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STATE OF THE HOUSING MARKET: REMOVING BARRIERS TO ECONOMIC RECOVERY

HEARING

BEFORE THE

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

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE STATE OF THE HOUSING MARKET

FEBRUARY 9 AND FEBRUARY 28, 2012

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C O N T E N T S

THURSDAY, FEBRUARY 9, 2012

TUESDAY, FEBRUARY 28, 2012

STATE OF THE HOUSING MARKET: REMOVING BARRIERS TO ECONOMIC RECOVERY—PART I

THURSDAY, FEBRUARY 9, 2012

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

The Committee met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order. I thank our witnesses for joining us.

Today's hearing is a continuation of our in-depth look at housing finance reform that we just started last year in a bipartisan fashion. Many of the previous hearings have examined the long-term structure of the Nation's housing finance system. In this hearing, we will focus on the current state of the housing market and its effect on the larger economy.

In January, the Board of Governors of the Federal Reserve System released a white paper entitled "The U.S. Housing Market: Current Conditions and Policy Considerations." In this paper, the Board stated that continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery.

The white paper documents the problems that so many families and communities are facing, such as: declining home prices and the loss of $7 trillion in home equity since 2006; millions of responsible homeowners are underwater on their homes through no fault of their own; excess supply of homes for sale at the same time that rents are rising; obstacles to refinancing at today's record low mortgage rates.

The paper also discussed policy options for addressing what it identified as impediments to a housing—and ultimately economic—recovery. Such impediments include: the excess supply of homes for sale, tightened mortgage credit, and the flow of additional homes entering the foreclosure pipeline under current conditions. Many potential solutions are being offered by a wide range of interested parties. In recent weeks, the Administration has outlined administrative steps and legislative proposals for overcoming barriers to housing market recovery. An interagency group led by the Federal Housing Finance Agency has begun taking steps to address the large volume of real estate-owned properties held by the Government-sponsored enterprises and Federal agencies, including pilot projects converting some of these properties to rentals. I look forward to hearing more from the Administration and FHFA about their proposals.

Finally, this morning, we are expecting an announcement in the long-anticipated mortgage servicing settlement. I look forward to carefully reviewing the details of these agreements as part of the Banking Committee's continued oversight efforts to hold servicers accountable for their failures and protect homeowners from abuse. I agree with the Fed's assessment. Without an improvement in the housing market, the economic recovery will also continue to drag. We must do everything we can to help with economic recovery. This is important to me and my constituents. This means we must find ways to improve the housing market.

Today, we explore potential solutions with three highly respected economists. I have invited our witnesses to share their insights on barriers to and solutions for housing market recovery. These witnesses have extensive experience analyzing the housing market and broader economy. I hope to learn from them practical solutions to improve the housing market, the economy, and the lives of millions of Americans.

With that, I would turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Unfortunately, as we sit here today, I believe the only realistic assessment of the state of our housing market is that it is weak and has faced continued decline. Home prices declined nearly 5 percent in 2011. This was the fifth straight year of declines. Worse yet, some States saw declines of more than twice that rate. In Illinois, prices declined over 11 percent; in Nevada, prices declined more than 10 percent.

The troubled state of our housing market should be a call for Congress to take action. Traditionally, this Committee has acted in a bipartisan fashion to address pressing problems facing the Nation, and during my tenure on the Committee, which is 26 years, we have worked across party lines to pass important legislation to reform the GSEs and resolve the savings and loan crisis. But there is a lot of work to do. I believe we can and we should return to that practice.

Some have speculated that Congress will fall into gridlock during the rest of the year. However, that does not have to be the path of this Committee. Given strong bipartisan support for helping homeowners, I believe that it is unfortunate that Congress has yet to devise a thoughtful and effective program to revive the housing market.

As early as 2008, right here I warned that, to be effective, we needed to address the underlying fundamentals driving the housing market and the mortgage foreclosures. We have not done that. I warned that if we did not adopt such an approach, we would risk wasting a lot of taxpayer money. And perhaps we have. Unfortunately, the Administration has rolled out one ineffective homeowner assistance program after another.

The Administration's latest proposal, as I understand it, reveals its unwillingness to provide the leadership necessary to make the tough choices required to really revive the housing market. This appears to be today now an ideal time for the Members of this Committee to step into the leadership vacuum. I have no illusions that this will be easy. However, we will never solve the problems with the housing market if we do not start working together to find a reasonable solution here.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby.

Are there any other Members who wish to make a brief opening statement?

[No response.]

Chairman JOHNSON. If not, thank you all. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and other materials you would like to submit. Now I would like to introduce our witnesses here today.

Dr. Mark Zandi is the chief economist at Moody's Analytics.

Dr. Christopher Mayer is the Paul Milstein Professor of Real Estate, Finance, and Economics at the Columbia Business School.

And the Honorable Phillip Swagel is a professor at the University of Maryland's School of Public Policy and the former Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Dr. Zandi, you may proceed with your testimony.

STATEMENT OF MARK ZANDI, CHIEF ECONOMIST AND CO-FOUNDER, MOODY'S ANALYTICS

Mr. ZANDI. Thank you, Mr. Chairman, Mr. Vice Chairman, and Members of the Committee. I am the chief economist at Moody's Analytics. My remarks, though, are not those of the Moody's Corporation. They are my own views. You should also know that I am on the Board of Directors of mortgage insurer MGIC. You should know that.

I will make five points in my remarks.

Point number one is that the housing crash is not over. Home sales and housing construction have hit bottom. They have stabilized. There are even some signs of life there. But house prices continue to decline. Since prices began declining 6 years ago, they have fallen by about a third, and I expect more price declines in coming months.

The key problem is the still large number of properties that are in the foreclosure process. Just to give you a number, there are 3.6 million loans that are in foreclosure or pretty close, 90 days and over delinquent. They are unlikely to cure, and they will likely go to foreclosure. So the share of home sales that are distressed, that are foreclosure and short, will likely rise later this year, and that means more house price declines.

Point number two is that when house prices are falling, it is hard to be entirely enthusiastic about the economic recovery. The home is still the most important asset that most households own, most middle-income households. Many small business people use their home as collateral to get a loan. So, for example, when I started my company 20 years ago, I had to go get a loan, and I put my home up as collateral. I doubt I could do that in today's environment. Many local governments obviously rely on property tax revenue, which has been falling because of the decline in housing values.

Most significantly, though, is the risk that we fall back into a vicious cycle that prevailed back in the recession; that is, price declines result in more homeowners that are underwater. By my calculation, there are 14.6 million homeowners that are in negative equity positions, half of which are underwater by more than 30 percent, and the average amount of negative equity per homeowner is about $50,000. So that is the fodder for more default; more default means more distressed sales and more price declines.

This leads to point number three, and that is, I do think the policy response to the housing crash has been helpful and did, in fact, break that vicious cycle back in late 2008 and early 2009. There were a myriad of policy steps taken to break the cycle, everything from the Federal Reserve's quantitative easing efforts, buying mortgage securities to bring down mortgage rates, which has brought fixed mortgage rates to record lows, to temporarily raising conforming loan limits, to three rounds of housing tax credits; and, of course, the FHA, a yeoman effort to fill the void in mortgage lending left by the collapse of private mortgage lenders. So, in my view the policy response, while obviously not perfect and we can take umbrage with any individual aspect of the response, reasonable criticism, I think the totality of the response was pretty good.

Point number four is at this point I think policy makers should remain supportive of the housing market and continue to provide temporary, modest support to housing so that we do not reignite that vicious cycle. We cannot allow that to occur because if it does, there will not be any good policy response and our economy will pay a price for it.

The proposals put forward by the Federal Reserve Board and the Administration I think are pretty good. They focus on three things, and I think this is where you should focus.

First is facilitating more marriage refinancing. I think that is a slam-dunk idea in the context of record low fixed mortgage rates. That is an immediate boost to these very stressed homeowners.

The second thing is facilitating more loan modifications, particularly principal write-down mods that are very well targeted, and I think that dovetails very nicely with the mortgage settlement that we are going to be getting, hopefully today. I think facilitating that effort would be very helpful.

And then third is promoting REO to rental. The GSEs, obviously—FHA has a lot of properties sitting in REO. We want to get that into rental before it hits the market and drives house prices lower. So anything that could be done—and there are lots of things that can be done—to address those—to facilitate those three policy steps.

Finally, my fifth point is that this should not cost taxpayers money. These are things that can be done, I think, without any cost to the taxpayer. Some of the things will require some cost, particularly the principal reduction, if we juice up HAMP and increase the incentives there. But we have TARP money that has been budgeted for these purposes, and I think they should be used.

Finally, let me say I think it is very important for Congress, the Administration, the FHFA, and other regulators to remain aggressive and vigilant, make sure that this housing crash definitively comes to an end, because until it does the recovery will not gain traction.

Thank you.

Chairman JOHNSON. Thank you, Dr. Zandi.

Dr. Mayer, you may proceed.

