, if applicable. His principal balance is given by P_{N-M} (his last payment was made in month N-M) and his arrearages equal $M^*(i+T+I)$ or $\sum_{t=N-M+1}^{N}(i_t+T+I)$. For simplicity, any other additional fees are not considered here. A traditional loan modification places the delinquent arrearage into the unpaid principal balance and re-amortizes the loan over the remaining term, making his new payment:

$$x_{new} = \frac{r\left[P_{N-M} + \sum_{t=N-M+1}^{N}(i_t + T + I)\right](1+r)^{(360-N)}}{(1+r)^{(360-N)} - 1} \tag{2}$$

If the amortization has been extended to a new term, *TERM*, then the new monthly mortgage payment can be determined by:

$$x_{new} = \frac{r\left[P_{N-M} + \sum_{t=N-M+1}^{N}(i_t + T + I)\right](1+r)^{TERM}}{(1+r)^{TERM} - 1} \tag{3}$$

So, the new total debt is determined by the original unpaid balance and the capitalized arrearages. The new monthly mortgage payment is a function of the new total debt, new interest rate, and the new amortization term. Assume we have a fixed-rate mortgage originated in January 2006 with an original principal of $238,726, the average of our study sample. The interest rate was 8.84 percent annually (0.737 percent monthly), the average of all modified loans in this sample. So, the monthly mortgage payment would be $1,893. As of May 2008, the borrower was 90-days delinquent on this mortgage, which means his last payment was in February 2008 and the outstanding balance on his mortgage was $234,878. The three missed interest payments total $5,187. And if we assume that property taxes and insurance together are 3 percent of the original principal annually, then we add another $1,762 to bring the escrow account current, making the total amount due $241,827.

Under the traditional loan modification structure, the arrearages will be added to the principal and re-amortized over the remaining 331 months; his new mortgage payment will be $1,953, a four-percent increase. To lower the borrower's payment, for example, by 10 percent, servicers can either lower the interest rate to 7.33 percent from 8.84 percent or reduce the principal to $210,949, or use a combination of the two. For example, reducing principal to $223,134 and the rate to 8.20 percent lowers the mortgage payment by 10 percent. A rate reduction to 8.12 percent and a term extension to 40 years can also reduce the payment by 10 percent.

4. Empirical Results

We now describe the results from the logit regression models. The dependent variable is whether or not the loan was 30+days delinquent (including those that had been foreclosed) as of December 2008, as in Table 5, or at 90+days delinquent, as in Table 6, conditional on the loan being modified during the second quarter of 2008. In Model 1 we used the measures of the change in mortgage payment, while in Model 2 we tried different types of loan modifications. In Table 7, we further tested the relationship between redefault risk and the level of equity in the property for those modified loans with significant payment relief. We report the estimated coefficients, p-values, and marginal effects of different models in the tables.

Redefault risk and payment relief

Relative to a modification with increased mortgage payment, a loan modification that lowers the mortgage payment by at least 5 percent can significantly lower the redefault risk. Based on Model 1 in Table 5, it is estimated that the six month redefault rate for an average borrower will be about 55.6 percent if the mortgage payment is increased. As Table 5 shows, a modification reducing the borrower's payment by just 5 to 10 percent lowers the probability of refedault (30+day) by 10.3 percent, compared to a modification with an increased mortgage payment. If the payment is lowered by 30 percent to 40 percent, the probability of redefault is more than 18 percent lower. When redefault is measured by 90+day delinquency, the results are consistent but the magnitude of the impact is less. Overall, the results indicate that modifications that reduce the borrower's monthly payment do reduce the redefault rate. This suggests that the key component of a successful loan modification is whether the modification is able to reduce the mortgage payments enough to be truly affordable to the borrowers.

To illustrate the effect of payment relief on redefault rate, we estimated the six-month, 90-day delinquency probability for an average nonprime borrower who was 90+day delinquent as of May 2008. As Figure 4 shows, when the mortgage payment is reduced by 7.5 percent by lowering the interest rate, the probability of 90+day delinquency drops from over 39 percent to 32 percent. And if the payment is cut by 25 percent, the 90+day redefault rate drops further to about 28 percent.

Because a loan modification with a principal write-down can also reduce the loan-to-value ratio, such a modification has an even lower redefault rate, even when it results in the same level of mortgage payment. Among all approaches that can lower the payment by 7.5 percent, the redefault rate for a modification based on a principal write-down is 0.9 percent lower than for one based on an interest rate cut. When the payment is reduced by 25 percent, the redefault rate of a principal write-down modification is 2.2 percent lower than that of a rate-reduction modification. The difference in the redefault rate seems modest, likely because we used a continuous loan-to-value variable; in reality, however, the impact of loan-to-value on default may be non-linear. This issue will be revisited a little later.

Redefault risk and different types of modifications

Conditional on being modified, a loan with a reduced interest rate, a reduced principal, or both is less likely to redefault, relative to a loan modification where neither the principal nor the interest rate is reduced. In the latter, a loan is modified either by extending the loan term or by adding the unpaid interest and escrow payment to the total loan balance, which usually results in an increased mortgage payment. As Table 5 shows, the coefficients of three loan modification dummies (*r0p0*, *r0p1,* and *r1p0*) are consistently negative and significant. The effects are large: after controlling for other variables, a combination of principal write-down and rate reduction lowers the probability of redefault by 19 percent. When the modification involves a rate-reduction only, the probability of redefault is lowered by 13 percent. The principal write-down itself has a similar effect but the magnitude is a little smaller (10 percent). The results are generally robust enough when we use the 90+day delinquency as the outcome variable except the principal write-down group (*r1p0*) becomes insignificant.

Though it seems the combination of principal write-down and rate reduction is more effective in reducing the redefault rate, we cannot conclude on the relative effectiveness of different loan modifications here because these variables do not account for the magnitude of the rate reduction or principal write-down. For example, if the level of principal reduction has been marginal, as in this case, it is reasonable to expect that the impact of the principal write-down modification would be quite small. However, the evidence supports the view that the type of loan modification has substantial impact on the performance of modified loans and that modifications need be tailored to the particular borrower based on household and product characteristics.

Redefault risk and home equity

In the short run, the principal write-down may influence the performance of modified loans by lowering both the mortgage payment and the total debt. Since the results suggest that redefault risk will be significantly lower if the mortgage payment is reduced by at least 5 percent, we examine the impact of home equity on redefault risk for those loans with significant payment relief. Instead of using a continuous variable, we ran a separate regression in which the loan-to-value ratio was coded into buckets for all modified loans with a 5 percent or more reduction in their mortgage payments. When we used 30+day delinquency as the measure of default, the results suggest the equity in the home does matter. Relatively to borrowers with substantial equity in the property (with estimated loan-to-value ratios less than 70 percent), borrowers with less equity or negative equity in the property are more likely to default (all the coefficients are significant at 0.05 level). However, when we used serious delinquency (90+day) as the measure of default, only borrowers with negative equity remain significantly more likely to default (significant at 0.1 level), even with the reduced payment. This suggests households with less or negative equity in the property are more likely to redefault even when the modifications lower their mortgage payments. But they usually would not exercise the put option (foreclosure or serious delinquency) unless they have negative equity. It is reasonable to expect that during the period of house price depreciation, underwater borrowers (those with negative equity) are more likely to default (ruthless default) even if their payments are affordable to them, and the results support this hypothesis.

In the long run, those modified but still underwater loans may have very high probability of redefault. According to the option-based theory of default, as long as the equity in the home is negative, the option to default remains in the money (see, for example, Foster and Van Order 1984) and borrowers will be more likely to default when confronting a crisis. More simply put, loan to value has always been the most powerful predictor of default, and borrowers whose home is worth less than what they owe are more likely to default, either in a "ruthless" manner, or because they cannot afford to sell the house if they need to. This will be especially the case during a prolonged period of economic downturn, which heightens the likelihood of job loss and continued house price declines. We plan to examine the role of house price changes and the level of home equity using a dynamic model in a companion paper.

Results of other controls

The sign and significance of the coefficients of other variables are generally as expected. Loans originated with less than full documentation, adjustable rate mortgages, and home purchase mortgages are more likely to redefault. Nonprime purchase mortgages originated during the peak of the subprime bubble seems to have a very high risk. The results also suggest that some loans or loans in certain markets were poorly underwritten at origination, so many mortgage holders simply could not afford them, even with reduced monthly payments.

Not surprisingly, early intervention seems to result in lower redefault risks. Relative to borrowers who are current on their mortgage payment, those whose loans were modified after only one to two missed payments are 12 percent more likely to default, compared to 14 percent for those whose modifications occurred after three or more missed payments (Model 1 in Table 5). The results suggest that loans should be modified as early as possible after a missed payment; ideally, serious consideration should be given to modifying loans preemptively.

Local economic conditions are a crucial factor affecting the ability of borrowers to meet their debt obligations, even after a loan modification. The local unemployment rate is a significant predictor of redefault in all models, with redefault rates higher in places with a high unemployment rate: one percent increase in the area unemployment rate increases the probability of redefault by about 1.4 percent.

Two other significant results are worth mentioning. First, the coefficient on the origination FICO score suggests that, conditional on being modified, loans with higher FICO scores redefault less, which is consistent with the negative relationship one typically observes between FICO and delinquencies. Second, consistent with findings elsewhere, market and servicing seem to matter. Because of unobserved characteristic, loans in Florida, those serviced by Servicer 2, and those originated in 2006 are more likely to redefault after being modified, even after controlling for important determinants.

5. Conclusions

Confronted with the worst financial and economic crisis in decades, government and industry are considering strategies to deal with the flood of home foreclosures. One promising strategy is to modify mortgage loans so that borrowers can remain in their homes. Unfortunately, there is scant evidence about the effectiveness of loan modifications, and the evidence that does exist suggests a high rate of recidivism. In this article, we examine the relationship between post-modification redefault rates and different types of loan modifications. For this analysis, we use data from a large sample of recently modified loans.

Our study attempts to identify those modifications that work and those that are more likely to lead to redefault. We find that the key component to making modified loans more sustainable, at least in the short run, is that the mortgage payments are reduced enough to be truly affordable to the borrowers.

Unfortunately, this is contrary to many practices today. According to White (2008), most loan modifications do not lead to lower payments, in fact, many result in higher payments and higher balances. This is because traditional modifications add the payments owed plus any penalties and fees to the outstanding balance without changing other terms of the loan. By contrast, to successfully enable a struggling homeowner to meet their obligation, loan modifications need to significantly reduce mortgage payment. For example, a modification that reduces the mortgage payment by 35 percent can lower the redefault probability by 18 percent, compared to a modification that does not reduce payments.

Moreover, the findings show an even lower level of redefault when payment reduction is accompanied by principal reduction. A payment relief can be the result of a reduction in the interest rate, extension of the loan term, or forgiveness of principal. The results suggest that among the different types of modifications, the principal forgiveness modification has the lowest redefault rate. We believe that this is because it addresses both the short-term issue of mortgage payment affordability and the longer-term problem of negative equity. This finding is consistent with current efforts to include principal reduction when modifying loans. Of course, to compare the relative effectiveness of different loan modifications, the net present values of different loan modifications need to be calculated, based on a dynamic model of loan performance. We plan to examine these issues over a longer period of time in a companion paper.

We also find that there are significant differences in redefault risks on the basis of the timing of the intervention (loan modification). Early intervention works best as it is associated to lower redefault risks. This supports efforts such as the FDIC's program that allows for modifying loans preventively, i.e., when borrowers appear likely to experience new difficulties meeting their mortgage obligations. Conversely, the findings suggest that waiting for borrowers to be 90 days delinquent before intervening may not be a good idea as the probability of redefault is much higher at that point in time.

As expected, we find that local economic conditions play a key role on the success of loan modifications: a one percent rise in local unemployment leads to a 1.4 percentage point increase in the probability of redefault. As the economy continues to deteriorate, it may be increasingly difficult to disentangle these macro-factors from loan-related issues. Even if modifications are successful in the short term, for instance, by lowering the loan rate to increase affordability, redefault may occur if borrowers later experience job loss due to a deteriorating local economy.

Finally, the results underline the importance of finding more innovative approaches to help borrowers who have negative equity in their homes. The results indicate that households with negative home equity are more likely to redefault over time, even when a modification has initially lowered mortgage payment. For these loans and loans that were poorly underwritten at origination, more significant loan restructuring or refinancing may be needed to minimize redefault risks. This finding is consistent with current bankruptcy reform efforts to pass legislation that would give bankruptcy judges new power to restructure mortgages and reduce mortgage payments.

Our findings illustrate that not all modifications are created equal. The industry clearly needs standards and directives for making more modifications and more sustainably than is the current practice. To the extent practicable, modifications need to be tailored to the particular conditions of the borrower, loan product, and market. We believe much data exists in the shared databases and within servicers' own portfolios to apply better modification decisions at a greater scale.

Reference

Ambrose, B. W. and Capone, C. A. 1996. Cost-Benefit Analysis of Single-Family Foreclosure Alternatives. *The Journal of Real Estate Finance and Economics* 13(2): 105-20.

American Securitization Forum (ASF). 2007. Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans. Available at http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf (last accessed 2/19/09).

Aversa, J. and Zibel, A. 2009. Fed Moves to Help Distress Homeowners. Associated Press, Available at http://news.yahoo.com/s/ap/20090128/ap_on_bi_ge/fed_foreclosure_relief (last accessed 2/19/09).

Bureau of Labor Statistics. 2009. The Employment Situation: January 2009. Available at http://www.bls.gov/news.release/empsit.nr0.htm (last accessed 2/19/09).

Capone, C. A. J., and Metz, A. 2003. Mortgage Default and Default Resolutions: Their Impact on Communities. Available at http://www.chicagofed.org/cedric/files/2003_conf_paper_session2_capone.pdf (last accessed 2/19/09).

Credit Suisse. 2007. "The Day After Tomorrow: Payment Shock and Loan Modifcations," *Credit Suisse Fixed Income Research*, 05 April 2007. www.credit-suisse.com/researchandanalytics.

_____. 2008. *Subprime Loan Modifications Update. Credit Suisse Fixed Income Research,* October 1 2008.

Cutts, A.C., and Green R.K. 2005. Innovative Servicing Technology: Smart Enough To Keep People In Their Houses? In N. Retsinas, & E. Belsky (Eds.), *Building Assets, Building Credit: Creating Wealth In Low-Income Communities*, 348–377. Washington, DC: The Brookings Institution Press.