STATEMENT OF CHRISTOPHER J. MAYER, PAUL MILSTEIN PROFESSOR OF REAL ESTATE, FINANCE, AND ECONOMICS, COLUMBIA BUSINESS SCHOOL

Mr. MAYER. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. My name is Chris Mayer. I am the Paul Milstein Professor of Real Estate at Columbia Business School.

Despite record low interest rates, some signs of economic recovery, mortgage activity and house prices continue fall. Purchased mortgages last year were at the same level as in 1992, according to data from the Mortgage Bankers Association, and refinancings were at the second lowest level since 2001. By comparison, new consumer lending for items like autos and credit cards is up 11 percent.

In its recent white paper, the Federal Reserve observes, “Obstacles limit access to mortgage credit among creditworthy borrowers, barriers to refinancing blunt the transmission of monetary policy.”

Unfortunately for taxpayers, homeowners, and the economy, 3 years into the FHFA’s conservatorship of the GSEs, Fannie Mae and Freddie Mac continue to act as profit-maximizing private firms determined to remain in the game for long-term profits through their near monopoly power in the mortgage market rather than making the market more efficient. The FHFA has taken a narrow, ineffective, and harmful approach to managing GSE activities.

Conservatorship has failed to adequately address critical conflicts of interest between the two principal GSE businesses: providing mortgage guarantees and managing a large retained portfolio of mortgages and MBS. Examples abound of GSE actions that padded their portfolio profits even while restricting refinancing. Fannie Mae imposed new origination fees called LLPAs that could be 3 percent or more of the mortgage balance only weeks after the Federal Reserve announced its intention to purchase what would eventually be $1.25 trillion of GSE MBS. Freddie Mac followed suit 2 months later.

LLPAs were applied to those refinancing existing mortgages even though lowering the payments for those borrowers would save Fannie Mae and Freddie Mac and the taxpayers money by lowering defaults. Existing borrowers with high loan-to-value ratios, those at the greatest risk of default, were locked out of refinancing altogether.

The GSEs made it harder to refinance with another servicer despite borrowers’ many complaints about poor service from their existing servicers. Consumers now pay three-quarters of a percent more per year for their mortgage to originators than they did before conservatorship due to limited competition to originate mortgages.

The GSEs failed to address critical problems in mortgage insurance. The only seemingly plausible reason for policies that unduly restrict credit and, thus, raise defaults by existing borrowers is to protect high interest payments on assets held in the GSEs' portfolio.

Reports by National Public Radio and ProPublica highlighted these conflicts of interest and how they may have influenced portfolio decisions at Freddie Mac. Instead of selling off its MBS, Freddie Mac created and help complex, highly leveraged, risky mortgage derivatives that had no value as a hedge. More recently, Freddie Mac created new and complex long-term financing for its mortgage-backed security positions called MLANs. Both types of transactions were structured so that the enterprise lost valuable interest payments if borrowers with very high interest rates refinance their mortgages, a policy that is substantially under the control of Freddie Mac. These transactions also make it harder to unwind Freddie Mac and its portfolio in the future, something all of us should be concerned about.

While seemingly consistent with conserving and preserving assets, these policies appear to violate a number of the GSEs' other mandates under HERA to foster liquid, efficient, competitive housing finance markets and to operate in a manner consistent with the public interest.

Finally, the GSEs need to reform their loss mitigation practices. Private portfolio lenders were the first to adopt widespread mortgage modification programs and principal reduction plans with their own loans and have also much lower redefault rates than the GSEs. The GSEs need to follow practices that portfolio lenders use for their own defaulted mortgages and work to attract private capital to purchase and manage nonperforming loans and REO.

We must change the mandate of conservatorship. Legislation should mandate that an independent trustee wind down the GSEs' retained portfolio of MBS and require other steps to attract private capital. The GSEs should finally remove all of the obstacles limiting access to refinancing for existing GSE borrowers and address constraints on mortgage credit as identified by the Federal Reserve. Conservatorship as it stands now is laden with conflict of interest and is going to be incredibly difficult to unwind these institutions.

I appreciate the opportunity to address you today and look forward to answering any questions you may have.

Chairman JOHNSON. Thank you, Dr. Mayer.

Professor Swagel, you may now proceed.

STATEMENT OF THE HONORABLE PHILLIP L. SWAGEL, PROFESSOR OF INTERNATIONAL ECONOMIC POLICY, UNIVERSITY OF MARYLAND SCHOOL OF PUBLIC POLICY

Mr. SWAGEL. Thank you, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. The housing market remains weak even as the job market improves. The latest housing proposals we are considering today largely expand on previous actions.

My concern is that the proposals share a common feature of the previous actions, and that is their moderate impact, an impact that is in every case less than was advertised when the various policies were launched.

It is useful to consider a specific example of why the new proposals will share this unfortunate feature. One proposal is a broad refinance for loans to be refinanced by the FHA, the Federal Housing Administration. The Administration's fact sheet—and that is all we have is a fact sheet—says there will be no red tape, no delays, no tax forms, no appraisals. The policy applies to owner-occupied homes and not to investors.

Now, the problem is that the lenders have to verify that a home is owner-occupied. This is the case even if a lender is refinancing its own home because now it will be getting a Government guarantee. Without access to tax forms, without appraisals, it is not clear how the lender is supposed to do this. Are they supposed to send someone to the house and look in the window? So these implementation details matter greatly. And, again, we have no text for the legislative proposal. We just have a fact sheet, when these details are really crucial. It is 2 weeks after the proposal has been announced. I have serious doubts about whether it can actually be implemented in practice, and there is really no way to know.

In general, what we have learned over the last 3 years is that the one-at-a-time nature of the transactions involved in dealing with the housing weakness is a considerable hindrance to implementing these proposals.

Now, on their impact, I think it is clear that credit was too loose before the crisis during the housing bubble, and I think a good case can be made that now credit is too tight, and access to mortgage financing is too difficult for many homeowners.

To me, the lessons is to get the standards right, not to have the standards be set by unelected and unconfirmed Government administrators, but to think about what are the right standards and let the private market decide how to deploy capital and what risks to take on that capital.

I worry that there will be a modest impact from the new proposals in terms of avoiding incremental foreclosures. Many of these proposals might have made more sense in early 2009, but at that time the measures were considered not prudent, not a good ratio of benefits to costs. So here we are in 2012. If anything, as my written testimony explains in detail, the ratio of cost to benefits has gone up. There are fewer incremental foreclosures avoided for each dollar of taxpayer resources used.

If these proposals work, to the extent they do, it will be mainly as economic stimulus, as writing checks from taxpayers to particular homeowners. I think it is fine if someone wants to make a case that we should have more fiscal stimulus. I think that will have a limited impact and is probably not needed in light of the improving economic data. But that debate should be made openly as stimulus and not as a housing policy or as pressure on a Government administrator.

Another point, related, is that Government aid should probably be better focused. Rather than having the FHA refinance anyone's mortgage, it might be useful to look at which homeowners and which income levels. As I mentioned in my testimony, the White House has recently defined the middle class as topping out at

$80,000 a year or $100,000 a year, and it might be useful to limit FHA to homeowners of that income level.

There are actions that can be taken that will be useful to speed the housing adjustment. The REO initiative to move empty houses into rentals I think will be very useful, and that really should be the focus of policy, a focus on speeding the adjustment. We want a recovery in housing. We need the housing market to lift off the bottom. But, unfortunately, that does mean the housing market has to hit bottom so that it can lift off of it, and we want that to happen as quickly as possible. We want to end the legal and regulatory uncertainties that are now waiting on the market. Moving forward with housing finance reform, reform of the GSEs in particular, will be helpful for bringing private capital back to the market and moving the housing market forward.

Thank you very much.

Chairman JOHNSON. Thank you, Professor Swagel.

As you mentioned at the outset, the long-anticipated mortgage servicing settlement has been reached. Although we may not have all of the details, I am interested to hear each of your thoughts on the impact of this settlement on the housing market. Dr. Zandi, we will start with you and go down with the panel in turn.

Mr. ZANDI. I think it will have a meaningfully positive impact on the housing market and the broader economy for three reasons:

First, it provides a substantive amount of resources for more loan modifications, and it sounds like a fair number of those will be principal reduction modifications, which the servicers are already engaged in quite successfully. According to OCC data, roughly 20 to 25 percent of their current mods are principal reduction mods, so I think this will be helpful in that regard.

And, by the way, the Administration proposal to triple the benefits to principal reduction mods in HAMP I think would dovetail beautifully with that settlement. And I think that is meaningful. I think you will get a half a million to a million homeowners that get substantive help here, and that will make a big difference in terms of that share of home sales that are distressed, and that will help to keep any future house price declines limited.

The second reason is that I think this does help the banking system. One of the reasons the banking system has been slow to provide credit is the cloud hanging over it with regard to various legal, regulatory issues. There are still many, and there are still many clouds. But this was one significant cloud, and I think lifting it will be helpful, and it will allow the banking system to gain confidence and become more aggressive in extending credit, which is very key to the economic recovery.

Third, I do think this is consistent with Professor Swagel's point about facilitating the foreclosure process. This will allow the foreclosure process to reaccelerate for us to move through the mountain of foreclosed property that is still plaguing the housing market. Many of these foreclosed properties are vacant. They are investor properties. They are blighting communities. We need to work through these properties; otherwise, we are not going to find a bottom. So I am hopeful that this leads to a clearer path toward more foreclosure—resolving more of these foreclosure issues and coming to the day when we find the bottom of the housing market. So I think this is a very encouraging development.

Chairman JOHNSON. Dr. Mayer.

Mr. MAYER. Yes, I agree with Dr. Zandi on many of these points. I think it does continue a practice which private lenders are doing with their own portfolios, which are principal modifications.

What is unclear is how well we have bifurcated past actions versus future results. One of the problems has been there are many people who are not making their payments for 2 years or longer and are remaining in their properties, and we are starting to see in the data that people in judicial States where that is happening are defaulting relatively more relative to people in nonjudicial States. And so we should start to worry about that moral hazard, and if this presents a path for either modifying or foreclosing a home, we really need that. We cannot have people who stay, you know, years in homes without payments and without really having an ownership stake in where they are.

The third is something that I think really highlights what Senator Shelby said at the beginning of this hearing, which is we are going to have a lot of stuff coming on the market, and given the current structure of both the GSEs and the lending market, we are not going to have the credit or the capacity to absorb this stuff. If we end up with a couple million homes that come on the market next year with the sale rate of, you know, under 5 million today, a third of those home sales are already cash sales; a third are home sales under contract; a third, brokers report that their sales fall apart because of credit problems. So it is critical for this Committee and for policy makers to address the issue of restoring a more normal credit standard in the market; otherwise, this flood of housing may well push prices down a lot more and push us into a situation where we have other problems.

So I think this is a wonderful proposal. Lots of people, including myself, are talking about refinancing. But we also need to open up a reasonable standard for new mortgages, whether they be for people who are owner occupants, whether they be investors buying in bulk. And the GSEs at the moment are not accomplishing that goal, and I think that needs to change.

Chairman JOHNSON. Professor Swagel.

Mr. SWAGEL. I also welcome the settlement on the robo-signing. Obviously, the robo-signing was outrageous, and illegal behavior should be—illegal actions should be punished.

I think the positive impacts will be twofold: One is there will be some assistance for individual homeowners. I think the bigger impact on the overall economy and on the housing market is removing the uncertainty that is preventing banks from operating and from lending going forward. We have to remove that uncertainty to start origination going forward.

We have to be realistic about the impacts, 17 or 37 billion, somewhere in that range, in terms of principal writedowns. Those are big numbers, but there is $700 billion or more of underwater borrowers, negative equity. So the impact will be pretty modest relative to the scale of the problem.

The original HAMP proposal was supposed to help 3 or 4 million, and it has helped less than a million. It is just an indication that we should all be wary of these promises.

The last thing to mention is that the market is moving. Lenders are paying homeowners to avoid foreclosure, and it makes sense, right? If it takes 24 to 36 months to actually foreclose on someone who is not even making their payments, it makes sense for lenders to pay that person to move out, and there is much greater dignity in that solution than in a foreclosure.

So these adjustments are useful, and we want them to keep happening, but, again, I think the biggest impact, positive impact of the AG settlement is the certainty about market conditions going forward.

Chairman JOHNSON. Dr. Zandi, we have heard arguments that the market should be left to hit bottom. I would like to hear your analysis of this issue. Do you see any barriers to the market healing itself? Are there any risks with remaining housing prices to fall further?

Mr. ZANDI. Well, I would make two points. First, I think house prices have fallen sufficiently to be consistently now with household incomes and effective rents, so effectively house prices are at bottom. They are at equilibrium. Affordability is very high, and you have fairly strong investor demand because rents have risen so considerably. So I think any further house price declines would be what you might call overshooting.

Second—and this is more important, and this goes to my point about the vicious cycle—what concerns me or makes me nervous is that once house prices start falling, it is very difficult to see where that ends. We can get back into a very vicious cycle. Prices decline. You have 14.6 million homeowners underwater. When prices are falling, people think prices are going to fall in the future, that gives them less incentive to hold on. They default. The defaults lead to more foreclosures, short sales, more price declines, more negative equity homeowners, and you can see this dark vicious cycle taking hold. And we had to throw enormous resources at this vicious cycle in the recession to break it. And we did. If you look at prices, they have basically—they are soft, but they have basically stabilized since early 2009.

So I do not think it is worth taking the chance to allow that possibility to occur. The tail risks, as you would say, are very enormous.

So I think policy makers can do some things that are modest, do not cost taxpayers significant dollars, and mitigate that risk, and I think that is entirely appropriate.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Dr. Zandi, you estimated earlier in your testimony that an additional 6 million homeowners will lose their homes before the housing market recovers, and you also said that foreclosures will not return to normal levels until 2015.

How could you rationalize—I know you are an economist. Sometimes economists are right, sometimes they are wrong.

[Laughter.]

Senator SHELBY. How do you rationalize the housing market has bottomed out and so forth if you are going to have 6 million more foreclosures and so forth? You know, I hope you are right, but I am not sure. Tell us why.

Mr. ZANDI. Yes, very good question.

Senator SHELBY. In other words, you are saying that the price of housing is not going to continue to decline, but that seems counterproductive to what we see.

Mr. ZANDI. Yes, it is a very good question. First, let me say there are three broad measures of the housing market:

Home sales—that is, housing demand. That has hit bottom. It is actually starting to improve.

Senator SHELBY. How do you determine that has hit bottom? We hope it has hit bottom. What is your data?

Mr. ZANDI. Existing home sales from the National Association of Realtors, new home sales from the Census Bureau. If you take a look, they have basically been moving along the bottom for 3 years and are now starting to trend up a little bit.

Housing construction, single-family, multi-family starts, also Census data, that is starting to rise—admittedly, at very low——

Senator SHELBY. But not everywhere, right?

Mr. ZANDI. No, of course not. I am talking nationally.

Senator SHELBY. OK.

Mr. ZANDI. But house prices, you are right, they are continuing to be weak, and I do expect more house price declines in the immediate future. But this is a very important point, and it refers to something Dr. Swagel said. The key to house prices is the change in the share of home sales that are distressed, foreclosure and short. You can still have a very high level of distressed sales, and we are because we have a lot of property in foreclosure, and it is going to take many years to work through that. But if you can start moving that share downward, you are going to get house price growth. And lots of good things will happen as soon as house prices are moving north.

All I am arguing to you, sir, is that we are very close. We do not need to solve the $700 billion, by my calculation $750 billion negative equity hole. We just need to get another half million or a million homeowners on solid footing, get that share of home sales that are distressed moving south, and we will start making progress on house prices.

Senator SHELBY. Do you have that same feeling in areas like Florida, Nevada, California, you know, some distressed areas where so many properties are underwater or is your language, your testimony, basically across the Nation?

Mr. ZANDI. Well, also a very good question. I so far have been speaking nationally, but obviously there is a great deal of variability across the country. Places like Florida, Atlanta, Arizona, Nevada, Central Valley of California, parts of Rhode Island, parts of the Midwest are encumbered with a great deal of foreclosed property, so price declines there are going to be more deep and longer. It is going to be harder to get that share of distressed properties moving south in those areas because the foreclosure problem is a bigger problem.

Senator SHELBY. Dr. Mayer, do you have a comment on this?

Mr. MAYER. Sure. I am actually in the camp of prices have fallen further than equilibrium. In many parts of the country, house prices are below construction costs of comparable homes. And given where interest rates are——

Senator SHELBY. Is this an area where it is like Florida, California, Nevada, Arizona, where——

Mr. MAYER. Yes, and Atlanta and Phoenix. You know, this is true in many parts——

Senator SHELBY. Where housing was overbuilt and oversold perhaps.

Mr. MAYER. Yes, that is true. But the sort of question is where—if you sort of think about where we should be in equilibrium, that is the sort of analysis. Now, I think it——

Senator SHELBY. That is the ideal way. If demand and supply are in equilibrium, things are fine, right?

Mr. MAYER. Right. The problem with that is that, on the other side of the coin, what is not working is access to credit, which is part of what is contributing to prices hanging below the market.

One of the things I would point out is that I pay a lot of attention not necessarily to foreclosures but as well to sort of vacant houses, because if you take a family who leaves a home, they are going to go somewhere else, and someone else is going to move into the home that they have. And the question is, is there somebody—what determines house prices is, is there somebody who can sort of buy that home and either provide a rental or someone else who is going to occupy the property? And that sort of transition is a place that I think policy makers can and should be focusing on, which is: How do we make sure that when people leave these homes, whether through short sales, as Dr. Swagel talked about, or foreclosures, that there is somebody else who can acquire that property without a huge amount of distress and make it available for families to live in so it does not become vacant and get destroyed?

The really big overbuilding is in a small number of parts of the country, and in many other parts of the country house prices are below construction costs, but we are not seeing it because of this transition challenge.

Senator SHELBY. Professor Swagel.

Mr. SWAGEL. Yes, I also worry about the impact of the delayed foreclosures on house prices going forward. There is a sense in which we have put a bunch of foreclosures on hold, meaning millions of foreclosures on hold, but we have not prevented them, especially with the economy having been relatively weak over the last 3 years.