Cutts, A.C., and Merrill, W.A. 2008. Interventions in Mortgage Default, Policies and Practices to Prevent Home Loss and Lower Costs. Freddie Mac Working Paper, Available at http://www.freddiemac.com/news/pdf/interventions_in_mortgage_default.pdf. (last accessed 2/19/09).

Eggert, K. 2004. Limiting Abuse and Opportunism by Mortgage Servicers. *Housing Policy Debate* 15(3): 753–84.

_____. 2007. What Prevents Loan Modifications? *Housing Policy Debate* 18(2): 279-297.

Evers, J. H. 2009. Testimony of Joseph H. Evers before the Subcommittee on Housing and community Opportunity of the U.S. House of Representatives (February 24).

Federal Deposit Insurance Corporation (FDIC). 2008. FDIC Loan Modification Program Overview. Available at http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf (last accessed 2/19/09).

Federal Housing Finance Agency (FHFA). 2008. Federal Housing Finance Agency Foreclosure Prevention Report: Disclosure and Analysis of Fannie Mae and Freddie Mac Mortgage Loan Data for the Third Quarter 2008. Available at http://www.fhfa.gov/webfiles/404/Q3ForeclosurePrevention.pdf (last accessed 2/19/09).

Board of Governors of the Federal Reserve System. 2008. Flow of Funds Accounts of the United States: Flows and Outstandings Third Quarter 2008 . Available at http://www.federalreserve.gov/releases/z1/current/z1.pdf (last accessed 2/19/09).

Foote, D. L., Gerardi, K., Goette, L., and Willen, P. S. 2008. Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't. Federal Reserve Bank of Boston, *Public Policy Discussion Paper* No. 08-2

Foster, C. and Van Order, R. 1984. An option-based model of mortgage default. *Housing Finance Review* 3(4): 351-72.

Kau, J.B., Keenan, D.C., and Kim, T. 1993. Transaction costs, suboptimal termination and default probabilities. *Journal of the American Estate and Urban Economics Association* 21(3): 247-63.

Immergluck, D. 2008. From the Subprime to the Exotic, Excessive Mortgage Market Risk and Foreclosures. *Journal of the American Planning Association* 74(1): 59-76.

Inside B&C Lending. 2008. Subprime Mods Increase; ASF Extends Rate Freeze. 13(15).

Inside Mortgage Finance. 2008. GSEs Launch Streamlined Modification Programs, But Even Lenders Acknowledge More Must be Done. 25(49).

_____. 2009. Boosting Mortgage Activity, Consumer Protection Will Preoccupy Congress in 2009, Observers Say. *Inside Mortgage Finance* 26(1).

Mayer, C. and Gan, Y. 2006. *Agency Conflicts, Asset Substitution, and Securitization*. Available at http://ssrn.com/abstract=917564 (last accessed 2/19/09).

Mortgage Bankers Association (MBA). 2008. Delinquencies Increase, Foreclosure Starts Flat in Latest MBA National Delinquency survey Available at http://www.mbaa.org/NewsandMedia/PressCenter/66626.htm (last accessed 2/19/09).

Office of the Controller of the Current and Office of Thrift Supervision (OCC and OTS). 2008. OCC and OTS Mortgage Metrics Report: Third Quarter 2008. Washington, DC:. Available at http://files.ots.treas.gov/482028.pdf (last accessed 2/19/09).

Pennington-Cross, A., and G. Ho. 2006. Loan Servicer Heterogeneity and The Termination of Subprime Mortgages. Federal Reserve Bank of St. Louis, *Working Paper Series* 2006-024A. Available at http://research.stlouisfed.org/wp/2006/2006-024.pdf (last accessed 2/19/09).

Piskorski, T., Seru, A. and Vig, V. 2008. Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis (December 30, 2008). Available at http://ssrn.com/abstract=1321646 (last accessed 2/19/09).

Stolberg, S.G. and Andrews, E.L. 2009. $275 Billion Plan Seeks to Address Housing Crisis. http://www.nytimes.com/2009/02/19/business/19housing.html?_r=1&hp, (last accessed 2/19/09).

Stegman, M. A., Quercia, R.G., Ratcliffe, J., Ding, L., and Davis, W. 2007. Preventive Servicing Is Good for Business and Affordable Homeownership Policy. *House Policy Debate* 18(2): 243-278.

Vandell, K.D., and Thibodeau, T. 1985. Estimation of mortgage defaults using disaggregate loan history data. *Journal of the American Estate and Urban Economics Association* 13(3): 292-316.

Vandell, K. D. 1995. How Ruthless is Mortgage Default? A Review and Synthesis of the Evidence. *Journal of Housing Research* 6(2): 245-62.

White, A. M. 2008. Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports. *Fordham Urban Law Journal*, Forthcoming. August 26. Available at http://ssrn.com/abstract=1259538 (last accessed 2/19/09).

White, A. M. 2009. Deleveraging the American Homeowner: The Failure of 2008 Voluntary Mortgage Contract Modifications. *Connecticut Law Review*, Forthcoming. January 9. Available at http://ssrn.com/abstract=1325534 (last accessed 2/19/09).

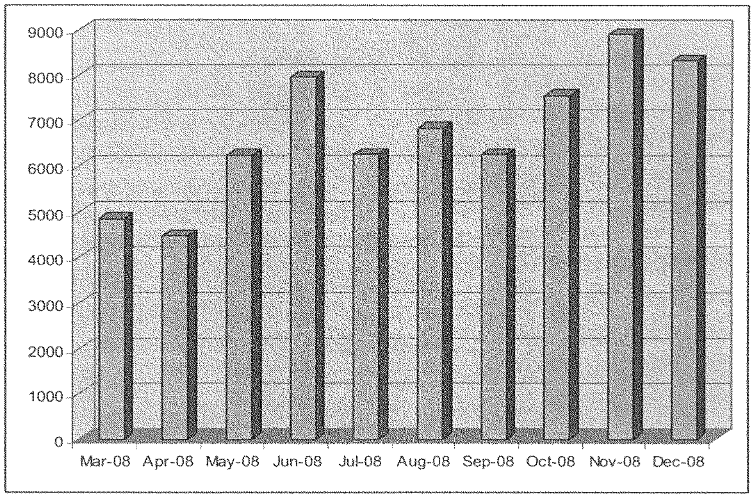


Figure 1 Loan Modifications by Month

Note: based on the 2006 deals of the remittance reports. These are raw numbers without any exclusion.

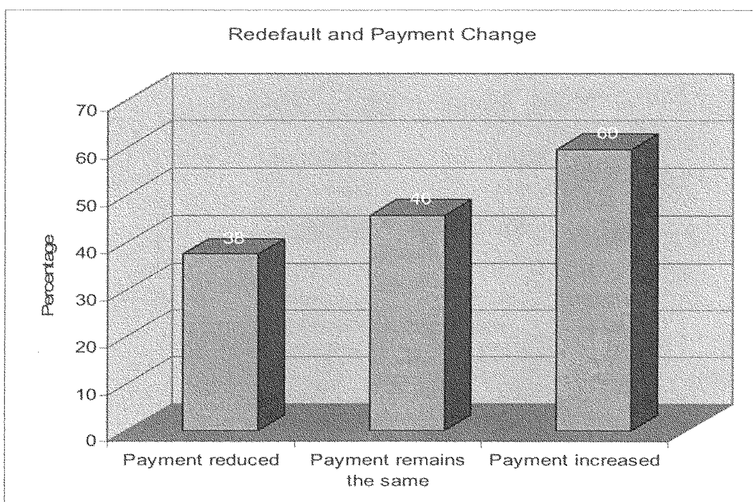


Figure 2 Redefault (30+day) and Mortgage Payment Change

Note: based on the 2006 deals of the remittance reports. Redefault is defined as 30+day delinquency as of December 2008. If the value after modification is in the range of 99-101 percent of the value before the modification, we consider it as "the same".

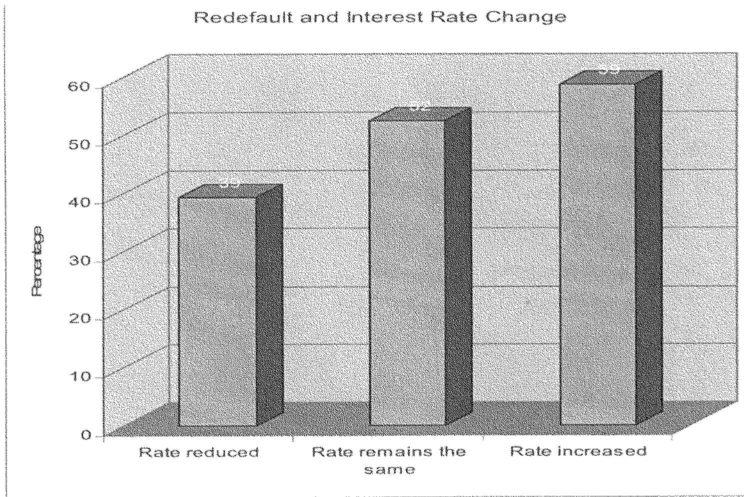


Figure 3 Redefault (30+day) and Interest Rate Change

Note: based on the 2006 deals of the remittance reports. Redefault is defined as 30+day delinquency as of December 2008. If the value after modification is in the range of 99-101 percent of the value before the modification, we consider it as "Same".

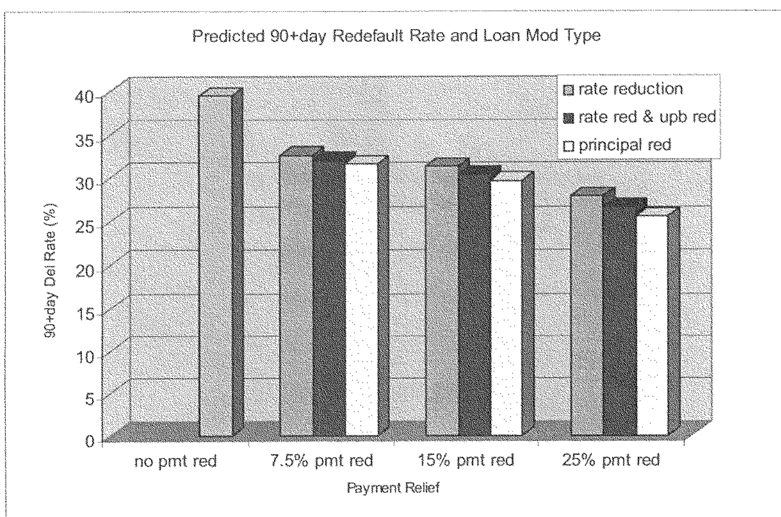


Figure 4 Predicted Redefault (90+day) Rate and Type of Modifications

Note: Estimation is based on the results of Model 1 in Table 6. Estimation is for an average borrower holding 30-year home purchase mortgage originated in January 2006, with an adjustable interest rate of 8.84 percent in the second quarter 2008. The original loan amount is $238,726. The property is not in CA or FL and not served by the major four servicers. The loan has average value for other regressors.

Table 1 Characteristics of Different Loan Types

	Loan-type	FICO Score	OLTV	Interest rate	ARM (%)	PPP(%)	Interest Only(%)	Low/No doc (%)	At least 1 risky factor *	N Obs
All Loans	Missing	671	73.25	8.12	61.45	53.11	27.9	55.2	88.11	757,035
	Conventional	698	72.72	7.17	58.74	35.69	42.51	52.6	85.57	205,018
	FHA	564	93.46	6.84	4.44	0	0	95.1	99.48	4,075
	VA	578	88.82	6.96	1.51	0	0	99.8	100	465
	Conventional w/ PMI	715	90.62	6.82	13.78	3.9	6.37	55.3	81.12	1,822
	Jumbo	740	71.00	6.64	0	0	15.61	45.7	55.46	1,839
	Conforming	674	72.12	8.24	63.24	50.39	28.78	68.6	79.52	90,244
	Non Conforming	695	76.01	7.66	70.53	48.29	37.66	66.5	94.78	35,586
	Subprime	629	71.73	9.07	57.57	62.24	19.18	37.3	91.54	171,743
	Other	694	74.45	7.25	0	11.83	29.28	85.6	91.33	2,206
	Alt A	702	76.11	8.15	60.41	55.4	22.02	76.2	92.25	20,675
	Total									1,290,708
Modified Sample	Missing	617	81.53	8.84	91.42	78.77	24.49	36.8	89.70	6273
	Conventional	604	82.33	9.04	76.92	58.65	19.71	43.7	96.47	624
	Conforming	614	81.91	8.85	93.89	70.90	17.36	46.7	96.09	409
	Non Conforming	635	81.31	8.40	97.45	79.62	28.03	63.7	94.90	157
	Subprime	604	82.59	8.80	90.18	76.26	26.35	34.8	93.92	2220
	Other	663	80.00	7.38	0.00	0.00	100.00	100	100.00	2
	Alt A	675	75.03	10.06	75.00	62.50	37.50	75	87.50	8
	Total									9,693

*Features that are considered risky include 1) borrower FICO score less than 620; 2) interest-only mortgage; 3) negative amortization mortgages; 4) limited or no documentation; 5) original loan-to-value ratios higher than 90 percent.

Table 2 Descriptive Statistics

Characteristics	Value
Original FICO	614
Interest rate	8.84
Appraisal Value	260194
Loan Amount	238726
OLTV	81.83
Home purchase	46.04%
ARM	90.37%
Interest Only	24.39%
Negative Amort	4.30%
Full-doc/Alt-doc	62.34%
Origination Year	
2005	33.57%
2006	66.43%
Property Location	
CA	24.95%
FL	11.72%
TX	4.56%
AZ	4.32%
MI	4.22%
MD	3.43%
Others	46.80%
Servicer	
Servicer 1	30.42%
Servicer 2	23.32%
Servicer 3	13.30%
Servicer 4	7.49%
Others	25.47%
Redefault as of Dec 08 (30+day)	44.75%
N	9,693

Table 3 Loan Modifications by Payment Reduction

Payment reduction	Frequency	Percent
>40% reduction	566	5.84
30-40% reduction	844	8.71
20-30% reduction	1272	13.12
10-20% reduction	1479	15.26
5-10% reduction	596	6.15
1-5% reduction	404	4.17
No reduction	2272	23.44
Increase	2260	23.32
Total	9,693	

Note: Based on the 2006 deals of the remittance reports. All second-liens, non-owner-occupied, and loans with missing information have been excluded.

Table 4 Types of Loan Modifications

Variable1	Loan Mod Type 1	Percent
r0p0	rate reduction and principal reduction	6.19
r0p1	rate reduction only	52.92
r1p0	principal reduction only (rare)	2.26
r1p1**	no rate reduction and no principal reduction (traditional)	38.63
Total		9,693

** Reference group in the model.

Note: Based on the 2006 deals of the remittance reports. All second-liens, non-owner-occupied, and loans with missing information have been excluded.