Senator SHELBY. Is one of the problems of delayed foreclosures that each State has a different law regarding foreclosures and the speed of them and so forth?

Mr. SWAGEL. That is right, and judicial States take a lot longer. That is right. We have started to see lenders essentially paying homeowners considerable amounts to move out of their home and avoid foreclosure. It seems like the market then is finally starting to adjust.

Senator SHELBY. Professor Swagel and Dr. Mayer, I will refer this to you. In both of your testimonies, you cite the lack of GSE reform, Freddie and Fannie, as impeding the recovery of the housing market. So what will be the consequences to the housing market if Congress continues to neglect and push down the road GSE reform? Professor Swagel.

Mr. SWAGEL. I would say it is very much an impediment to having the housing market recover, and it is an impediment to the policy debate today. We see everyone pounding on poor Ed DeMarco to adjust the refinancing standards. That should not be his line of business. It should be the market. But we need GSE reform for that to happen. It would be hard for private market participants to lend someone money for 30 years when the Government could change the rules entirely in a few years.

So that is what I would want. Move forward with GSE reform and have private capital come in and take the risks.

Senator SHELBY. Dr. Mayer.

Mr. MAYER. I am not as sanguine on the actions of the conservator in this regard. I think there——

Senator SHELBY. That we have now?

Mr. MAYER. Yes, the current conservator of the FHFA. As I made comments, I think the conflicts of interest have been material. The GSEs under conservatorship have imposed new fees, new restrictions, and new things that never existed before conservatorship and are enormous impediments to the recovery of the mortgage market and can only be explained by the retained portfolio. And these are things that, in principle, the conservative could within his power adjust, but he has chosen not to. So the conservator could hand, without legislation, an independent trustee to manage and wind down the portfolio, but the conservator has chosen not to do that. The conservator could take many other steps that would reduce the losses and foreclosures and open up credit but has chosen not to do it. So while it does not require legislation——

Senator SHELBY. Isn't that going to make it worse in long run and harder to do and more costly?

Mr. MAYER. Actually, it is counterintuitive, and, you know, this is based on work I have done with Dean Hubbard at Columbia Business School, Alan Boyce, and James Witkin. What the GSEs are doing is actually making it harder for them to be unwound. So the way they are managing their portfolio with issuing—they just put out 10-year debt. They have created these complex derivatives. These are not transactions that are sort of making it easier to unwind. They are actually making it harder to unwind. And the frictions in the market that they are creating are also making it harder to unwind them because nobody will sort of—this is not a market anybody wants to be in. When you sue your originator, same problem. The litigation creates a harder space for private capital to——

Senator SHELBY. Is this a philosophical design by the conservator?

Mr. MAYER. I have had different views——

Senator SHELBY. It is not an unknown.

Mr. MAYER. I would not want to speculate as to why the conservator has taken the actions that he has. I just look at the results of those actions. And I think as the manager of any institution, one of the critical things, you know, that CEOs have to deal with are conflicts of interest in an organization, and not managing those conflicts of interest effectively is something that a CEO should be held responsible for if they are not doing that. And so to my mind, that is the sort of critical question, and I do not want to—I cannot speculate. I do not know why these have or have not been——

Senator SHELBY. You might not speculate, but you can evaluate the real data.

Mr. MAYER. Our report clearly—you know, I have done a lot of writing on this, some of which is in my testimony, more of which is written on a Web site that we have been maintaining. We have been arguing this, Dr. Hubbard and I, since September of 2008 when we saw the mortgage spreads go crazy and, you know, conservatorship not fixing things.

Senator SHELBY. Dr. Zandi, I know the time has eaten away, but in fairness, what is your view here?

Mr. ZANDI. Thank you. Yes, I think it is very important for Congress to resolve Fannie and Freddie, that as long as they remain in conservatorship, nothing good happens. Of course, you have many other moving parts that you need to nail down before you can actually resolve Fannie and Freddie. The private residential mortgage securities market is, as you know, dead in the water, and that needs to be revived before we can resolve Fannie and Freddie.

But I agree with you. You know, the longer they are in this no-man's-land, it is a problem for everybody.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, gentlemen, for your excellent testimony.

Dr. Zandi, longer term we have to do lots of things, but in the short term, I think that both you and to a degree Dr. Mayer are saying there are steps that the conservator could and should be taking right now. In fact, one of the recent Presidential proposals through HAMP, as you have noted, Dr. Zandi, for principal writedown modifications has given additional resources potentially to FHFA and the Fannie and Freddie to do that. And the question, I think, is why is it—it should be increasingly difficult for FHFA to argue that they cannot do it because of their obligation to preserve the portfolio, *et cetera, et cetera, et cetera,* when, in fact, there are resources available that will make the calculation positive.

Just a final point, too. One of the themes that I sense out is that, first of all, this settlement today I think is very encouraging, but that essentially goes to the paper owned by the banking institutions.

Mr. ZANDI. Correct.

Senator REED. And as many have noted, banking institutions, good businessmen and women are making decisions about principal writedown mortgage modification not because they want to help the homeowner, but they are looking at their shareholders' bottom line. So the business logic here is to get FHFA to do what business is doing and use resources that have been recently made available to start principal writedown modifications and add further momentum. And that can be done instantaneously. They do not have to wait for new statutory authority. Is that accurate?

Mr. ZANDI. Yes, I think first I would like to say the principal goal of the conservator should be to preserve taxpayer money, right? I mean, we have ante'd up $160 billion for Fannie and Freddie, and this is getting to be very costly, and I think it is prudent that the regulator focus on that.

But in that context, I think there are many things that can and should be done. I think, for example, mortgage refinancing, facilitating more mortgage refinancing—it perplexes me why FHFA is not being more aggressive here in trying to promote that activity.

Now, we had HARP II, the juiced-up HARP, and that is progress. But even to this day, for example, I think HARP II rules—and we can describe what they are, but it facilitates more refinancing—should be extended to all Fannie and Freddie borrowers. But Freddie has different rules than Fannie, and it is just mucking up the process. This makes no sense and should be resolved, as an example.

Moreover, REO to rental I think everyone agrees makes—you know, it is a slam-dunk thing, I think. And I know it is a hard process and we need to have pilot projects, and we are not sure exactly—and we do not want to give too much away to investors. I am on board with that. But it feels to me that this should be moving at a much greater pace.

Moreover, the third point, to your point, I am perplexed. I have my models, and I look at this data very carefully—with the argument that Fannie and Freddie do not believe in principal writedown, they believe in principal forbearance. Well, under some circumstances, under reasonable assumptions, principal writedown works better than principal forbearance. Just to completely say we are not going to have any principal writedown in a targeted way so we do not have moral hazard issues, I mean, I understand that. I think that is just a step too far.

So, as you can tell from my voice, I am frustrated. I am frustrated by it.

Senator REED. You are not alone because, you know, I have been arguing in REO, for example, for 2-plus, 3-plus years to move on that. That seems to be sort of something that is obvious. And I think, Dr. Mayer, you, too, feel that the REO issue is something that should be moved aggressively.

Mr. MAYER. Yes.

Senator REED. It should have been done.

Mr. MAYER. Right. I should say one thing, which is I do advise a group of a startup company that is working in the space of trying to acquire homes on the rental market. I should say that straight off. They are not actually deploying capital at the moment, but I do believe in this as a really, really important step to move the market forward.

I would respond to your question and also that of Senator Shelby at the end about data and how to account for this. We have posted an incredibly detailed model that goes through the profitability of a mass refinancing program to all the various parties. This model is, I think, a state-of-the-art model and probably better than anything that we have seen out there in terms of analyzing the costs and benefits, because I agree with Dr. Zandi and Dr. Swagel, and

I think the Members of this Committee, that, you know, conserving and preserving assets is an incredibly important goal.

If the GSEs were to do a refinancing program where they added a modest increase in the G-fee—because many of the old G-fees were as low as 12 to 15 basis points. If they were to raise that G-fee on refinanced mortgages to 25 to 35 basis points, which would still leave enormous benefit for homeowners, a mass refinancing program would be enormously profitable for taxpayers and for the GSEs and would actually help wind down the process by reducing credit losses in the future.

The problem is that that analysis is hard to do without also considering the portfolio. We have done very careful work, and if you sort of tell me that, gee, the portfolio has X, Y, Z bonds in it—and, of course, the conservator has never made public what kinds of bonds are sitting inside the portfolio. But if you did that and you told me, gee, you know, 25 basis points was not enough but 35 basis points would do it, given that many of these borrowers have a 6-percent mortgage and they could be refinancing in something below 4, there are 200 basis points of spread there. There has got to be a place that that is profitable for the GSEs, even considering their portfolio, profitable for taxpayers. In fact, we even go through and calculate the opportunity costs for the Federal Reserve because we also believe that we should look at this in a very holistic sense of the Government to include all the mortgages that the Federal Government holds.