Table 5 Logit Regression of Redefault (30+day)

Parameter	Model 1			Model 2		
	Estimate	P -Value	Marginal Effect	Estimate	P -Value	Marginal Effect
Intercept	-4.769	0.000		-5.111	0.000	
FICO Score	-0.003	0.000	-0.001	-0.003	0.000	-0.001
30- or 60-days Del when Modified	0.488	0.000	0.121	0.489	0.000	0.121
90+day Del when Modified	0.572	0.000	0.141	0.574	0.000	0.141
Times_in_del in prior 12 mons	0.118	0.000	0.029	0.127	0.000	0.031
Loan Balance (in log)	0.397	0.000	0.098	0.406	0.000	0.100
Estimated CLTV	0.314	0.054	0.077	0.421	0.011	0.104
ARM	0.184	0.020	0.045	0.203	0.010	0.049
Interest only	0.070	0.203	0.017	0.119	0.030	0.029
Full_doc	-0.106	0.032	-0.026	-0.096	0.052	-0.024
Home Purchase	0.343	0.000	0.084	0.334	0.000	0.082
Unemployment rate	0.058	0.000	0.014	0.052	0.000	0.013
y2006	0.123	0.015	0.030	0.156	0.002	0.038
CA	0.075	0.334	0.018	0.064	0.407	0.016
FL	0.330	0.000	0.082	0.318	0.000	0.079
Servicer1	0.131	0.043	0.032	0.155	0.021	0.038
Servicer2	0.202	0.002	0.050	0.231	0.000	0.057
Servicer3	0.030	0.711	0.007	-0.046	0.555	-0.011
Servicer4	-0.025	0.796	-0.006	0.087	0.359	0.022
pmt reduced >40%	-1.052	0.000	-0.229			
pmt reduced 30-40%	-0.802	0.000	-0.183			
pmt reduced 20-30%	-0.577	0.000	-0.136			
pmt reduced 10-20%	-0.470	0.000	-0.112			
pmt reduced 5-10%	-0.432	0.000	-0.103			
pmt reduced 1-5%	-0.215	0.064	-0.052			
pmt same (99%-101%)	0.043	0.557	0.011			
r0p0: rate and principal reduced				-0.840	0.000	-0.189
r0p1: rate reduced only				-0.543	0.000	-0.133
r1p0: principal reduced only				-0.420	0.007	-0.100
pseudo R-sq		0.1520			0.1477	
Log likelihood		-5866.1			-5890.4	

Note: N=9,693

Table 6 Logit Regression of Redefault (90+day)

Parameter	Model 1			Model 2		
	Estimate	P -Value	Marginal Effect	Estimate	P -Value	Marginal Effect
Intercept	-6.344	0.000		-6.428	0.000	
FICO Score	-0.001	0.026	0.000	-0.001	0.026	0.000
30- or 60-days Del when Modified	0.513	0.000	0.098	0.459	0.000	0.088
90+day Del when Modified	0.707	0.000	0.130	0.620	0.000	0.114
Times_in_del in prior 12 mons	0.089	0.000	0.016	0.094	0.000	0.017
Loan Balance (in log)	0.329	0.000	0.058	0.340	0.000	0.060
Estimated CLTV	0.490	0.006	0.086	0.585	0.001	0.104
ARM	0.247	0.005	0.041	0.294	0.001	0.049
Interest only	-0.011	0.862	-0.002	0.027	0.654	0.005
Full_doc	-0.168	0.002	-0.030	-0.160	0.003	-0.029
Home Purchase	0.410	0.000	0.073	0.407	0.000	0.073
Unemployment rate	0.052	0.000	0.009	0.047	0.001	0.008
y2006	0.142	0.013	0.025	0.176	0.002	0.031
CA	0.204	0.016	0.037	0.215	0.011	0.039
FL	0.380	0.000	0.072	0.375	0.000	0.071
Servicer1	-0.023	0.755	-0.004	-0.049	0.514	-0.009
Servicer2	0.161	0.024	0.029	0.226	0.001	0.041
Servicer3	-0.078	0.396	-0.014	-0.184	0.042	-0.031
Servicer4	-0.204	0.054	-0.034	-0.144	0.166	-0.025
pmt reduced >40%	-0.884	0.000	-0.123			
pmt reduced 30-40%	-0.651	0.000	-0.098			
pmt reduced 20-30%	-0.523	0.000	-0.082			
pmt reduced 10-20%	-0.362	0.000	-0.059			
pmt reduced 5-10%	-0.300	0.007	-0.049			
pmt reduced 1-5%	-0.151	0.222	-0.026			
pmt same (99%-101%)	0.347	0.000	0.064			
r0p0: rate and principal reduced				-0.776	0.000	-0.113
r0p1: rate reduced only				-0.517	0.000	-0.092
r1p0: principal reduced only				-0.179	0.291	-0.030
pseudo R-sq		0.103			0.0971	
Log likelihood		-4986.5			-5017.9	

Note: N=9,693

Table 7 Logit Regression of Redefault for Modifications with Significant Payment Reduction (with 5% or more payment reduction)

Parameter	30+day			90+day		
	Estimate	P -Value	Marginal Effect	Estimate	P -Value	Marginal Effect
Intercept	-4.669	0.000		-5.796	0.000	
FICO Score	-0.002	0.002	-0.001	-0.001	0.320	0.000
30- or 60-days Del when Modified	0.437	0.000	0.103	0.309	0.013	0.046
90+day Del when Modified	0.762	0.000	0.177	0.652	0.000	0.097
Times_in_del in prior 12 mons	0.105	0.000	0.024	0.097	0.000	0.014
Loan Balance (in log)	0.309	0.000	0.070	0.274	0.000	0.038
ARM	0.142	0.272	0.032	0.079	0.611	0.011
Interest only	0.073	0.362	0.017	0.083	0.387	0.012
Full_doc	-0.037	0.606	-0.008	-0.049	0.559	-0.007
Home Purchase	0.254	0.000	0.058	0.305	0.000	0.043
Unemployment rate	0.054	0.000	0.012	0.068	0.000	0.010
y2006	-0.027	0.696	-0.006	-0.088	0.281	-0.012
Servicer1	0.163	0.058	0.037	-0.087	0.393	-0.012
Servicer2	-0.181	0.127	-0.040	-0.210	0.125	-0.028
Servicer3	-0.106	0.298	-0.024	-0.326	0.010	-0.043
Servicer4	-0.030	0.862	-0.007	-0.059	0.773	-0.008
estimated cltv 70-80%	0.167	0.189	0.038	0.083	0.595	0.012
estimated cltv 80-90%	0.319	0.010	0.074	0.175	0.244	0.025
estimated cltv 90-95%	0.344	0.020	0.081	0.356	0.144	0.055
estimated cltv 95-100%	0.406	0.006	0.096	0.275	0.129	0.041
estimated cltv >100%	0.304	0.024	0.070	0.300	0.063	0.044
pseudo R-sq		0.1255			0.0708	
Log likelihood		-2815.4			-2138.6	

Note: N=4,757

Support & Guidance For Homeowners

Statement of

Faith Schwartz

Executive Director, HOPE NOW Alliance

before the

Subcommittee on Housing and Community Opportunity

of the

Committee on Financial Services

United States House of Representatives

March 19, 2009, 10:00 a.m.

Hearing on

"Examining the Making Home Affordable Plan"

2128 Rayburn House Office Building

Chairwoman Waters, Ranking Member Capito, and Members of the Committee, I am Faith Schwartz, Executive Director of the HOPE NOW Alliance. I appreciate the opportunity to appear before you today to talk about what the members of the HOPE NOW Alliance are doing to help at-risk homeowners stay in their homes during this challenging time. I will discuss our work with the Administration on the President's Making Home Affordable Plan to help servicers prepare to implement the program, the latest HOPE NOW data regarding loan modifications and other workouts for homeowners, the upgrades to the HOPE NOW website making it more useful for homeowners who are seeking help, and our in-person outreach events across the country.

The HOPE NOW Alliance is a broad-based voluntary collaboration between lenders, HUD-approved housing counselors, investors, mortgage market participants and trade associations. Currently, we have 34 servicer members which account for over ninety percent of the subprime market and nearly seventy percent of the prime market. A full list of HOPE NOW members is attached for your reference.

HOPE NOW utilizes a coordinated, national approach working to enhance our ability to reach out to borrowers who may have or expect to have difficulty making their mortgage payments and to offer them workable options to avoid foreclosure. We connect distressed homeowners with counselors and their servicers at no-cost to the homeowner.

Briefly, here are some of the key roles performed by the HOPE NOW Alliance:

1. HOPE NOW supports the national 888-995-HOPE hotline to connect concerned homeowners to trained non-profit counselors at HUD-certified agencies.
2. HOPE NOW reaches out to at-risk homeowners through events in communities across the nation to enable homeowners to talk in-person with their servicer or a trained counselor.
3. HOPE NOW operates a website that is continually upgraded to provide homeowners with another option to contact their servicer or a certified counselor.
4. HOPE NOW conducts an on-going direct mail campaign to the most at-risk homeowners urging them to seek assistance.
5. HOPE NOW serves as a clearing house for servicers as they work toward best practices in servicing.
6. HOPE NOW coordinates and shares information between the government, the GSEs and servicers as they develop policies to apply to loan modification efforts.
7. HOPE NOW serves as a contact and facilitator between counseling agencies and servicers.
8. HOPE NOW collects data on actual loan workouts and modifications and voluntarily publishes these results.

I am pleased to have the opportunity to comment on the HOPE NOW Alliance's efforts to respond to the Administration's program, as well as our on-going efforts to reach and assist troubled homeowners.

ADMINISTRATION'S MAKING HOME AFFORDABLE PLAN

HOPE NOW applauds the President for the "Homeowner Affordability and Stability Plan" (HASP) and supports the Administration's efforts to help at-risk homeowners. Over the past year, the HOPE NOW Alliance has promoted cooperation with mortgage servicers and counselors to minimize foreclosures and keep as many people in their homes as possible. We will continue to work toward this goal and are committed to working with the Administration to make the President's program as effective as possible. We are already working with representatives from Treasury, HUD and the GSEs to understand and implement this important program and will do our best to make it a success.

The Administration's loan modification program is consistent with and expands on the streamlined approach to loan modifications that the GSEs and servicers began in December. The purpose of this type of approach is to produce an affordable payment for at-risk homeowners through a combination of methods including rate reductions, term extension, and principal forbearance; this can have a positive impact on large numbers of at-risk homeowners and to make the loan modification process more timely and efficient. We appreciate the willingness of the Administration to work with servicers in developing the implementation guidelines of the program and to answer many questions servicers have about how they must implement the program.

The President's plan is the first wide scale program for uniform modifications that will provide an affordability ratio of 31% housing debt to income for homeowners who need to have their payments reduced to be able to stay in their homes. First, servicers are required to make changes to reduce the borrowers' housing debt ratio to 38% and then the government will share the cost of reducing it to a more affordable 31%.

For homeowners with significant other household debt- debts greater than 55% of income- counseling is required. The program directs servicers to validate the borrower's hardship and income and for the loan to remain current for 90 days at the new terms in order for servicers to complete the modification. In addition to the loan modification program, the Administration's plan also calls for the GSEs to offer a refinance program to help borrowers who are current on their payments but were unable to refinance their homes. This is very significant and may help millions of homeowners receive a lower rate and a more affordable solution if they have a Fannie Mae or Freddie Mac-owned loan and are current on their payments.

HOPE NOW is working with its mortgage servicer member companies to help them understand the details of the Administration's Making Home Affordable Plan. We are hopeful that the plan will help millions of Americans avoid foreclosure. As you know, a number of major servicers have stated that they would like to participate in the program. All servicers handling Fannie Mae and Freddie Mac loans will participate for GSE-owned loans. Servicers for private label securities are examining their ability to apply the program to loans in private mortgage-backed securities (MBS). It is too early to know the full acceptance rate for companies that manage their own portfolios and loans in private MBS, but our view is that servicers are optimistic about the program and want it to succeed.

We are working with our HOPE NOW servicers, Treasury, HUD, Fannie Mae, Freddie Mac, and with the Housing Policy Council and the Mortgage Bankers Association in identifying issues about implementation of the program and getting these issues resolved and questions answered. We have had four very productive calls with Administration and GSE officials coordinated by the Mortgage Bankers Association, HOPE NOW and the Housing Policy Council to answer the questions of the servicing industry on the specifics of the program. These calls have been productive and we await final official documents from the appropriate agencies to enable full implementation to begin.

To participate in the program for lender portfolio and non-GSE-owned loans, servicers will have to sign a contract with the Department of Treasury. It is our understanding that Treasury is working to finalize the contract form and provide it to servicers.

To help ensure that homeowners are aware of the options the government program will provide, the HOPE NOW Alliance will help educate borrowers on the Administration's program through the Homeowner's HOPE Hotline and our homeownership preservation events across the country. HOPE NOW will be including Making Home Affordable information in all outreach initiatives. This includes handouts and facilitating information sessions at all outreach events, prominently including program qualifications on the HOPE NOW website, devoting a session throughout planned radio programming, and incorporating the theme throughout all campaigns. This also includes making the program a clear option for borrowers who call the Homeowner's HOPE Hotline, 888-995-HOPE.

EXPANDING CAPACITY TO HELP BORROWERS

There is a great deal of public interest in the President's program and individual servicers and the Homeownership Preservation Foundation's Homeowner's HOPE Hotline are reporting significant increases in calls from homeowners. Since the program guidelines were announced on March 4, more than 124,000 homeowners have called the HOPE Hotline, 888-995-HOPE. On average, more than 13,500 homeowners have called the Hotline each day since the announcement, which is about 3 times the average number of daily calls prior to the release. HOPE NOW and its members have taken many actions to handle the increase of borrowers seeking refinances or modifications under the new program. Servicers have expanded call centers, phone messages, and websites to deal with the expanded volume.

HOPE NOW has expanded our website, www.hopenow.com, to link borrowers directly into the home preservations sites of all HOPE NOW servicers as well as provide links to government sites including HUD, Fannie Mae, Freddie Mac, and the Financial Stability website. Most importantly, we created a customer intake form on the HOPE NOW website which allows borrowers to input personal information including their financial situation which is then sent directly to the servicer. This way, day or night, the homeowner can go to the HOPE NOW website and request for assistance without even making a call. HOPE NOW and its members will continue to expand capacity and assist borrowers.