The other thing I would sort of say is I completely agree on the mortgage modification. If you look, for example, in 2008, GSE modifications were about 40 percent less effective than private lenders in their own portfolio. In 2009, same thing. In 2010, the GSEs caught up, and their modifications started to have similar effectiveness to private portfolio lenders. In 2011, we are back to the GSEs' modifications being about 40 percent less effective; that is, the redefault rates are about 40 percent higher than what the private sector is doing with their own loan modifications.

I think that is the best place to look, is when somebody owns a loan outright, what do they do with it? Well, oftentimes they sell it to special servicers whose job is to write down the loan, modify it, get the people out, pay them, do whatever they need to do to work forward. And the GSEs have consistently lagged behind the private market, which sort of tells me that what they are doing is not what is the state-of-the-art. And if they cannot do that themselves, they should be selling off some of those NPLs into the market and letting the private sector do the kinds of things the private sector would do well, which I suspect would get some of the principal modifications that many people hope for, but would also sort of, I think, get us out of the bureaucracy that we are in at the moment.

Senator REED. Well, thank you.

Dr. Swagel, I must apologize because my time has long been exceeded, and my colleagues are waiting, and they have brilliant questions to ask, much more so than I. But just one point is everything you have talked about I think can be accomplished with the current authority of the conservator right now. In fact, my sense is you are arguing that this is really what he should be doing because of his obligations under the present law to, you know, stabilize and to recover as much assets and be as businesslike as possible. You are nodding your heads. I will take that as unanimous.

Mr. ZANDI. Yes.

Mr. MAYER. Yes.

Mr. SWAGEL. I would just make a very small point, if it is OK.

Senator REED. Can I just—go ahead, please.

Mr. SWAGEL. It ultimately comes down to numbers and the costs. The Federal Reserve is a substantial owner of mortgage-backed securities and would be affected by this. Mr. Garrett asked Chairman Bernanke last week, "You are in favor of this. What is the impact on you?" And the Fed has not done the calculation. It is just puzzling that they are affected and have not done the calculation. I wonder if there is a message there.

Senator REED. Hopefully they will do the calculation, and it will be the right calculation.

Chairman JOHNSON. Senator Corker.

Senator REED. Thank you.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony, and I appreciate your being here.

I think that all three of you have said that Fannie and Freddie staying in their present state in perpetuity is probably not a very good thing, and in order for them to wind down from their dominant position, what we have to do is really bring the private sector back. They are on strike for lots of reasons, and what we have to do is build a mechanism to bring them back in and have a real TBA market on the private side and make sure that reps and warranties are actually there and there is actually the types of underwriting that they can expect to take place. And if we can figure out a way to do that, then we can really begin to diminish the amount of reliance we have on Fannie and Freddie. Is there general agreement on that? And that the longer they stay like they are, actually more mischief kind of comes into play.

I would love to have your responses very briefly to Congress, for instance, for 2-month payroll tax adding a G-fee, if you will, to all Fannie and Freddie loans over the next 10 years to pay for that. Is that something that is good for our housing industry? I think I get three noes.

So I hope there is a way that—we have a bill out there that is just a marker for discussion. We want to attract one of our great friends on the other side of the aisle and know that changes have to be made to cause that to happen, and we only did that to begin conversation. We never offer a piece of real legislation until we have a Democratic cosponsor, but I sure hope you will weigh in on that.

But let me move to another question. You know, we have this chart of underwater loans, and it is pretty interesting how they are concentrated more fully in a handful of States. Dr. Zandi, what is the reason for that? I mean California and Nevada and Arizona and Florida, why is the concentration so heavy there?

Mr. ZANDI. Well, as you know, that is where the housing bubble was its most significant.

Senator CORKER. Well, I know that, but why was that housing bubble predominantly in those States?

Mr. ZANDI. Well, a number of reasons. One key reason is that these markets generally are supply constrained. It is hard to build. So if you get any pick-up in demand for housing, because of the supply constraints house prices start rising very quickly. And once house prices start rising quickly, like any asset market, people start forecasting with a ruler, and they speculate.

Senator CORKER. Speculation, yes.

Mr. ZANDI. And then adding fuel to this fire was, of course, very easy credit, so private label, subprime lending, Alt-A lending, Option ARM lending provided the credit, the juice to speculate, and you saw this surge in prices.

Senator CORKER. I knew you were going to say that, and I thank you. So——

[Laughter.]

Mr. ZANDI. Uh-oh, that sounds scary.

Senator CORKER. I enjoy so much working with you on the auto deal.

Mr. ZANDI. I got in some kind of trap.

[Laughter.]

Senator CORKER. I say this to my friends from Colorado and Oregon and Virginia and Alabama and Rhode Island and South Dakota. I guess as I start looking at the principal reductions, I have supported what Dr. Mayer said from the very beginning 3 years ago, that if Fannie and Freddie—if there were spreads there and there was an opportunity for people to refinance at lower rates, let us have at it within those institutions. It made them strong, it made the homeowner stronger.

You start getting into principal reductions, and whether using existing TARP money, which, you know, our country still owns, or whether you are doing it through other mechanisms, in essence what we are doing is really creating a transference of wealth from Tennesseeans and Alabamans and Virginians and Oregonians and people from Colorado, a transference of wealth from their taxpayers to people in these States that speculated. Now, why would we do that? It just makes no sense to me that everybody has gotten on this bandwagon of principal reduction when the creation of this bubble was exactly what you said.

Now, I want you to tell me how I go back home to Tennessee and say that this is a great policy for you to send a check up each year to the Treasury and let them write a check to Fannie and Freddie for losses because we are going to do principal writedowns.

Now, explain to me how that makes sense and why maybe it would not be better just to say in California or Florida, in places where people did a lot of speculation—which, by the way, drove a lot of revenues for those States, I might add. Wouldn't it be better if those States themselves put up the money for those principal writedowns? I mean, it is a geographic issue. It is not a national issue. I do not understand why people have not thought about it in that way.

I would love for you to respond to that.

Mr. ZANDI. Yes, you make very good points. This is a very difficult problem, and fairness is, you know, at the heart of it. You know, there are moral hazard issues. How do you do this so you do not set off a firestorm?

Senator CORKER. Right.

Mr. ZANDI. I hear what you're saying, and I understand what you are saying. This is not something that I would——

Senator CORKER. Well, tell the farmer in west Tennessee the answer to that question.

Mr. ZANDI. OK. I would say a couple things.

The first thing I would say is that I would disagree a bit with your characterization that this is only a California and Florida——

Senator CORKER. No, it is not "only." All of our States have those issues, but it is hugely disproportionate.

Mr. ZANDI. It is by my calculation, 14.6 million—and I can provide it for your State of Tennessee. It is not insignificant. There are a lot of homeowners in your own State that are underwater.

Senator CORKER. But most folks in other States played by the rules. They were not going and specking a housing bubble with almost no money down.

Mr. ZANDI. I am not so sure. Subprime lending was pretty widespread.

Senator CORKER. Well, tell me the answer for the west Tennessee farmer.

Mr. ZANDI. Let me get to the more fundamental point.

Senator CORKER. All right.

Mr. ZANDI. The more fundamental point is that I think we are very close to solving this problem, to putting an end to it, and getting house prices moving north. And if it requires a half million to a million principal reduction mods that are very well targeted and done by the banking system and some hopefully by the GSEs, then I think that is a reasonable cost to make a reasonable thing to do to get the housing market on solid footing, moving north, and our recovery engaging. And this will benefit all Americans, not just Floridians but people in Tennessee who are unemployed.

You have to think about this—it is almost—you know, sort of the metaphor is if someone else's house is on fire and you are in the same block, you have to put that fire out because it is going to save your block. Same deal. I know that does not resonate particularly with the farmer in Tennessee, but the reality is, I think—it is my judgment—that that is——

Senator CORKER. Let me ask you another question. You know, I have really enjoyed working with you on numbers of things, and I always appreciate the input of all three of you. The other thing we are looking at doing, we are going to take—I understand about refinancing Fannie inside Fannie and Freddie inside Freddie. But the fact that we are now going to take private loans and banks and if they are going to be—let us say they are 5.5, 6 percent rate and they want to refinance, we are going to transfer those over to FHA, and the ones that are going to be transferred obviously are the ones that are problematic.

Do you think that is a good idea, to take from private lending institutions, transfer them on to the Government's balance sheet? Do you think that is a good idea? I am just stunned by that.

Mr. ZANDI. Well, I would put that at the bottom of the list of things that I would be focused on. I think the most important thing is to facilitate more Fannie/Freddie refinancings and more FHA refinancings. If at the end of the day there is a long list of things that have been proposed here, I would put that near the bottom.

Senator CORKER. Well, now, that is one of the top-list things that is being proposed. I would love to have the input——

Mr. ZANDI. Well, can I say, by my calculation, if you look at the benefit of these various refinancing proposals, the biggest benefit is to refinancing more Fannie, Freddie, and FHA loans. That is where——

Senator CORKER. Within Fannie, Freddie, and FHA.

Mr. ZANDI. Exactly.

Senator CORKER. I agree with that. And I do not know why we would not do that. I agree that is an absolute no-brainer.