In addition, the Homeowner's HOPE Hotline, 888-995-HOPE, through a grant from Fannie Mae, added capacity at their triage call center. This enabled them to take up to 20,000 calls a day; this is up from 7,000 calls a day. The Homeownership Preservation Foundation has upgraded their technology making it easier for counselors to enter in data, thus freeing up more of their time to assist more homeowners. The ten network agencies that handle the Hotline's calls have added counselors; there are now a total of 580 counselors available to the HOPE Hotline, 500 of them full time, the rest available to be re-deployed during spike times. This is up from 450 counselors at the beginning of the year. The Homeownership Preservation Foundation continues to work to maximize capacity, efficiency, and effectiveness in providing free HUD-approved counseling to at-risk homeowners.

HOPE NOW'S DATA ON FORECLOSURE PREVENTION RESULTS

Collecting data on our foreclosure prevention efforts is a key component of the HOPE NOW Alliance's mission. We have tried to document the real efforts that servicers have made to provide solutions to troubled homeowners. Each HOPE NOW servicer submits detailed loan-level data: survey data on their foreclosure prevention efforts as well as loan delinquency numbers for mortgages that they service. In reporting our data, we are candid about the serious challenges facing the mortgage and housing market, as well as the very real steps servicers are taking to meet these challenges and help homeowners.

Members of the HOPE NOW Alliance have made an unprecedented voluntary effort to document their results. Via legal agreements with our members, we have put together a comprehensive, wide-reaching, and market representative database of first lien mortgage delinquency and loan modification data. This data represents roughly 75% of the entire American mortgage universe and adds up to more than $6 trillion in outstanding unpaid principal balance. Equally important, our data is not restricted to federally chartered and regulated institutions. We collect detailed data from a broad range of banks, servicers, sub-servicers, and mortgage originators, making our database one of the most complete sets of information available. Included in our data over the coming months will be statistics around foreclosure prevention efforts performed under the Administration's recently announced loan modification initiative.

A few highlights from our latest data include the following:

- In January, 2009, 2.9 million first lien mortgage loans were 60 or more days past due.
- 1 in 10 mortgages were at least 30 days delinquent, in foreclosure process, or in completed foreclosure sale also called REO inventory.
- The trend line of modifications completed each month continues to point upward, with the last month for which data was collected – January 2009 – showing the largest number of modifications yet at 123,000.
- For the past 2 months modifications have represented half of all workout solutions.
- One quarter of all loans lost to foreclosures in 2008 were non-owner occupied properties, e.g. investor properties or vacation homes.
- Nearly half of all loan modifications went to borrowers with FICO scores below 620.

More homeowners are facing new challenges. By reaching out across the industry to collect information from all sizes of servicing operations, we report on a very broad section of the market and provide valuable information on what is happening to homeowners.

HOPE NOW's WEBSITE: WWW.HOPENOW.COM

HOPE NOW's website is a trusted, reliable source, available to consumers at no cost to them. To better assist at-risk homeowners, HOPE NOW has made some significant changes to our website, www.hopenow.com. The purpose of the website is to be a national online center to inform, educate, and assist consumers to preserve homeownership. The recent changes make it easier for homeowners to get information and reach their servicer and get assistance.

HOPE NOW's website, www.hopenow.com, now has two new ways borrowers can connect with their servicer. The first is direct links to mortgage companies' loss mitigation websites where homeowners can find more information about how to reach their servicer and what information they will need to provide. This is another tool for borrowers to get in contact with their mortgage servicers. If a borrower's servicer is not listed, the website provides information about how they can obtain free counseling by HUD-approved counseling agencies. This free counseling is available through HUD-approved housing counselors and the Homeowner's HOPE Hotline, managed by the Homeownership Preservation Foundation, 888-995-HOPE. The hotline is available 24 hours a day, seven days a week. After the announcement of the Administration's plan, calls often spiked to nearly 16,000-23,000 a day with almost half being Spanish-speaking homeowners. Homeowners are hungry for information and HOPE NOW and the HOPE Hotline are trusted sources of information for distressed homeowners.

In addition to these links, the HOPE NOW website now has a simplified input tool for borrowers to reach their servicers and servicers obtain basic information about the borrowers upfront. On the homepage of www.hopenow.com, homeowners can submit a request for assistance by filling out some basic information about themselves, their mortgage, and their income. This form is then sent directly to the mortgage servicer they select in an encrypted and secured email. The mortgage servicer will then contact the borrower within 5-7 business days. By asking homeowners to provide information at the beginning, servicers will be able to contact and assist homeowners faster and more efficiently.

We have worked to make the website consumer friendly and informative. HOPE NOW's website is able to handle 500,000 hits a day and up to 1 million a day if needed. For the week of March 2, over 64,000 people visited the HOPE NOW website and for the week of March 9, over 52,000 visited the site. With the announcement of the Administration's Plan, we established a link to the Treasury's website www.financialstability.gov so homeowners can find the most up-to-date information and details of the Plan. We will continue to work on enhancing the website in more ways to continue to be a useful tool for homeowners in need.

We ask Members of Congress to continue to make your constituents aware of HOPE NOW's website and the information and links that can be found on it.

HOPE NOW OUTREACH EFFORTS

HOPE NOW continues to sponsor and coordinate local outreach events across the country getting borrowers in contact with their mortgage servicer and housing counselors. NeighborWorks America has played a key role as co-sponsor and has worked to help organize and implement many of these events. In 2008, HOPE NOW reached and assisted over 20,000 homeowners through 29 Homeownership Preservation Workshops across the country. For example, HOPE NOW has held two events in central Los Angeles assisting a combined total of 1900 homeowners. The most recent event in Los Angeles was held in December on a Saturday at the Crenshaw Christian Center and featured 14 non-profit counseling agencies and 21 mortgage servicers. In addition, last August, we hosted another successful event with the Federal Reserve Bank of Boston at Gillette Stadium in Foxborough, Massachusetts where we assisted over 2,100 homeowners.

In response to new challenges, we have a new five-prong outreach program to reach as many troubled homeowners as possible in 2009. With help from celebrities concerned about the foreclosure issue, planned phone-a-thons, new Alliance partners, and deeper outreach initiatives, we are building a stronger and broader network to reach homeowners. We are partnering with Federal Reserve Banks across the country. We have already hosted four events this year, reaching over 2,500 borrowers. Attached please find details of the 2008 outreach events and our planned events for 2009. Also attached you will find two of the many success stories about borrowers we have helped at these outreach events.

In addition to our ongoing outreach events, we have also partnered with Fannie Mae in creating an additional outreach campaign, "Bringing HOPE Home." Queen Latifah volunteered to be face of this campaign and she is urging struggling homeowners to reach out for help, either by contacting their servicer, a HUD-approved counselor, the Homeowner's HOPE Hotline, or visiting the enhanced HOPE NOW website. In each target market, the campaign includes a celebrity bus tour of impacted communities and families, the airing of a Queen Latifah narrated educational video, a series of radio programs, and a face-to-face outreach event where families meet with their servicer or a counselor. This campaign launched in February in Newark and will be in Atlanta, Miami, and Cleveland in the next two months.

We continue to mail outreach letters to delinquent borrowers and have also started a new pilot letter program to assist at-risk homeowners. This new pilot program is called Reach Out and is an additional outreach mail campaign targeting delinquent borrowers to link them to local HUD-certified counseling organizations. We are piloting this initiative throughout the state of Wisconsin with the Wisconsin Housing Economic Development Authority within the next month. We hope to expand more broadly later in the year.

A NOTE ON MORTGAGE HELP SCAMS

It is imperative that at-risk homeowners get assistance from reputable companies and HUD-certified non-profit agencies. They should be wary of paying third parties for services they can obtain directly from their mortgage servicer or a non-profit counselor. HOPE NOW has been cooperating with a number of state Attorneys General and with the Federal Trade Commission to try to make consumers aware that many individuals and companies that have used the word "HOPE" in their titles are not associated with HOPE NOW. As you know the services provided by HOPE NOW and the non-profit counselors we work with are free to homeowners. Yet many other companies and individuals are charging distressed homeowners for services that are provided by HOPE NOW members at no cost to the homeowner. In addition, while it is hard to say if services are actually provided by these for-profit third parties, many of these firms are not providing effective loan modification assistance or counseling and some appear to be fraudulent based on what individual consumers have told us at some of our outreach programs.

We are pleased with the efforts of state AGs, and the FTC, and they should be encouraged to continue and to try to combat firms and individuals who do not provide legitimate services to at-risk homeowners. At a minimum, consumers should understand that they do not have to pay for counseling and that the services these firms provide can be obtained from HOPE NOW Alliance members at no cost. I hope you will help us get this message to your constituents.

CONTINUING CHALLENGES

The HOPE NOW Alliance has achieved real success in preventing foreclosures however significant challenges remain. Our main challenge is that because of the weakness of the economy, more homeowners are facing potential problems. As our data indicates, 2.9 million borrowers are now 60 days past due on their mortgages. This is a significant number and we continue to work to assist borrowers in financial difficulty.

Another issue continues to be difficulty in reaching at-risk borrowers. Since November 2007, HOPE NOW servicers have sent over 3 million outreach letters to no-contact borrowers who are 60 days or more past due and receive on average a 20% response rate. While this is a dramatic improvement over the normal 3-4% response rate, it still means that many at-risk borrowers are not in contact with their servicer.

Additionally, while many options to avoid foreclosure are necessary as borrowers are in different situations, the variety of programs available can be confusing to homeowners. All participants, the government, industry, and HOPE NOW need to work to clarify what options are available for at-risk borrowers. We believe that the Administration's program of standardizing loan modifications will help alleviate the confusion and ambiguity.

The Administration's plan has great potential to help a tremendous number of homeowners, potentially millions. However, the program details and requirements are not yet in effect, so it is not yet possible to measure its actual impact, nor is it possible yet to know the degree of participation in the President's program. We hope the program gains wide acceptance for loans in private label securities.

As I noted, mortgage scams using HOPE NOW's name also confuse homeowners. HOPE NOW and its partners provide free services but homeowners are sometimes paying for servicers which they do not need to do. HOPE NOW will continue to work to overcome these challenges and continue to assist as many at-risk homeowners avoid foreclosure as possible.

Due to the growing number of homeowners facing economic challenges, there is a need for more counseling from trained HUD-certified agencies. The Administration could provide funding for counseling through TARP or Congress could provide more through the appropriations process. The earlier process that provided funding to certified counselors through NeighborWorks worked well. Legitimate non-profit agencies need funding to continue to counsel Americans at risk of losing their home and can help connect them to their servicer.

CONCLUSION

HOPE NOW continues to work to help at-risk homeowners avoid foreclosure by connecting them to their servicer and/or a HUD-approved counselor who can assist them in finding an affordable solution. We work to develop lines of communication. Outreach to homeowners is essential to preserving homeownership and educating homeowners on their options based on their financial situation. We support the Making Home Affordable Plan and other legitimate efforts to help at-risk homeowners will also need to continue. The HOPE NOW Alliance wants to continue to work with the Administration and our member companies and non-profits to assist as many homeowners who need and want help to stay in their homes. Our work is on-going and I will continue to keep you updated on our progress.

Thank you for inviting me to testify before you today on HOPE NOW's ongoing efforts to assist at-risk homeowners in avoiding foreclosure. I am happy to answer any questions you may have.

HOPENOW

Support & Guidance For Homeowners

HOPE NOW Membership

Counselors

- ACORN Housing Corporation
- Catholic Charities USA
- Citizens' Housing and Planning Last saved by Association, Inc.
- Consumer Credit Counseling Service of Atlanta
- HomeFree- USA
- Homeownership Preservation Foundation
- Housing Partnership Network
- Mission of Peace
- Mississippi Homebuyer Education Center-Initiative
- Mon Valley Initiative
- Money Management International, Inc.
- National Association of Real Estate Brokers-Investment Division, Inc.
- National Community Reinvestment Coalition
- National Council of La Raza
- National Credit Union Foundation
- National Foundation for Credit Counseling, Inc.
- National Urban League
- NeighborWorks America
- Neighborhood Assistance Corporation of America
- Rural Community Assistance Co.
- Structured Employment Economic Development Co.
- West Tennessee Legal Services, Inc.

Servicers/Lenders/Mortgage Market Participants

- Acqura Loan Services
- Accredited Home Lenders
- American Home Loan Servicing, Inc.
- Assurant, Inc.
- Aurora Loan Services
- Bank of America
- Carrington Mortgage Services
- Chase
- Citigroup, Inc.
- Countrywide Financial Corporation
- EMC Mortgage Corporation
- Fannie Mae
- Freddie Mac
- Genworth Financial
- GMAC ResCap/Homecomings
- Home Loan Services, Inc. (d/b/a First Franklin Loan Services & NationPoint Loan Services)
- HomEq Servicing
- HSBC Finance
- IndyMac Federal Bank
- LandAmerica Financial Group, Inc./LoanCare Servicing Center
- Litton Loan Servicing
- MERS
- Metlife Home Loans, (fka First Horizon Home Loans and First Tennessee Home Loans)
- MGIC
- National City Mortgage Corporation
- Nationstar Mortgage, LLC.
- Ocwen Loan Servicing, LLC.
- PMI Mortgage Insurance Co.
- Residential Credit Solutions, Inc.
- Radian Guaranty Inc.
- RoundPoint Mortgage Services Corporation
- Saxon Mortgage Services
- Select Portfolio Servicing, Inc.
- State Farm Insurance Companies
- SunTrust Mortgage, Inc.
- Taylor Bean & Whitaker
- The CIT Group
- Wachovia
- Washington Mutual, Inc.
- Wells Fargo & Company
- Wilshire Credit Corporation

(Continued)

HOPENOW Support & Guidance For Homeowners

HOPE NOW Membership (cont.)

Trade Associations

- American Bankers Association
- American Financial Services Association
- American Securitization Forum
- Consumer Bankers Association
- Consumer Mortgage Coalition
- The Financial Services Roundtable
- The Housing Policy Council
- Mortgage Bankers Association
- Securities Industry and Financial Markets Association

HOPENOW Support & Guidance For Homeowners

HOPE NOW Alliance Homeownership Preservation Workshops

The Homeownership Preservation Workshops are key outreach initiatives designed to allow homeowners at risk of foreclosure an opportunity to meet with their mortgage servicer and a local foreclosure counseling organization face-to-face for free.

In 2008, the Alliance held twenty-nine (29) events across the country. Typically, NeighborWorks America served as a key co-sponsor. In addition, HOPE NOW servicers, the GSEs, local non profit counselors, and Federal Reserve Banks were major contributors to each event's success. The Alliance met with over 20,000 distressed homeowners, providing workout solutions to many of them.

New challenges bring new approaches for 2009, establishing plans for a five pronged outreach program to reach as many troubled homeowners as possible. With help from celebrity faces, planned Phone-A-Thons, new alliance partners, and deeper outreach initiatives, the coming year aims to build a stronger network to reach homeowners.

2008 Events

Date	Locations	Number of Non-Profit Counselors	Number of Servicers	Number of Borrowers Reached
March 3	Riverside, CA	N/A	10	227
March 5	Anaheim, CA	N/A	10	267
March 7	Stockton, CA	N/A	12	411
March 30	Columbus, OH	5	12	170
April 1	Philadelphia, PA	30	14	328
April 19	Atlanta, GA	N/A	13	696
April 21	Milwaukee, WI	16	10	501
April 22	Indianapolis, IN	N/A	14	312
April 24	Chicago, IL	17	17	642
May 3	Memphis, TN	19	9	232
May 5	Jacksonville, FL	23	12	237
June 9	Dallas, TX	28	22	469
June 10	San Antonio, TX	12	11	150
June 13 & 14	Las Vegas, NV	N/A	15	1328
July 25	Newark, NJ	23	12	193
July 26	Mount Laurel, NJ	10	12	206
August 12	Boston, MA	52	20	2176
August 21	Orlando, FL	7	19	1008
August 22	Estero, FL	9	17	614
August 23	Ft Lauderdale/ Miami, FL	14	19	1695
September 13	Fairfax County, VA	15	12	241
September 20	Prince Georges Co., MD	15	12	100
October 22	Tucson, AZ	21	17	490
October 23	Phoenix, AZ	22	17	1815
November 15	Houston, TX	9	18	953
November 19	Cleveland, OH	14	20	671
November 20	Cincinnati, OH	18	15	366
December 4	Sacramento, CA	18	19	2050
December 6	Los Angeles, CA	14	21	1635
Year-End Total Number of Borrowers Reached				20,183

HOPENOW Support & Guidance For Homeowners

HOPE NOW Alliance Homeownership Preservation Workshops

2009 Events

Date	Locations	Number of Non-Profit Counselors	Number of Servicers	Number of Borrowers Reached
January 10	Belleville, MI	Event snowed out, only intake forms collected 323		
January 15	Denver, CO	18	18	488
February 14	Hartford, CT	19	15	1013
February 26	Kansas City, MO	11	12	736
March 25	Edison, NJ	Events Pending		
April 15 & 16	Atlanta, GA			
April 22 & 23	Miami, FL			
April 25	Charlotte, NC			
April 28	Cleveland, OH			
May 1	Prince Georges County, MD			
May 2	Prince William County, VA			
Current Total Number of Borrowers Reached				2560

HOPENOW Support & Guidance For Homeowners

Success Stories from Outreach Events

July 2008, Newark NJ
We had a borrower attend the HOPE NOW event in New Jersey. Mrs. X was escorted to our table and was upset because she had been trying diligently to work through a modification. She came with documents in hand. The negotiator at the event was able to review her documents and immediately we waived all late charges for any inconvenience, and to demonstrate our ability and willingness to work with her. The borrower is self-employed and was challenged with collection of receivables, in addition to the business aspect as a result of the economy. The combination of the two made it difficult for her to maintain her mortgage payment at the existing rate, by reducing it she has been successfully with maintaining her payments even if receivables are late from her own customers. After careful review of the documents we were able to decision the modification at the event and reduce her ARM loan to a substantially lower fixed rate for the life of the loan. Monday morning following the event the Modification Agreement was drawn up, sent to the borrower, she signed and returned them promptly, and today she continues to be current.

September 2008, Prince Georges County MD
A homeowner came to the event who was over extended due to a recent reduction of income. She was juggling back and forth keeping her debts current basically by using credit cards to pay her bills. None of the debts she had incurred came from frivolous spending. She had trimmed her budget to the bare minimum, cutting out cable television and trimmed the grocery bill to almost nothing. I remember her telling us at the event that groceries were the last obligation on her mind because she was striving so hard to keep her credit clean. Based on the large deficit (in excess of $2000/month) we were unable to assist her initially. I went through routine suggestions including: trimming the budget, seeking credit counseling, getting a part time job and she indicated that she had tried all of that before and that (Counseling Agency) wasn't able to formulate a plan based on the lack of surplus. She was literally borrowing off her credit cards to pay the utilities and when she got paid, would use that to pay the minimum credit card payments, essentially accumulating more and more debt because of the constant deficit. I advised her to keep in contact with me, to contact each individual creditor on her own to try to work out a payment reduction with them to ultimately reduce the overall debt. Five months later she contacted me, having done the plan we suggested and she had reduced her over all debt to the point where she still had a deficit, but one that could be overcome with a loan modification. She faxed me documentation supporting every adjustment that was made. Using the total household income and reviewing the new household budget, she now qualifies for a loan modification. The case is in the last stages of completion. Each time I speak with this borrower she expresses her gratitude and how happy she was that she attended the event because each time she tried to get assistance over the phone, no one was willing to take the time to review her individual situation and see that she really was in real jeopardy of losing her home…hanging on by a thread. The personalization of a face to face meeting and advice she received led to what is ultimately a happy ending.

**Questions to Mr. Dean Baker, Co-Director,
Center for Economic and Policy Research**

Re a hearing of

The Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Program"

On March 19, 2009

1. In your testimony, you discuss your Subprime Borrower Protection Plan, which will allow homeowners facing foreclosure the option of renting their home for as long as they want at the fair rate.

    - Can you discuss the obstacles that could prevent banks, servicers, and borrowers from fully participating in such a program?

        The intention is to give homeowners facing foreclosure the right to stay in their house as renters for a substantial period of time. The idea is that this would alter the incentives for lenders. Foreclosure will be a much less attractive option if it could result in a homeowner remaining in the house as a tenant for a substantial period of time.

        If foreclosure is a less attractive option then lenders will be far more likely to seek to work out arrangements that allow homeowners to remain in their homes as owners. However, if this proves impossible, homeowners will at least have security in being able to stay in their home and not disrupt their lives by being forced to move.

        Lenders can allow homeowners to stay in their home as renters following foreclosure. Freddie Mac is already doing this, although only on a month to month basis. However to really provide security to homeowners, Congress would have to approve legislation, such as the *Saving Family Homes* Act (HR 6116) introduced by Representative Grijalva last year.

    - How many homeowners do you predict could be assisted with your proposed plan?

        This would depend on how broadly Congress opted to make the plan. The two key variables are the cost of the homes that qualify for the plan and the length of time that a homeowner would be able to stay in their home

following foreclosure. The legislation could be structured to only help relatively low-income people, for example restricting it to homes that sold for less than 80 percent of the median house price in a metropolitan area. Alternatively, it could be structured to include all but the affluent, for example by setting the cutoff at 200 percent of the median house price.

The length of rental tenure will also make a substantial difference in the impact. If it were only a relatively short period (e.g. six months to a year), then lenders may view it as only an inconvenience. This may not substantially alter their incentives. However, if the period was substantial (e.g. 10 years), then lenders would likely be far less anxious to foreclose.

2. In your opinion, what are the obstacles to implementing more effective types of loan modifications, similar to the ones addressed in your testimony?

I think the biggest obstacle is that the banks would have to acknowledge the losses that they have incurred on their loans. At the moment, the banks have not written down the losses by anywhere close to the true amount. As long as they can avoid acknowledging losses, they will not have to raise more capital and may even be able to report good profits. This can boost stock prices and increase the value of executive stock options and make top executives eligible for bonuses.

It is also worth noting that this problem will be made worse by the suspension of mark to market accounting. This allows banks to keep these loans on their books at whatever value they choose.

3. Is more data and research necessary to better understand the magnitude of the foreclosure crisis and the impact of different types of loan modifications?

There are always areas in which more research can be helpful, but I think the answer to most of the big questions are already known. The major problem is a reluctance for policymakers to look at the evidence.

For example, it is easy to compare the costs of ownership under various modification schemes with the cost of renting comparable units in the same area. This is the most basic test of whether a market is subject to a bubble. If ownership costs substantially exceed rent on a comparable unit, then it is likely that prices will fall further in the years ahead. In these cases, most modifications will still lead to situations in which families are spending more on ownership costs than they would to rent a comparable unit. And, since house prices are going to fall, they are almost certain to leave their home with little or no equity when they move.

Modifications in these circumstances do not help homeowners and are likely to just end up wasting taxpayer dollars. However, there is very little interest among policymakers in considering this issue for some reason.

4. What kind of oversight and evaluation metrics should be used to assess the success of the program?

The most obvious metric would be the number of people who are able to stay in their homes as owners for a substantial period of time. It would also be helpful to know how many end up accumulating equity by the time they leave their home. Finally, we do want to know the cost to the taxpayers. There are competing uses for government money and we should know how much the taxpayers are paying for each foreclosure prevented.

5. What measures do you recommend to prevent for-profit mortgage servicers from defrauding borrowers?

The penalties for fraud in these cases have to be enforced. Also, the servicers have to be put on notice in a very visible way that fraud will not be tolerated. This can presumably be done with a sting operation. The F.B.I., or perhaps another law enforcement agency, can send agents posing as homeowners to servicers who are known as being abusive. If the servicers do attempt to defraud these agents then there would be an airtight case for prosecution.

Such an action would likely get a great deal of publicity and put all the servicers on notice that fraud will no longer be tolerated. This should be a relatively low cost mechanism for getting the message out.

Questions to Dr. John D. Geanakoplos, Professor of Economics, Yale University

Re a hearing of

The Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Program"

On March 19, 2009

Answers prepared by John Geanakoplos and Susan Koniak[1]

1. In your testimony, you advocate getting rid of the President's plan and implementing a new scheme that emphasizes principal reductions. Can you describe how you would build upon the President's plan to include your recommendations?

We do not believe that the current plan can be tweaked to include principal reductions on a scale that will solve the problem.

A major premise of the President's plan is that the existing contract restrictions on what and how much can be modified are left in place. Far more modifications are needed than the current contracts allow.

The central idea in the President's plan is the writing down of interest, as opposed to writing down principal. To buck the intent of the plan and write down principal the servicers would have to run all sorts of legal risks. As I explained in my oral and written testimony, writing down interest is not the solution to the foreclosure problem. We recommend writing down principal on a scale not permitted by current contracts.

Even if the President's plan could be massaged or interpreted in a way that allowed Servicers to write down principal, they would not do so because it is not financially advantageous to them. Under the President's plan the Servicers will get paid to write down interest. If the plan gave them the option of writing down principal, they would not do so because it is not in their financial interest. They would take an immediate hit in their monthly fees, since they are generally paid a fixed percentage of the principal. They might lose even the whole fee if the homeowner sells the house with the reduced principal, a risk the servicer does not run if the house remains underwater.

Further, capitalizing arrearages, which the plan requires as step 1, actually increases principal and brings higher fees to the servicers. This plan seems designed to serve the interests of the servicers, and if there is no compulsion, they will not choose to write down principal if they have the option to write interest down to as low as 2%.

Finally, this problem of aligning servicer incentives and getting around contract restrictions cannot be solved by granting a safe harbor to servicers from lawsuits brought by investors. First we note that that itself would be a change in

[1] Susan P. Koniak, Professor of Law, Boston University.

contract requiring legislation. We do think legislation is needed to change contracts, but not this change. A safe harbor would only give servicers free rein to serve their own interests, for example by excessively writing down interest, at the expense of the bondholders, and in the long run, of the homeowners.

2. One premise of the President's plan is that by making payments affordable, people will avoid the psychological distress of being evicted from their homes. The term of the plan is 5 years. Do you believe five years is sufficient time for underwater homes to regain their fair market value so that homes are no longer underwater?

We believe that the millions of homes now 40% or more underwater will still be underwater in 5 years. But that does not mean that the President's plan should be extended beyond five years. It means that many of those homeowners will walk away from their homes long before the five years are over.

3. Your testimony has noted that principal write downs offer the best hope for homeowners staying in their homes and not re-defaulting on their mortgages. What does your research suggest about the best rate of return for lenders?

Our research suggests that for non-prime loans, lenders will do much better (i.e. get a higher rate of return) if principal is reduced to below the current appraised value of the house than they would under the President's plan. Step 1 of the President's plan is to increase principal by capitalizing arrearages and other costs. That itself will encourage defaults by putting homeowners further underwater. Defaults are very bad for bondholders, because foreclosure costs are so high. Step 2 of the President's plan is reducing interest, which is also very bad for lenders. The bondholders get significantly less cash flow. The only compensating advantage to them might be that the homeowner does not default. But our research suggests that there is no reason for this optimism when the homeowner is way underwater. He will eventually default, and the bondholder will suffer the foreclosure costs anyway, which are likely to be higher for having been postponed.

And reducing interest to keep a homeowner in his house temporarily is also bad for the homeowner. He pays more than he would by renting, and he will still lose the house.

4. Do you think the financial system can sustain principal write downs on a large scale? In other words, on the aggregate level, can the system handle a massive devaluation of all these assets at once?

The assets should go up in value if the principal is reduced correctly. If they go down in value, it would be because the assets are not properly marked right now. So if your question is, can the system afford to admit the truth of where we are now, our answer is that it can't afford not to admit the truth. Confidence cannot be restored until prices correspond to market values.

5. You note that servicers will be glad to reduce interest rates to 1% on every loan, or even to 0%, since servicers get their fees from bondholders, not from interest rates. As long as a loan is being paid according to its terms, the

bondholders must continue to pay fees to the servicers. What is your analysis about the net present value test in the plan?

The President's plan does not allow interest to be written below 2%. The net present value test is designed to identify those loans where modification can bring more value to the investor than foreclosure. It cannot fulfill that function with any credibility if it contains, as it does, too much latitude for the servicer to assess the value of the property and the probability of re-default. As it stands now, the servicer will find it all too easy to justify any modification that suits his financial interest.

6. In your testimony, you state that servicers have no incentives to do modifications. As you say, since reducing interest rates is a virtually costless gain to them, they will bank the money we pay them and not reinvest it in hiring people to do modifications. However, the President's plan will incentivize servicers so long as the homeowner doesn't default. Can you discuss the impact of the servicer incentives based on your research?

My testimony did not say the servicers have no incentive to do modifications. I assume the first sentence of your question meant to say that I testified that under the President's plan servicers have insuperable obstacles to reducing principal on a large scale, and great encouragement and incentive to reduce interest.