Is it OK if the other two respond to taking private lending institutions and transferring them over to the FHA books as thinking that is good public policy?

Chairman JOHNSON. Would you please make it brief?

Mr. SWAGEL. I will be very short, yes. FHA is already about $50 billion under—is going to need a $50 billion or maybe a $100 billion bailout. I think it would be difficult to countenance transferring over more risk. A year ago the Treasury report on GSE reform said we should shrink the FHA from its 30-percent share back to 10 to 15 percent. And now they are going in the opposite direction. So it is puzzling.

Mr. MAYER. Any such program that involved taking on the risk of loans from private lenders I think should be predominantly funded through the owners of those mortgages. There might be ways to do that, but I think that would be an important thing to look at in this regard.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and I appreciate the comments of my friend from Tennessee. I have enjoyed working with him, and I want to go back to his kind of somewhat similarly answering I think a really legitimate issue that you raised. As somebody on the principal reduction—and Lord knows as somebody who spent more time on the business side than I have on this kind of job, I absolutely start with the same premise that you start with. But I do kind of think it is more than just certain States' problems. We do have now $160 billion worth of taxpayer exposure. The notion that one of the tools in the toolbox, as long as it was narrowly defined that we would exclude that tool from being used, particularly when we see the private sector—and I think I go back to Dr. Mayer's comments, that the private sector is using that tool and has a more—is it a 40-percent lower redefault rate than the GSEs?—to me argues—as hard as I would say if somebody would match my capitalist credentials with you, you know, that we are in such a hole here, and this has such a potential effect on the overall national economy that I would not take that tool out of the toolbox. But, you know, you make a great—I think you make a very strong, strong case on the other side.

I guess one of the things I want to start with here is that Senator Reed made mention a number of times about the fact that the conservator can go ahead and take more actions than he has taken at this point. It seemed to me, Dr. Mayer, that you were saying—and I also agree with, I think, Senator Shelby and Senator Corker that we need to move on fuller GSE reform. But one of the things that I think, Dr. Mayer, you were saying, I just want to make clear that you were saying perhaps as an interim step that we need to legislatively make clearer to the Administrator that you ought to not put these further impediments in terms of unwinding the portfolio, that they need to be—he needs to move more aggressively on the refinancing opportunities. Did I hear that in your testimony?

Mr. MAYER. Yes, I think I fully appreciate the challenges we all have with trying to figure out what the future of the U.S. mortgage finance system is going to look like. That is an enormously challenging problem, and, you know, I am an economist, not a political scientist, but I know we have an election coming, and, you know, there are a lot of issues going on here.

That said, I think there are a number of areas which should be in common ground across the parties that, unfortunately, would require legislation because of the existing impasse in the institutions. I liken it to the responsibility of a board of directors when the CEO does not step in on his or her own to manage an existing conflict of interest. That means that the board of directors, unfortunately, has to step in and manage that conflict of interest. And so I think——

Senator WARNER. The conflict, again, to be clear, you are saying implicitly, is the conflict between preserving taxpayer dollars at the end of the day and the macro goal of one trying to refinance and also trying to have overall economic health? Is that——

Mr. MAYER. No, no. Actually, the conflict of interest is more mundane than that, so to speak, which is the conflict of interest is they are managing a portfolio of mortgages, of hundreds of thousands of dollars——

Senator WARNER. In Freddie's circumstance that was exposed recently by NPR.

Mr. MAYER. Right. You know, but long before NPR, many people had been talking about these issues, and, you know, the conservator's comments were not to actually deny that there was a conflict of interest, only to sort of say that he instructed the GSEs in November of 2011 that they should not consider their portfolio. But that conflict of interest has existed for years, and I think it is still the only plausible explanation for some of the comments that Dr. Zandi made about restrictions on refinancing that exist today. And so I think, unfortunately, that requires legislation.

Senator WARNER. I would like to—again, I do not want to take beyond my time, but I would like to get Dr. Swagel and Dr. Zandi. It does seem to be that there is this common agreement that we would all agree, whether some of the Administration's new proposals merit or not, that the refinance opportunity, at least within the GSE portfolio, we ought to be moving more aggressively on it, and what else should we do—do you believe that it requires legislation? Or what else should we do to urge those actions to place? Dr. Swagel and Dr. Zandi.

Mr. ZANDI. Go ahead.

Mr. SWAGEL. The refinance issue is a tough one. There are people who are paying a higher interest rate than it seems like they should. On the other hand, someone who has lost a job over the last 3 years of the weak job market, it is not clear that taxpayers should take on the additional risk.

One other note is that the proposal from the Administration specifically is limited to people who have been essentially current on their mortgage for a year. So in terms of preventing incremental foreclosures, the impact will be modest because the proposal is restricted to people who look like they are doing OK.

So that is what I mean, it is really a stimulus, it is writing people a check. That might be the right thing to do, but it is not foreclosure avoidance, mainly. It is mainly——

Senator WARNER. Wouldn't it be by definition, if they are current, then their chances of default would actually be less as well?

Mr. SWAGEL. Absolutely. Absolutely.

Mr. ZANDI. Yes, I would disagree with Dr. Swagel. I think this is a slam-dunk. You should work very hard to facilitate more refinancing through Fannie, Freddie, and FHA loans. And I think the Administration's proposal to extend HARP 2.0 rules to all Fannie, Freddie, and FHA borrowers is a good one. It is not only—and I should say this means a lot to a lot of people. Just simple calculations, I think at least 5 million homeowners at current mortgage rates, say fixed mortgage rates stay around 4 percent, about 5 million homeowners could refinance over the next couple of years. And I think that makes a tremendous difference to those households.

Senator WARNER. How do we make that urgent? And then I will stop now, but just do you think we just need to continue to make that point, or do you think, as Dr. Mayer said, you actually need legislative direction?

Mr. ZANDI. I think at this point I would go down the path of writing legislation and hopefully the FHFA, you know, engages. So, for example, there is a piece of legislation I have seen floating around—Senator Franken, I believe—trying to require that Freddie adopt the rules that Fannie has adopted with respect to refinancing. Something along those lines. That is getting really into the weeds, and you would hope that, you know, this would be done administratively, not legislatively, because once you do legislation, things get complicated, right? You do not want to do that. But I think I would start moving down that path, and hopefully that lights a fire.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you all for your presentations.

The perspective that folks bring to my town hall is that the Government intervened with enormous support for our major financial institutions, and as we know, a few months ago that included additional support from the Fed—and I am including the Fed as part of the definition of "Government" here—of trillions of dollars of loans, more than $1 trillion. It rolled over several times, which is what led us to that $7.7 trillion figure. And folks say, you know, if the Government can intervene with so much help and such low interest rate money to help our major financial institutions, why can't they intervene in that manner to help ordinary citizens wrestling with a housing market that was put into a bubble by policies that allowed predatory loans and teaser rates and steering payments, if you will, kickbacks, an enormous set of Government policies that drove that bubble?

I raise this because I think it is important to return to that framework, and as we think about this question of refinancing, it is helpful to have that citizen's voice in our mind. It is easy for us to talk about those loans that are currently guaranteed by the Government by chance; that is, when someone comes into our casework team and says, "Would I qualify for what is going on?" do you have a Fannie or Freddie mortgage? Because if you do, then you may be able to get refinanced. But they have no idea where their loan has been sold until we help them find out.

So you have so many families out there at higher interest rates who are wondering, well, why should it just be a matter of the lottery, that if my loan happened to be acquired by Fannie and Freddie, I qualify for this improved HARP program, but otherwise not? And given we have been so generous in helping financial institutions—I mean, let us not just look at the economy from the top. Let us look at it through the success of families. And certainly the economy in Oregon depends upon a successful home ownership market.

We sell grass seed, which is down the tubes without people buying homes. We sell nursery stock. We sell lumber. We sell insulated doors and windows. And that is true for virtually every State. A piece of their economy is driven by the housing market.

I have listened to the conversation about let us focus on those loans that happen to be with Fannie and Freddie, but the rest, well, maybe we just leave those people adrift, I feel a little bit of pushback that I wanted to share with you.

I do feel indeed like the conversation about the conflict of interest, Mr. Mayer, that you have been pointing out with Fannie and Freddie, where they have resisted financing because they have high-interest loans. Well, this is an argument that one can also make on the other side of the non-Fannie/Freddie world and part of why exactly home modifications have been so difficult to achieve. Maybe you would just like to share a little bit about that.

Mr. MAYER. So, first, I share your concern about the seeming unfairness of how the mortgage market and the economy have worked at the moment, and I think that that is a very, very deep concern, and I hear it a lot because I, you know, do talk shows and NPR and other kinds of things, you know, and I talk to a lot of people—not as many as you do, certainly, or as any of the Committee Members do, but I share that, and I have relatives who are locked into these situations as well. So I feel that very deeply. The challenge is how to do that within the existing structure.