The President's plan gives servicers enormous incentive to modify too many loans badly. The president's plan incentivizes servicers to modify delinquent loans first; in fact, it gives the servicers incentive to simply modify all delinquent loans. Servicers get to capitalize the arrearages. That means that they immediately recover the money they advanced for each month of delinquency, which for a typical subprime loan of $200,000 at 7% interest comes to $1200 per month. So for a 3 month delinquency, the servicer immediately recovers $3600. (The servicer could expect to recover that amount once the foreclosure is completed and the house is sold, but that is generally eighteen months after delinquency). On top of that they get $1000 upfront from the government. Servicers are also allowed to charge the investors for the "cost" of this modification. There is much testimony that the servicers wildly inflate costs to extract more money from investors. It is hard to judge how much the servicers are profiting from this, but it may well be more than $1000. If they modify every delinquent loan, they do not need to spend any money hiring people to distinguish good borrowers from bad, or to accurately appraise house values. But we can be sure they will still charge investors, since the contracts allowing for these charges provide no mechanism to monitor the costs charged by servicers. By reducing the interest to as little as 2% in some cases, the servicers are likely to get the homeowner to pay again for a few months, thereby collecting their monthly fee of .4% x 200,000 x 1/12 = $67 per month. So a conservative estimate is that by mechanically reducing interest on a 3 month delinquent loan, the servicer immediately stands to gain $5,600 if not more, depending on how much they charge the investors for cost.

It is important to note that there is no reason for the Servicers not to do these interest modifications for delinquent homeowners. They get the $5600 upfront, and the homeowners might start paying with a lower interest rate. My testimony, and the data I already provided, and common sense, all suggest that if these people are far underwater, their renewed payments will not last, i.e. they will redefault. Then the homeowners will be in the same position they were in the beginning, except a little poorer for having made payments to no good end, and the servicer will be in the same position that they would have been at the beginning, but $5600 richer. And for the homeowners who do not re-default right away, the servicers might get paid another $1000 per year by the government.

In our view the most important loans to modify are ones that are current but underwater. As our data showed, subprime and option arm loans default at a rate approaching 8% per MONTH if they are 50-60% underwater. So there is tremendous urgency in saving these loans. But the incentives built into the President's plan, and the restrictions imposed by existing contracts, make these loans least likely to be modified, and certainly least likely to be modified first. The plan does provide a bonus of $500 to servicers for modifying a current loan, but that is small potatoes to a cash-strapped servicer compared to the immediate release of $3600 in back payments for a 3-month delinquent loan.

Even the current loans that the President's plan will modify will still be in great danger of re-default. As my testimony emphasized, writing down interest will not prevent default in the long run. It will just reduce payments to bondholders. The reduced payments the homeowners make will still turn out to be good money thrown after bad when they default, and come to regret having accepted this illusory "benefit". Had they walked away instead of accepting the modification, they would have found their new rental sooner and for less money. The extra $1000 per year that the president's plan promises servicers if the homeowner is still paying will prove as illusory as the benefit to homeowners, because underwater homeowners will continue to default at an alarming rate.

7. You contend that the President's plan is elusive about its intent to pay off second lien holders. Within the framework of the President's plan, how would you recommend that second liens be handled?

It is absurd to design an entire program to write down the interest on the first loan, while leaving what happens to the second loan completely up in the air. What we are left with is a classic hold-up problem. When a first loan is in enough danger of default to be modified, the second loan should be written off to zero. That requires legislation (because the second loan holders have no incentive to agree) and cannot be grafted onto the President's plan. In our view this is one of many reasons that any serious modification plan requires legislation. A serious plan would need to eliminate the provisions in the contract that restrict the number and manner of modifications. We also suggested that the best plan would replace servicers with agents dedicated to helping maximize bondholder revenues by keeping more people in their homes when that will yield more money to bondholders, as opposed to looking for modifications that enrich servicers at the expense of bondholders and homeowners.

8. In your opinion, what are the obstacles to implementing more effective types of loan modifications, similar to the ones addressed in your testimony?

A failure of political will to propose or enact legislation that will solve the problem, as opposed to delaying the problem at great expense. The executive and legislative branches seem unwilling to take on the Big Banks/Servicers and the supposed sanctity of contracts.

9. Is more data and research necessary to better understand the magnitude of the foreclosure crisis and the impact of different types of loan modifications?

Certainly there should be much more data collected, and more studies. But there is a growing consensus that for non-prime borrowers, the single best indicator of future defaults is the amount of (negative) equity in the home. See for example the Congressional Oversight Panel report of March 6, 2009, page 32.

10. What kind of oversight and evaluation metrics should be used to assess the success of the program?

How many people are being kept in their houses. What is happening to bond prices. We note that since the President's plan was announced, the subprime and option arm bond indices have fallen by as much as 30%, indicating that the plan does grave injury to bond holders. (Other bonds and the stock market have risen during the same time).

11. What measures do you recommend to prevent for-profit mortgage servicers from defrauding borrowers?

I did not give testimony that bears directly on this last question. And I am no expert on mortgage fraud. But a few thoughts come to mind.

First, as we understand, it is illegal in about half the states, according to Illinois' Attorney General, to charge a homeowner an upfront fee for mortgage modification help. Given the federal involvement in foreclosure mitigation efforts and the great effects on interstate commerce of the current housing/mortgage security crisis, we would recommend a federal statute making it illegal to charge an upfront fee for mortgage modification help, thereby extending the prohibition to the rest of the states. By illegal, we mean a crime, but if criminal liability is rejected in favor of a civil wrong the penalties have to be extremely high to deter this practice because the money to be made by violating the statute is enormous.

Second, the statute should also set a cap (quite low) on the amount of money that could be charged by anyone who helps a homeowner get a mortgage modification under the President's plan or under any other government program now set up or set up in the future to help homeowners. The government plans are designed, presumably, so most if not all homeowners can apply without resorting to fee charging advisers. Thus any charge might be prohibited, but because some might find help useful and not be able to secure free help, we think a very low cap on what could be charged would be appropriate.

Finally, servicers and bondholders should be encouraged by the government to set up a bounty fund, a reward system, for information provided that materially contributes to the closing of any mortgage scam operation. This would help mobilize private citizens to collect the information to aid the government. The financial sector engaged in mortgage lending and mortgage securities investing is harmed along with homeowners by these scams. A bounty fund set up by the industry would provide the industry with some good will among homeowners—a way to separate in the minds of homeowners the "legitimate" mortgage industry from those who prey on borrowers.

Response to Follow-up Questions
of Ellen Harnick, Senior Policy Counsel,
Center for Responsible Lending
from a hearing of
The Subcommittee on Housing and Community Opportunity
"Examining the Making Home Affordable Program"
On March 19, 2009

1. **Based on your reading of the President's plan, what do you think will be the most important compliance issues among servicers? What are examples of non-compliance, or gaming the program, that you foresee being a problem?**

It is essential that servicers be monitored to ensure that they do not impose improper fees or costs on borrower, or require borrowers to sign documents that, for example, effect a waiver of rights in order to obtain a modification, or otherwise impose on borrowers burdens or costs that violate the letter or spirit of the plan's intended relief.

2. **Do you believe the incentive payments for both the servicers and the homeowners are set at the correct levels?**

The levels seem appropriate, but the program will need to be monitored to determine, promptly, whether they prove sufficient in practice, or whether additional or enhanced incentives will be necessary.

3. **When interest rates begin resetting to current levels five years out, do you foresee any problems for homeowners affected by the President's plan?**

This is an area of potential concern. The extent to which this may be a problem depends both on broader economic factors – such as the rate of economic recovery generally, and the unemployment rate particularly – and on the scale of financial stresses that borrowers face from other substantial costs, such as those associated with health care and education. These factors may suggest the necessity of amending the plan to require further adjustment of loan modification terms to avoid or correct certain post-modification defaults.

4. **In your opinion, what are the obstacles to implementing more effective types of loan modifications, similar to the ones addressed in your testimony?**

As noted in my written testimony, the major obstacles to date appear to be: misplaced servicer incentives; limited servicer capacity (both staff and infrastructure) to perform modifications on a scale appropriate to the need; fear of claims by investors; and the presence of second liens.

5. **Is more data and research necessary to better understand the magnitude of the foreclosure crisis and the impact of different types of loan modifications?**

As noted in my written testimony, what is needed is loan-level detail on the terms of the modifications offered by participating servicers and lenders. This should include data on modifications performed, both within the program outside it, and should include data on the outcomes for homeowners rejected for modification under the program. Treasury should publicly disclose participation, modification, and success rates by servicer and also should make loan-level data available to independent researchers under common-sense protocols.

6. **What kind of oversight and evaluation metrics should be used to assess the success of the program?**

Foreclosures are occurring at the rate of approximately 200,000 per month. A failure to avoid a substantial proportion of these in the early months of the program's implementation will suggest the need for changes to the program and/or additional measures to stop foreclosure.

7. **What measures do you recommend to prevent for-profit mortgage servicers from defrauding borrowers?**

Active investigation and monitoring of private lenders and servicers are essential. Special grants for this purpose should be made to the Federal Trade Commission and state Attorneys General for proactive real-time monitoring of servicer conduct so that cease and desist orders can be timely obtained, and damages paid to injured borrowers. Special funding also should be provided to legal services attorneys, and the restrictions on legal services representation of clients should be revisited so that they can assist borrowers who are defrauded or abused.

Questions to the Department of Housing and Urban Development

Re a hearing of

The Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Program"

On Thursday, March 19, 2009

1. Mr. Morris, in your testimony, you mention that homeowners with total "back end" debt equal to 55% or more of their income will be required to enter a housing counseling program.

   a) Will HUD be providing a housing counseling program?

   HUD-approved Housing Counseling agencies are eligible to provide counseling to clients seeking to participate in the Making Home Affordable Program. Borrowers with a back-end debt-to-income ratio at or above 55% must certify that they will participate in counseling as a condition of a modification under the Program.

   b) What are the details of the housing counseling program?

   Since the launch of the Making Home Affordable Program, HUD has worked closely with Treasury to conduct extensive outreach to HUD-approved housing counseling agencies to educate counselors and provide them with information on the Program. HUD has developed a standard counseling protocol that counselors must use with clients seeking to participate in the Making Home Affordable Program.

   c) Will HUD contract the services of established community groups to provide the housing counseling?

   HUD-approved Housing Counseling agencies that have received a grant award from the Department can seek reimbursement from HUD for counseling provided under this program.

   d) Does HUD have the capacity to connect millions of homeowners with housing counseling?

   The funding for foreclosure prevention counseling that is currently available through HUD's Housing Counseling Program and NeighborWorks National Foreclosure Mitigation Program (NFMC) will cover only a portion of the approximately 4 million borrowers that will be eligible for loan modification through the Making Home Affordable Program.

e) What is the average processing time to determine when a homeowner has 55% of back end debt? What is the average processing time to connect that homeowner to housing counseling?

A counselor would determine a client's back end ratio after reviewing and verifying income and expense and the credit report. A standard counseling session can take approximately five hours to complete. This does not include the time it takes for counselors to communicate with servicers on the client's behalf since counselors have encountered significant challenges obtaining responses from servicers. Counseling sessions are typically scheduled within two weeks of initial contact with the counseling agency.

f) How do the program rules ensure that assistance is only going to taxpayers who would likely otherwise go into foreclosure?

Each transaction requires a Net Present Value calculation to determine if the modification is a better financial option for the investor than not modifying the loan. The parameters of the NPV test include assumptions about the likelihood of foreclosure. Loans likely to terminate in foreclosure will generally fail the NPV test and will not be modified.

2. How did the Treasury arrive at the amounts you noted for the servicer incentives? Do you believe the incentives are sufficient but not excessive to induce servicer participation?

An interagency working group including Treasury, FDIC, the Federal Reserve, FHFA, OCC, OTS and HUD conducted extensive modeling to determine at which point federal incentives and subsidies paid to investors would "tip" the NPV calculation in favor of modification. Great care was taken to ensure that subsidies were sufficient to positively influence investor and servicer behavior.

3. In your testimony, you note that the Neighborhood Stabilization Program's goal is to mitigate the effects of those homes that do go into foreclosure. Has the Department thought about how these program resources could be leveraged or targeted along with loan modification efforts under the President's plan?

NSP does attempt to mitigate the effects of foreclosed and abandoned properties on the nation's communities as opposed to providing foreclosure prevention or loan modification assistance. NSP funds under HERA were distributed by formula to states and local jurisdictions to help stabilize communities hardest hit by foreclosures, subprime loans and delinquencies. All state and local governments receiving NSP funds submitted their plans to HUD in December, 2008, prior to development of President Obama's housing plan. Nonetheless, HUD believes that many of the local efforts funded through NSP are consistent with the goals of the President's housing plan. Further, grantees may propose amendments to their approved NSP plans that would bring NSP and the President's housing plan into closer alignment.

4. In your assessment, should the President's plan and the Neighborhood Stabilization Program work together to get the most targeted investments in distressed communities?

   The President's plan and Neighborhood Stabilization Program complement each other. The President's Housing Plan is targeted to lenders to encourage them to refinance and modify FHA, VA, USDA, Fannie Mae, Freddie Mac, and private label securities loans. The NSP funds are intended to address the effects of foreclosed and abandoned property in the nation's communities. The initial $3.92 billion in NSP funds was already been awarded to states and local government and HUD is developing a competition for the distribution of the $2 billion in additional NSP funding provided through the American Recovery and Reinvestment Act. It is the Department's intent to ensure that the Recovery Act NSP funds will be targeted to the areas having the greatest need for the assistance.

5. To date, what have been the efforts of FHA to coordinate the President's plan with Hope for Homeowners and other foreclosure prevention programs? Please describe in detail what your office has done to ensure that the programs are streamlined.

   The supplemental guidance published on April 13, 2009 requires servicers to consider a borrower for a Hope for Homeowners refinance, before assessing their eligibility for a HMP.

6. What is FHA's role in ensuring that homeowners are educated about the President's plan? What steps have you taken to get information out to the public?

   FHA is participating on team which also includes Treasury, Fannie Mae and Freddie Mac. This team is developing public service announcements, outreach materials and identifying points of contact.

7. What will FHA's response be if, after your quarterly meeting with Treasury, data suggests that servicers either a) aren't participating in the program or b) aren't complying with program rules?

   FHA does not anticipate this issue, because Fannie Mae and Freddie Mac servicers are already participating and most of the nation's largest servicers have agreed to participate. Nevertheless, FHA would work with the integrated team to resolve any issues that arise.