I think there are ways that we could think more creatively that fund something a little bit like the Home Owner Loan Corporation, for example, or some other sort of structure where the funding does not necessarily have to come from taxpayers, but may also come from mortgage holders or other kinds of—you know, I think there are some creative structures that one could build to do this in a way that would encompass more people but at the same time be respectful of taxpayers' obligations as well. And I do think we have an obligation to think harder about those things, so I think the Administration bringing this up is important. I am not sure about a bank tax—how I would fund it. I would like the incidence of this to be on the holders of the mortgages so they understand their cost to that.

I would also sort of say that I think there are other—we could help those people also by doing other kinds of reforms in the market that help stabilize housing and that bring private capital in as well. There is no single tool that is going to fix this. It is going to be a variety of things. But I do think that there are going to be ways, if there is bipartisan support, to move this forward in a way that is respectful of taxpayers but is inclusive of a broader group of people, and I think those are both important concerns.

Senator MERKLEY. The 5 minutes disappears magically, so quickly. So thank you. The HOLC model, there are many, many variants of it. The President has put out one variant of it. There are many other ways to tackle this, but I feel like time is passing; that is, efforts that should have been concluded and put in place very quickly 2 to 3 years ago, we still have a window now, and we should get it done.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. And let me thank several of you who have appeared before our housing Subcommittee and given a lot of great insights, and I appreciate it, as do the Members.

You know, I have, as the Subcommittee Chair, been listening to a lot of our colleagues, and there seems to be a pretty strong universe of those for the refinancing camp. And, you know, I fully appreciate the question of the conservator's challenge in conserving and preserving assets. The question is whether you do that for a foreclosure or refinancing to a large degree, because it is, you know, very well if it is a default option, it is going to be one of those, too.

And so I do not get it when you could create a large base of continuing responsible borrowers at the end of the day and, therefore, solidify a significant part of the housing market and have an economic stimulus, because if I have been patching the roof because I cannot afford to, you know, get a new one and now my mortgage rate is down and I have some extra money I am going to go ahead and get the new roof, and that means that there is going to be a stimulus in the economy as well as a foundation for the housing base.

So that makes me wonder, then, and I would like to ask you, Dr. Mayer, when I hear about Freddie Mac having investments—some call it "bets"—against the homeowners that are contrary to the interests of homeowners, is that one of our challenges here? Because I do not think people make investments to then go against their investments.

Mr. MAYER. Right. I do agree that this is a very serious concern. In my written testimony, I go through in fairly good detail, particularly in the conclusion, how it is that that ended up in a situation where well-meaning people ended up doing things that present an enormous appearance of, you know, a significant conflict of interest and a bet against homeowners. And I think you do not have to have—you know, you could believe, as I think was reported in that story, that paying $2.5 million salaries to the people that created those instruments might well have been involved in the process. I know many Members of Congress have been very critical of the salaries paid to, you know, some of the executives in those organizations.

But I think there are—the conflict of interest of an organization that controls an outcome and also holds securities that are dependent on that control make it very, very difficult to manage the portfolio, because if you try and sell those bonds, people in the market look and say, “But I do not want to buy them because the only reason you are selling them is you are about to refinance them 10 minutes later.” And history says that Fannie Mae and Freddie Mac—particularly Freddie Mac—actually did that.

Senator MENENDEZ. So do you think these investments that influence Freddie’s policies may very well have discouraged homeowners with high-interest mortgages from refinancing?

Mr. MAYER. Yes, I think they have to do, and I go through the logic in my written report. I would not follow the conservator’s argument that this is $5 billion in a $600 billion portfolio so who cares, this cannot really have driven anything. I think that argument is not right because, one, these are derivatives that are based on probably, you know, $26 to $30 billion of mortgages, not $5 billion. You never value derivatives based on the value of the derivative. You value it based on the value of the underlying.

But the second is that almost surely many of the other mortgages in their portfolio look exactly—MBS—look exactly like these. And so without disclosure of what the whole portfolio looks like, I really think it is—we cannot conclude that that conflict of interest is——

Senator MENENDEZ. Do we know if Fannie or Freddie have other investments or financing arrangements that are contrary to the interests of homeowners?

Mr. MAYER. I think the mortgage-linked amortization notes that I talked about earlier give Freddie Mac the same economic interest, which is they finance over a 10-year period holdings of high-interest rate mortgages, leaving them with a strip or a spread which is 3.96 percent that lasts only as long as the refinancing does not occur or default does not occur.

Senator MENENDEZ. Well, this is a real concern to me because I do not understand why you make a bet that you can largely control the outcome of and want your bet to lose. I think that is against human nature. So I am not quite sure these firewalls exist in a way that are not affecting policies, and that is a problem.

Let me ask any one of you, do you think the $25 billion State-Federal foreclosure settlement is a good deal? Do you think that that is the right amount? There is a lot of angst out there in the country that says $25 billion fell short of the mark.

Mr. ZANDI. Well, I do not know what is appropriate in the context of the misdeeds that were done. I do think $25 billion is substantive and can make a difference in terms of responding to the housing crisis. I think if $15, $20 billion go to modifications and some additional refinancing, I think that is substantive, particularly if it is executed over the next 12 to 18 months. So is $25 billion the right number? I do not know. But it is a substantive number.

Senator MENENDEZ. Do any of you have a view on that?

Mr. SWAGEL. I would just say we should expect a modest impact and it will help some people. The biggest value is removing the uncertainty and having the housing market move forward and origination restart.

Senator MENENDEZ. One last question. We talked a lot about refinancing. I have been pursuing and am introducing legislation today that creates a pilot program at the FHA and the FHFA that would reduce principal writedowns to 95 percent loan to value in exchange for the bank or the investor getting a share of the profits when the home is sold or refinanced down the line, generally known as "shared appreciation mortgages." I think it takes away some of the concerns that Senator Corker was talking about. It is not a complete question that we raise very often here about the moral line. You are getting a writedown, but you are also giving up the possibility of appreciation in return for the writedown.

What do you think of that as a concept?

Mr. ZANDI. I think that is an excellent idea. I wish I had thought of that in my response to Senator Corker. But I do think that that is appropriate, that there should be shared appreciation of any principal writedown, and perhaps clawback provisions, too, if homeowners do not execute in the way that they are contracted to do in the principal reduction modification. So, I think there are a lot of moving parts here, and I am sure you know this may not work out as you would hope for because there are just so many things going on. But I think given that we have got this issue for the next 3, 5, 7 years, I think this is entirely appropriate to do. Hopefully we will learn from this and this will become part of the toolkit going forward.

Mr. MAYER. I would support the idea of trying to look for ways that—as you pointed out, the private sector are already managing these mortgages, and we know some of them are using shared appreciation mortgages. And I think in legislation, as I note in the written comments, we should actively call for such pilot programs modeled off of private sector initiatives.

The other thing I would sort of just point to in that process is one thing that might help in this legislation would be taxpayers could, in fact, have a clawback over a longer period of time, which is to say homeowners could promise a share of not only the appreciation of the existing home but future homes to help pay for that. That could be done through the existing Tax Code which has a deferral of certain capital gains on homes and would be a way of making such a proposal even more profitable or break even for taxpayers as well.

Mr. SWAGEL. I would just say that the shared appreciation mortgage might be useful for some people. Again, I would worry about a limited impact. People just do not like to share their home with the bank or the taxpayer. We have some experience with the so-called Hope for Homeowners program that was in the 2008 legislation, and there are more people in this room than were helped by that program. So it is just a limited——

Senator MENENDEZ. I appreciate it. Ocwen is doing this as one servicer who is doing this pretty successfully, and we think it can be, as referred to, a tool within a larger—thank you, Mr. Chairman.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman. And thanks for your testimony today.

I know the President recently released his plan to help responsible homeowners and heal the housing market, and one pillar of this plan is to establish a broad-based refinancing plan for responsible homeowners. I understand that in both public and private refinance plans there has been a problem with take-up and lenders will present borrowers with refinancing plans that would lower their interest rates and monthly payments, but that some borrowers are simply not choosing to sign up.

Can you shed any light, any of you, on this problem and provide your thoughts on what might be done to remedy it?

Mr. ZANDI. Well, you are absolutely right, I think there is a problem with take-up, even when it ostensibly makes sense from a financial perspective for the homeowner to engage in the refinancing.

I do think that part of the problem in the take-up is that people are just very nervous that if they come forward, they are not sure what else in their financial lives is going to be uncovered and what other kind of damage could be done to their finances as a result. So I think it is very important, when servicers go to try to execute on these refinancings, that they make it very clear that, you know, they just want to make sure you have a job and that is it. So you have to be very, very clear that there are no other strings attached. All we want to do is make sure you have got a job, you are getting paid. If that is the case and you are current and you meet these other very limited restrictions, then you are good; we are going to refinance you.

The other thing is I think financial literacy obviously is a very significant problem. People are just confused. They do not know, they do not understand. And so I think anything that could be done to really educate people as to, this is really going to help you and make it very clear on one piece of paper, this is your mortgage, this is your monthly payment, this is exactly what is going to happen, you email it to them or you put it in their mailbox, then, you know, hopefully that will increase the take-up.

So I think it is a matter of communication and transparency with respect to——

Senator HAGAN. And how would you go about doing that?