8. Mr. Morris, what efforts have HUD taken to ensure that minority and disadvantaged communities are receiving outreach on the foreclosure mitigation tools?

HUD is working closely with Treasury to develop and implement a comprehensive outreach campaign to ensure that borrowers, especially those in communities hardest hit by foreclosures, are aware that Hope for Homeowners and the Home Affordable Modification options are available. We have jointly produced a borrower website that includes useful information in English and Spanish and self assessment tools so borrowers can determine if they meet the minimum eligibility criteria. Already more than 2 million viewers have been to the site. We are finalizing details of a national toll free information number where program information will be available in English, Spanish at all times and in 16 other languages by appointment.

9. Is the information provided in multiple languages for communities with limited English proficiency? If so, what languages?

   Yes; Spanish at all times and in Arabic, Burmese, Cantonese, Czech, Farsi, French, German, Hmong, Hungarian, Korean, Laotian, Nigerian, Romanian, Russian, Serbian and Tagalog is available by appointment.

10. Minorities and those with limited English proficiency were especially preyed on during the height of the subprime market. What outreach efforts are being made to ensure that minority groups and limited English proficient communities have equal access to the Making Home Affordable Program?

    HUD is working closely with Treasury and consumer advocacy groups representing Hispanic, African American and Asian borrowers to develop and implement a comprehensive outreach campaign to ensure that borrowers, especially those in communities hardest hit by foreclosures, are aware that the Making Home Affordable Program is available. Outreach efforts include presentations by HUD and FHA staff at consumer conferences about the Program, television public service announcements and program updates on Treasury's Making Home Affordable Program website. HUD and Treasury produced this borrower's website that includes useful information in English and Spanish and self assessment tools so borrowers can determine if they meet the minimum eligibility criteria. Already more than 2 million viewers have been to the site. Over 100 FHA staff have been trained on the Making Home Affordable Program.

11. A few weeks ago, Rep. Waters contacted HUD, the Federal Trade Commission and the Federal Communications Commission about a fraudulent website that was purporting to offer loan modifications through the Making Home Affordable Program. Within hours of submitting the letter, the website was taken down. However, I am concerned about your capacity to stay on top of these kinds of websites and scams that are taking advantage of desperate borrowers. What are you doing to ensure that borrowers who want to participate in the Making Home Affordable program aren't defrauded by deceptive websites and other marketing practices?

On April 6, 2009, the U.S. Department of the Treasury, the U.S. Department of Justice (DOJ), the Department of Housing and Urban Development (HUD), the Federal Trade Commission (FTC), and the Attorney General of Illinois jointly announced a new initiative to coordinate information and resources across agencies to maximize targeting and efficiency in fraud investigations, alert financial institutions to emerging schemes, step up enforcement actions and educate consumers to help those in financial trouble avoid becoming the victims of a loan modification or foreclosure rescue scam. In connection with the announcement, participating agencies took immediate actions to implement this campaign.

Also on April 6, 2009, the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued an advisory to help financial institutions identify loan modification/foreclosure rescue scams and report that information in Suspicious Activity Reports (SAR) for law enforcement purposes. The FTC announced a new education initiative to distribute materials directly to borrowers about how to spot and avoid mortgage rescue scams with the help of a broad array of government, non-profit organizations, and mortgage industry members. To bolster outreach efforts, HUD Secretary, Shaun Donovan, sent a letter to all HUD housing partners that included an attached flyer for distribution to homeowners which warns about mortgage scams. The flyer also explains how to obtain free information and counseling assistance to access the President's Making Home Affordable program and refinance or modify loans to a payment that is affordable.

12. I am concerned about the for-profit loan modification industry. These are companies that charge a fee to borrowers for modifying their loans. How are you monitoring this industry to ensure that borrowers who want to participate in the Making Home Affordable program don't pay for what should be a free loan modification?

HUD is working closely with Treasury and consumer advocacy groups representing Hispanic, African American and Asian borrowers to develop and implement a comprehensive outreach campaign to ensure that borrowers are aware of the services of HUD approved Home Counselors. Borrowers, especially delinquent borrowers, are strongly encouraged to contact a HUD-approved housing counselor to help them understand loan modifications and their other mortgage options. There is no charge to the borrower to work with a HUD-approved counseling agency. HUD sponsors housing counseling agencies throughout the country that can provide advice on buying a home, renting, defaults, foreclosures, credit issues, and reverse mortgages. A borrower can get immediate assistance by calling 1-888-995-HOPE (4673). Or borrowers can go to HUD.gov to find a HUD-approved foreclosure avoidance. In addition, there are disclaimers on websites and all printed materials notifying borrowers that there is no fee for participation in the program and they should not pay for counseling services.

13. Disclaimers on websites and all printed materials notifying borrowers that there is no fee for participation in the program and they should not pay for counseling services.

14. The for-profit loan modification companies have proliferated because mortgage servicers simply don't have the capacity to handle loan modifications. How will the Making Home Affordable program increase servicer capacity in this regard?

    Maintaining adequate staffing levels is a requirement of the MHA Servicer Participation Agreement and the financial incentives paid through the program will allow servicers to hire and train additional staff.

15. Many borrowers having problems with their mortgages today were given fraudulent loan documents that either grossly inflated their income or hid the terms of their interest rate or payment schedule. How will you ensure that borrowers who were defrauded in the loan origination process will be able to participate in the Making Home Affordable program?

    The primary participation requirement for borrowers is that their current loan be unaffordable. This can be the result of an interest rate reset, a change in income or expenses or because the loan was never affordable at origination. Borrowers only need to document this on the Hardship Affidavit by checking "other" and describing the circumstances that demonstrate un-affordability.

Questions to Dr. Roberto Quercia, Professor and Director, Center for Community Capital, University of North Carolina at Chapel Hill

Re a hearing of

The Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Program"

On March 19, 2009

1. Your testimony notes that the lack of guidelines and standards for principal reduction may limit or discourage the use of this successful tool to keep people in their homes. What would you suggest in terms of guidelines and standards in this regard? What would your ideal principal reduction framework look like?

The President's plan mentions the use of principal reduction as a last resort. It is our understanding that under the President's plan, principal reduction should be considered if other means of making a mortgage payment affordable do not bring payments down to a reasonable level. The plan is very explicit on how to use rate reductions and term extensions, but provides little clarity on the principal reduction approach.

When borrowers have some equity in their homes, rate-reduction or term-extension can lower the mortgage payment enough to keep them in their homes.

However, the current crisis is characterized by the pervasiveness of so called homeowners "underwater." Our research and the literature have demonstrated default rates are extremely sensitive to whether borrowers have real equity in their homes. At a minimum, we believe that principal reduction should be encouraged along with other forms of loan modifications. Use of principal reduction could be based on net present value (NPV) calculations. When deciding among types of modifications, short term affordability should be considered along with reducing long term re-default risks.

Thus, the key question is whether the expected future losses are lower when relying on principal reduction than those resulting from other types of loan modifications. If the answer is lower with principal reduction, then principal reduction should be implemented.

In our research, we found that, compared to rate reductions, a loan modification with principal forgiveness has a lower re-default rate and in many cases it increases the net present value for investors.

Ideally, for those with little or negative equity in their properties, some combination of rate reduction and principal reduction or forbearance will be the most effective tool to keep people in their homes. In order to increase borrowers' willingness to repay the modified loan and allow them to refinance/move if possible, principal forgiveness should be significant enough to help borrowers have some equity in their properties.

Under the President's plan, the payment reduction subsidy is based on affordability considerations, even in the event of principal forgiveness. However, compared to a rate-reduction modification, principal reduction involves an actual write-down of the value of the mortgage on the banks' books. This is one important reason why many banks are reluctant to do principal reduction loan modifications. We strongly encourage the government to develop a detailed guideline for principal reduction and provide some additional subsidy for loan modifications with a significant principal reduction.

More broadly, even for loans modified by ways other than principal reduction, principal reduction should be a consideration after a period of time, say five years, when borrowers want/need to refinance, or earlier if/when they need/want to move. If at that time, borrowers are still underwater, the principal should be reduced to the market value of the property. In particular, this should be the case for many borrowers with subprime loans.

Finally, bankruptcy reform that gives judges power to restructure mortgages and reduce mortgage payments should provide significant incentive to servicers to seriously consider principal reduction as an effective means of loan modification. Bankruptcy reform should be a key priority as most borrowers facing hardship with their mortgage payments are also facing hardship paying other expenses as well, for example credit card, car loan, medical, student loan, and utilities bills,

2. Can you expand upon what you noted about tailoring modifications to individual borrowers and unique housing markets? What kinds of situations are you thinking of? Many analysts have noted that the standardized modification process in the President's plan is a good thing – how would you build off of that to better fit individual circumstances?

The government's plan aims to standardize the modification process, allowing borrowers to get fair access to timely and consistent loan modifications. Our study findings confirm that one key component to making modified loans more sustainable is that the mortgage payments are reduced enough to be truly affordable to the borrowers. The current plan which focuses on rate reduction and payment relief should address the problem for many troubled borrowers.

However, we also found that the type of loan modification has substantial impact on the performance of modified loans and that modifications should be better tailored to specific borrowers in specific markets. For instance, government, servicers, and investors should develop clear guidelines for different types of borrowers, taking into consideration borrower FICO scores, debt-to-income ratios (DTI), and loan-to-value ratios (LTV), payment affordability, and the local market conditions.

Since our earlier study, we have done additional work in this area. We identified three types of housing markets in the country. We estimated the re-default risks associated with different types of loan modifications in each of these markets. Not surprisingly, we found that the re-default risks associated with specific types of modifications differ by market. For example, even the same type of modification, say rate reduction, exhibits a higher re-default risk in some markets, like California, Nevada, Florida and Arizona, than in others.

In addition, we were able to compare the impacts of increasing mortgage payment affordability using different types of modification. Thus, for example, for a typical borrower with negative equity and a debt to income ratio of about 50 percent prior to modification, a combination of rate reduction and principal reduction that brings payment to 31 percent minimizes losses over time. In contrast, for a similar borrower who has a debt to income ratio of just 40 percent prior to a modification, lowering their payment through principal reduction exclusively minimizes losses the most. We also found that relative effectiveness of principal reduction and rate reduction may vary across different markets and a modification with principal reduction is generally preferred in markets with more subprime mortgages and greater house price decline.

Overall, the additional research confirms that tailoring loan modifications to the specific characteristics of the market and the borrower has the highest likelihood of succeeding in the long run. Our simplified analysis suggests that it is possible to develop a set of criteria to guide loan modifications that make an active use of all options, including principal reduction.

3. Your research noted that the timing of the loan modification matters – early intervention can decrease the risk of re-default. Does your research include households that were targeted for modifications before they were delinquent? Are you referring to 30 days delinquent versus 90 days delinquent?

Yes, we include households that were targeted for modifications before they were delinquent, as well as those in different delinquency statuses (30, 60 and 90 days).

4. Do you believe the President's plan targets homeowners early enough? As you know, homeowners must show that they are either delinquent or face imminent hardship. Would you change anything with regard to this aspect of the plan?

We think the President's plan targets homeowners early enough so the key is the servicers' implementation of this guideline. This is because the program is driven by the servicer's actions and not the borrower's. The servicers need to approach the troubled borrowers proactively, especially those who are facing an imminent risk of default. Bankruptcy reform along the lines described above would provide a strong encouragement to servicers to consider all modification options pro-actively.

5. What kind of research and data do you and others need, going forward, to keep analyzing what works and what doesn't work in terms of loan modifications. What types of research questions do you suggest government agencies undertake?

The OCC, OTS, Treasury and GSEs have been collecting very detailed information on loan modifications. We encourage these agencies to make the data publicly available to researchers. Such data can certainly be made available without compromising privacy of borrowers or financial institutions. Allowing more researchers access to such data would advance the understanding of issues and solutions, in a very cost-effective manner.

Access to some large datasets such as Loan Performance and Lender Processing Services (LPS, formerly McDash) data can also be used to help benchmark the performance of modified loans to the industry overall. These are proprietary and expensive datasets to access. Why does the government have to pay for such data? Why is the information not in the public domain?

6. In your opinion, what are the obstacles to implementing more effective types of loan modifications, similar to the ones addressed in your testimony?

There are several obstacles to implementing more effective loan modifications.

First, there has been a lot of uncertainty about the market and about likely government action. When this occurs, market players tend to wait for clarity before acting. Players may have waited to see the depth of the crisis before considering whether loan modifications are more desirable than the foreclosure path. They may also wait to see if additional or alternative government policy may be more beneficial to them than the current policy. Until players get a better sense of emerging market trends and the permanency of government policy, they may not adopt loan modifications aggressively.

A second obstacle is the banks' reluctance to write down principal. They have concerns that if house prices were to fall further they need to write down again but if house prices rise subsequently, they could not share the gain. Of course, a rate reduction modification is also susceptible to additional pressure to write-down again when house prices continue to fall. Adoption of a NPV calculation of likely long term losses under all different modification options may help address this reluctance. As our research suggests, a reduction in principal can reduce the risk of foreclosure and may increase the expected payoff in many cases. Principal reduction should be considered along with other forms of loan modifications.

A third obstacle is the issue of securitization and PSAs. Mortgage servicers may be reluctant to modify loans because of fears of being held responsible for their action by bond holders. The servicers are afraid that bond holders may sue them if the contracts have restrictions on the kinds and numbers of loan modifications they can make. Most mortgage back investment instruments (MBS, CDOs, SIVs) have credit enhancement that are supposed to make the investor whole in the case of a foreclosure. In these cases, the bond holder would have to agree to take less through a loan modification than the credit enhancement is expected to pay. For securitized loans in bond without credit enhancement modification could be more likely. Although there have been some clarification and liability protection regarding the issue of servicer liability in recent legislation, market participants may be waiting for a legal test of these new protections before embracing modifications full scale. Any additional clarity that can be provided will be helpful.

Fourth, the issue of securitization becomes even more complex when second liens are in place. There is nothing in the President's plan or elsewhere that provides incentives to second lien holders to agree to a modification. A few months ago, it was estimated that 8.9 million borrowers with both first and second mortgages were underwater or almost underwater. This presents a difficult problem to solve, especially with credit enhancements in place, unless second lien holders are strongly encouraged or forced to modify loans.

A solution to the problem of securitization and second liens is bankruptcy reform. Allowing judicial modification of first and second mortgage loans would allow judges to deal with the legal quagmire faced by servicers in many instances where there is a securitized first lien and/or a second line.

Five, related to the points above, there are lack of guidelines about important aspects of loan modifications. For instance, there is a lack of guidelines to deal with second liens and the provision of appropriate incentives for more effective loan modification alternatives, such as principal reduction. Servicers are paid the same regardless of what modification they implement.

Last, but certainly not least, even in the absence of the above obstacles, we believe that there is a lack of capacity in the servicing industry to undertake the large number of loan modifications required. With limited available resources, and some perceptions about investor resistance, servicers are likely to prioritize the loans they service for their own portfolio over loans with mortgage insurance, those securitized with the GSE's or in private MBS, and those serviced for others.

7. Is more data and research necessary to better understand the magnitude of the foreclosure crisis and the impact of different types of loan modifications?

Definitely. Things have been changing rapidly. Since 2008, servicers have started to implement large scale modification programs. The crisis has impacted the housing markets in different ways. The policy environment is changing rapidly. All these factors make the collection of data and more research needed to understand what type of specific loan modification are most effective where.

8. What kind of oversight and evaluation metrics should be used to assess the success of the program?

We did not examine these issues in our research. However, we concur strongly with Andrew Jacobovic's testimony at the same hearing calling for development of early indicators or benchmarks. It is not necessary to wait a year to find out if the program has helped anyone. One suggestion for developing and tracking such benchmarks is to build off servicer performance monitoring systems such as S&P's SEAM system. A handful of straightforward metrics could be used to measure implementation and also to benchmark servicers to identify best and worst practices.

9. What measures do you recommend to prevent for-profit mortgage servicers from defrauding borrowers?

We did not examine these issues in our research.

**Questions to Ms. Faith Schwartz, Executive Director,
HOPE NOW Alliance**

Re a hearing of

The Subcommittee on Housing and Community Opportunity

"Examining the Making Home Affordable Program"

On March 19, 2009

1. **According to your testimony, you state that if the President's plan is not Ms. Schwartz, in your testimony, you state that HOPE NOW currently has 34 servicer members which account for over 90 percent of the subprime market and nearly 70 percent of the prime market. There are approximately 2.9 million borrowers who are 60 days past due. Since November 2007, HOPE NOW servicers have sent out 3 million letters. Yet, the response rate is only 20 percent. How many loans has HOPE NOW helped to successfully modify?**

   HOPE NOW data - which is comprised of 40,000,000 HOPE NOW member company loans and is then extrapolated to full market of approximately 54,000,000 loans - shows that the industry currently modifies in excess of 100,000 loans per month. Regarding the response rate to HOPE NOW letters, the letters are directed to the most at-risk borrowers, those homeowners who are more than 60 days past due on their mortgage and have not responded to contact attempts from their servicer. HOPE NOW's response reate of 18-20% far exceeds the normal 3-5% response rate from this group of very troubled homeowners.

2. **Can you discuss the capacity of HOPE NOW to handle the expected increase of millions of new mortgages?**

   The demand for workouts is very high. Incoming calls to servicer and counseling shops are often comprised of borrowers who are current on their mortgage but who want to know if they may be eligible for a possible modification in the new plan, as well as borrowers who are now 60 days or more days late on their mortgage payment.

   The industry, along with vendors and partners, is working hard to build capacity through web site improvements and expanded call centers. HOPE NOW has improved our web site to assist customers who may want to reach their servicer directly by allowing them to fill out an in take form in lieu of making a phone call. Automated tools are also underway by many technology vendors and the GSE's to assist in pre-qualification of borrowers. The combination of these efforts will assist the servicers and homeowners who are eligible for these programs.

Depending on full market uptake on the modification and refinance plan offered by the Administration, a newly constructed uniform modification program should be helpful longer term for servicers to have one process for multiple investors. Yet while the consistency will be helpful in reducing the time demands on servicers, this plan also introduces more process and documentation, so the timelines may exceed some more streamlined activity that has been underway.

3. **What is the current processing time for servicers to modify loans?**

When a borrower and or counselor is able to offer full documentation to support a hardship request and all information is provided, servicers are able to work with investors and MI companies to create a loan work out (modification) in 30 to 60 days. If there is more friction in the system due to multiple contact points, follow up faxes and e mails, second lien holders who do not respond to requests, and various third party approvals, the process can take up to 90 days or more.

4. **In your experience, what has been the biggest obstacle for servicers to modify loans?**

According to servicers, investors and counselors, the obstacles are generally the following:

1) Interpretation of investor contracts, trustees, and ability to modify to meet expected investor guidelines.
2) Borrower response and timeliness of documentation follow up, including non-contact and delay-in-contact with borrowers at risk. Also, when contact is finally made, after many months of initial attempts, the borrower's ability to pay has often deteriorated.
4) Some investor contracts explicitly restrict the number of loans that can be modified or the conditions for modification, though this is not the norm in most private label contracts but they should be NPV positive.
5) The business model of servicing was not originally set up for mass modifications versus collecting of payments. While capacity planning and process enhancements have improved tremendously, some delays and impediments remain.

5. **What type of loan modification is most commonly used?**

We have some very early data on modification type, although it is based on a sub-set of the population of total mods and as such is approximate. We believe that roughly 1/3 of modifiations provide interest rate reductions and 1/3 provide term extensions. Many loans have combinations of term extension, rate reductions, and some form of capitalization of arrears. Capitalization of arrears occurs when some of the missed payments are added to the principal balance of a loan when the terms of the loan are re-written under the modification.

6. **What type of loan modification has resulted in the least amount of re-defaults?**

HOPE NOW aggregate date reflects that 30 to 40 % of loans that were modified went to re-default. We define "re-default" as a loan that is 90 days or more delinquent 6 months or more after modification date. In 2008. Some of those loans may be re-worked, resulting in another foreclosure prevention solution being offered to the borrowers, and some may go to foreclosure. Accurately correlating a modification type with a specific re-default rate and then proving causation is an exercise that is currently beyond the scope of HOPE NOW.

7. **What efforts are being made to outreach to minority and limited English proficient communities? What languages does HOPE NOW accommodate?**

The Hotline provides counselors in these languages.

Arabic	1
Burmese	1
Catonese	1
Chinese	1
French	4
Hungarian	1
Korean	2
Laotian	1
Nigerian	1
Romanian	1
Russian	2
Serbian	1
Spanish	186
Tagalog	3
Czech	1
Total	207

At the triage call center, of the 151 call center workers currently, there are 24 spanish speaking FTEs and 41 part-time available to be re-deployed at spike times.

We have outreach efforts in communities that are at risk all across the industry. We bring in non-profits and translators and ensure we also have Spanish translation at our events. The hotline has access to counselors that represent 21 languages and have a significant amount of Spanish

8. **In your testimony you stated that modifications have represented half of all workout solutions for individuals reaching out to HOPE NOW. Among these people, what kinds of workouts were achieved? Are these mostly interest rate reductions or re-amortizing of the loans?**

See response to question 6 above.

9. **How many principal reductions have you achieved? What happens to the other half of individuals? How many foreclosures occur versus deed in lieu or short sales?**

We do not know the answers for sure. We are working to capture data on short sales and deed in lieu's now.

10. **Walk me through what types of questions you ask borrowers that call in looking for help. What happens once you know who their servicer is and you have an understanding of their problems?**

One primary objective is to ask borrowers for information on expenses so that an assessment of their monthly expenses and a realistic budget can be developed. By providing various expenses and other budget items to the counselor, the homeowner receives a detailed budget in writing. While this may seem rudimentary, many homeowners have never created a budget of their monthly expenses and may not know what other expenses can be reduced to provide additional resources to pay their mortgage.

Deleted: .

Each homeowner's unique situation is then evaluated by the counselor and options are provided that are aimed at improving the homeowner's situation. Options vary based on budget surplus or deficit, mortgage loan status, reason for default, mortgage loan type, etc.

A counselor will conference call a homeowner's servicer when a foreclosure sale date is within 2 weeks of the call, if a loss mitigation option appears workable based on the information provided (e.g. the reason for default has been resolved but the homeowner is unable to catch up on past due payments and the budget reflects a surplus or a small monthly deficit), if the homeowner requests assistance contacting their servicer, or if there are specific questions only the servicer can answer (e.g. checking on the status of a submitted loss mitigation package). Counselors have direct contact information for most loss mitigation departments (counselors are the conduit to servicers). This can be extremely beneficial for example, to homeowners who are facing a foreclosure sale date as counselors can often negotiate a temporary forbearance while other alternatives are being researched.

Counselors also assist homeowners with understanding what documentation is needed for loss mitigation options such as loan modifications, short sales and repayment plans

Counselors have access to an independent locator system containing community-based resources and local housing intermediaries for additional counseling and assistance with necessities such as food or utilities if needed. A Client Action Plan detailing the foreclosure prevention options discussed are sent to the homeowner along with a privacy disclosure and educational materials

Provided the homeowner agrees to consent, a file of data and counseling session details are transmitted to the homeowner's servicer, thus expediting communication between the homeowner and their servicer. Many individuals face terribly long wait times when they try to call their servicers. This is time that working people, and people in distress, typically don't have, and is an area that counselors look to be a source of assistance.

11. **Many individuals face terribly long wait times when they try to call their servicers. This is time that working people, and people in distress, typically don't have. What is the average wait time for someone calling into the HOPE NOW hotline?**

The average wait time with calls to the hotline in February was 32 seconds. The abandonment rate was 6%. In March with the announcement of details of the Making Home Affordable Program, the Homeowners' Hope Hotline received 240,893 calls had an average wait time at triage of 63 seconds and an abandonment rate at triage of 7.15%. Abandonment rate is the percentage of callers who abandon the call.

12. **When someone goes to the HOPE NOW website for help, what kind of data do they enter into the system? Who does that data go to, and what is the follow-up? How long does this usually take?**

The HOPE NOW website has recently been updated to offer the ability for borrowers to link directly to their servicers Home Preservation web sites. When a borrower links to a servicer, they leave the HOPE NOW web site and are in the servicers web site. We recently created a uniform intake form for borrowers to offer their financial information . This is instantaneous when they link and send this to the servicer web site. This is a new service and we have approximately 1700 people per week who have taken advantage of this capability this week. Servicers are asked to respond within 5 days of receipt acknowledging the information. We believe this and other efforts will assist in streamlining the ability for servicers to have better information quickly, without even a conversation, that enables them to review potential solutions for homeowners.

13. **How are your counselors trained to deal with homeowners in severe distress? My experience with some servicers suggests that the people answering the phones have neither the training nor the authority to give homeowners effective help.**

HPF, Hotline, Current Training at Agency and from HPF:

- Must receive HPF approved certification (from AICCCA or NFCC) within 6 months of hire (industry regulated)
- Each agency maintains counseling plans and training programs specific to mortgage foreclosure and loss mitigation counseling. This training better equips counselors to explain the intricacies of the various loss mitigation options to callers.
- New counselors receive agency created training *before* they take any calls on the phone. The training curriculum ranges in duration from agency to agency, but the average amount of time is 4 weeks. In addition to reviewing the entire counseling process, training includes knowing all required items in a budget, assessing and analyzing budget improvement areas, reviewing loss mitigation options and knowing the guidelines under which servicers will consider a loss mitigation option. This benefits the caller because counselors are more prepared to assist callers with varying needs and circumstances.
- New counselors sit with a senior counselor or supervisor who mentors them before they take calls on their own an average of three weeks. This is another way to help counselors internalize the training they've received, as well as allow the agency to gauge a new counselor's performance and aptitude prior to allowing them to answer calls unsupervised.
- All counselors are evaluated by their supervisor, manager and quality assurance group every month using a detailed evaluation form covering key aspects of a counseling session, the results of which are reviewed with the counselor.
- Monthly evaluations not meeting minimum agency standards can result in any or all of the following: 1) additional mandatory training specific to the area of weakness, 2) additional coaching/mentoring, 3) increased number of counseling sessions evaluated, and 4) disciplinary action.
- In-house training is available through all agencies. Some of these classes are refresher courses on loss mitigation options, training on new programs and guidelines (e.g. MHA), and learning acquired skills such as empathy training.

Training and counseling quality evaluated by HPF:

- HPF performs quality on-site audits of each agency annually where recorded calls are evaluated as well as agency training programs and counselor evaluations. Findings are documented and reviewed with senior management, and expected to be adequately addressed and/or remediated by the agency.

HPF performs "secret shopping" of each agency and tests for ability to connect with a counselor, delivery of privacy disclosure, ability to accurately capture a budget, appropriateness of options/recommendations provided by counselor based on information provided, and overall tone of the counselor.

- HPF holds weekly conference calls with agency supervisors and senior counselors to discuss current events and to pass on information such as new program details, efforts involving the FTC around scams, etc...
- HPF organizes quarterly operations meetings with representatives from each agency. The meetings are usually one full day and many operational topics are discussed. Some of the most recent topics include call volumes and dealing with capacity, MHA program implications and guidelines, and quality audit results.

HPF Counselor training (future):

- HPF has been collaborating with the top performing counselors from across the nation to identify the next level of counselor training using technically advanced learning systems. Barriers to learning and the most complex training topics have been identified and will be used to prioritize what type of counselor training is needed and should be developed to reach a mastery level of counseling. This effort is known as The Gold Standard.
- Gold Standard Strategy Statement: To increase responsible homeownership and healthy financial practices among those seeking mortgage counseling, the Homeownership Preservation Foundation upholds a gold standard of professional development for Homeowner's Hope™ Hotline counselors through collaboration and training for high quality, consistent and data-based outcomes.
- What is "a gold standard of professional development?" The HPF will set the highest training standards in the mortgage counseling industry by researching and implementing best practices for outcomes-based performance by affiliated counselors.
- How will this be achieved? HPF will increase the knowledge, skills and capacity of point-of-service counselors through direct instructional strategies developed with affiliates and increasing capacity for quality supervision, monitoring and coaching at the agencies.
  - The next level of counselor training will be delivered through asynchronous methods with a focus on skills that are usually more subtle to describe and harder to master, such as the ability to use empathy and understanding. Below are criteria, each of which could become individual training modules:
    - Criteria: *Demonstrates courteous, interested and individualized attention to each client without undue emotional investment or overly personalized investigation,*

- Criteria: *Is able to deliver direct, honest advice repeatedly and consistently so the clients can move forward realistically and successfully with their best options,*
- Criteria: *Listens actively with full attention and seeks information in a calm, attentive, reflective and straightforward manner,*
- Criteria: *Immediately gains rapport by being clear, specific and precise about what will happen in the session(s) and how the clients' needs will be addressed in a timely way, and*
- Criteria: *Demonstrates professional maturity by recognizing and acknowledging clients' feelings while at the same time assessing reality and facts*