Mr. ZANDI. Well, I think when Fannie and Freddie and the FHA sit down with the mortgage servicers and talk about how they are going to execute on this plan, if, in fact, we move forward on it, then these are the kinds of things that they discuss. How are we going to do this so that we do get more take-up?

Mr. MAYER. I agree that take-up is an issue, but I actually think that the right approach is one word: competition. We did not ever have to sort of push people to take mortgages. You know, in 2002 and 2003, there were 35 million new mortgages originated in this country. Those were predominantly not subprime loans. Some of them involved cash-out refinancing. But what drove that was competition among servicers for the businesses, and I think one of the most significant barriers to the take-up and one of the reasons that HARP in all its incarnations, including potentially this one, do not work is because you lock the existing servicer and you give them a big advantage relative to other servicers.

So what you need is not only the servicers who are in that room, but people who want to start a business as servicers who are not sitting in that room should have the opportunity to enter and take the business of the existing parties if they do not serve their customers well, of which there is some evidence is not happening. They are going to find lots of ways to reach people that is not just by mail. They are going to advertise on the Internet. They are going to be on late-night TV. They are going to figure out ways to do it because it is in their financial interest to do it, and that competition is also going to drive down these incredibly high spreads between retail and wholesale mortgage rates.

So my view is that we should be doing everything we can to open this up to competition. We should put out a list protecting privacy of borrowers who have Fannie and Freddie loans. Your mortgage is already a public record in virtually every State in the country. That should be available to any servicer, existing or not, who wants to come and say, "These are people who are eligible for this program, and I will jump in." My bet is that somehow those existing servicers will really quickly discover how to refinance their existing people if they think they are going to lose that servicing business.

Senator HAGAN. Thank you.

Mr. SWAGEL. I would just add very briefly, it is a tough issue. A borrower in trouble is being pounded by the bank, you know, "Pay up, pay up," and then gets a call, "OK, now we want to help you," and it is hard to know. So nonprofit counselors have been a big success story, a big part of the solution.

Just the other small thought is that it is a difficult issue just because of the screening, trying to get the right people to help, the more kind of screening you do to get just the right people limits the effectiveness, and that is in my written testimony as a concern I express about the White House fact sheet, the announcement, is that they are trying to say, OK, we want this to be no red tape, no hassles, but also no tax forms, but only owner occupied, and those things do not go together. You cannot make sure it is owner occupied if you do not have tax forms and you do not have an appraisal.

So I just worry about the ability to implement the proposal that the White House has proposed.

Mr. ZANDI. Senator, could I say one other thing? Just one other plug for the Administration's proposal, which is very similar to the Federal Reserve's proposal, and this dovetails with what Dr. Mayer is saying. The way this is designed is that it is going to relax some of the reps and warranty features of the refinancings, also the mortgage insurance companies, most of them have given up rescission rights. This is very important to the mortgage lenders, the servicers, and it is a reason to believe that they are going to engage in a lot more competition and do the kinds of things that Dr. Mayer has suggested.

So in the design of the proposal, there are a lot of good reasons to believe that you will get more take-up because you will have more competition. So just another reason why I think you would want to execute on this.

Senator HAGAN. Thank you. And, Mr. Zandi, your comment on financial literacy is near and dear to my heart. When I was in the State Senate, I mandated that financial literacy be taught, at least a portion, in civics and education class in high school, and it is certainly something that I am adamantly in support, that you look at the financial crisis that hit, I think we have got to do a better job educating our young people in particular on financial literacy and the skills. You cannot get by in the country today without understanding debt. You really need to work on that.

Mr. ZANDI. In my high school education, I learned how to make a really good omelet. I had no idea what a mortgage was.

[Laughter.]

Mr. ZANDI. I am not sure that makes any sense at all—although I really make a good omelet.

Mr. MAYER. In my high school, the omelets were on the ceiling.

[Laughter.]

Senator HAGAN. Then I had one other question, Mr. Chairman. Mr. Zandi, in your testimony you mentioned that Fannie and Freddie have historically not engaged in bulk foreclosure sales to investors or entered into agreements with property managers. Do you believe that a properly constructed—any of you—REO to rental program would reduce taxpayer exposure to Fannie and Freddie?

Mr. ZANDI. Yes, I think this is also a very fruitful area for addressing the housing crash. I think that if you look at property in REO, more than half now, and rising quickly, is at Fannie, Freddie, and the FHA, and increasingly the share of REO that is going to be Fannie, Freddie, and FHA is going to rise. So anything that they can do to facilitate moving that REO to rental as opposed to moving it through to a distressed sale is really very positive for the economy.

The one problem is they have no experience with it and, thus, it is taking them time to really get going. But Congress, I think, should really be pushing this and asking FHFA to really engage because this could reap enormous benefit.

And one other quick point. Again, this is a problem that is going to be with us for a number of years, 5, 6, 7 years. So I think we should—even if it does not reap benefit 6 months from now or a year from now, this is something that should be pursued very aggressively.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to thank all of our witnesses for your this and for being here with us today. A strong, robust housing sector recovery is not just vital to our country's homeowners; it is vital to our country's economic strength. This Committee will continue to search for consensus solutions to help responsible borrowers in these difficult times.

This hearing is adjourned.

[Whereupon, at 11:37 a.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF MARK ZANDI

CHIEF ECONOMIST AND CO-FOUNDER, MOODY'S ANALYTICS

FEBRUARY 9, 2012

Written Testimony of Mark Zandi
Chief Economist and Co-Founder Moody's Analytics

Before the Senate Banking Committee

"State of the Housing Market: Removing Barriers to Economic Recovery"

February 9, 2012

The six-year-old housing crash continues to threaten the U.S. economic recovery. Home sales and housing construction remain weak, while house prices are still falling in many parts of the country. Millions of homeowners have lost their homes, and millions more are likely to follow them, given the unprecedented number of foreclosures.[i]

It is hard to be enthusiastic about the U.S. economy's prospects as long as house prices are declining. A house is typically a family's most important asset. Many small-business owners also use their homes as collateral for business loans, and local governments rely on property tax revenues, which are tied to housing values, to fund schools and other important public services.

Most worrisome is the risk that housing will fall back into the vicious cycle that occurred at the depths of the last recession. As prices fell, homeowners found they owed more than their homes could sell for; this led to more defaults, more distress sales, and still-lower prices. That cycle was broken only through unprecedented monetary and fiscal policy support.

The gloom in the housing and mortgage markets notwithstanding, there are reasons to be optimistic that housing's long slide will end soon. While a mountain of distressed property remains to be sold, investor demand appears strong. Prices have fallen enough to allow investors to profitably rent these homes until the market recovers. Rental vacancy rates have fallen meaningfully over the past two years, suggesting that new construction is slow enough to let builders work down the still-considerable number of vacant homes.

Nonetheless, risks remain uncomfortably high. Policymakers should thus consider taking additional modest steps to support housing temporarily. These should include facilitating more mortgage refinancing, supporting increased mortgage loan modifications, and aggressively pursuing efforts to convert distressed properties to rental use before they are sold and further depress prices. These steps are consistent with the Obama administration's recent housing initiative and various policy steps proposed by the Federal Reserve in a recent white paper. Many of the proposals come at no cost to taxpayers; others have costs that are already accounted for in the budget.

While many of these policy steps will not be politically popular, the outcome may be much worse if policymakers stand by while a weak housing market continues to undermine the economy.

Six lean years

The housing crash is six years old and counting. Sales of existing homes—a gauge of demand—languish near an annual rate of 4.5 million, of which about a third are foreclosures and short sales. Sales of new homes are even bleaker, running at a record low rate close to 300,000 units per year. In a well-functioning housing market, about a million more new and existing homes would change hands per year, and fewer than a tenth would be distress sales.[ii]

Housing construction—the marker for supply—is also depressed. Single- and multifamily housing starts run close to 650,000 units annualized, and manufactured home placements barely reach 50,000 per year (see Chart 1). This is nearly the weakest pace for residential construction since World War II. A well-functioning housing market would produce closer to 1.75 million units annually.[iii]

Chart 1: An Epic Housing Crash

Sources: Fiserv, BEA, Moody's Analytics

Nationwide, house prices remain fragile. The Fiserv Case-Shiller national house price index has dropped by a third since peaking in the first quarter of 2006, and prices are still falling in many parts of the country as a result of the pressure created by the large number of distressed property sales. In a well-functioning market, prices should rise around 3% per year.[iv]

Economic fallout

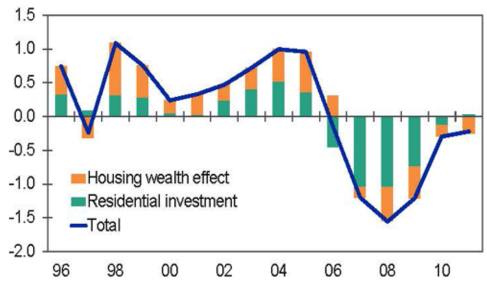
Although housing is no longer the drag it was during the worst of the Great Recession, it remains a significant weight on economic growth. This is particularly disappointing since housing is often a major source of growth early in an economic recovery (see Chart 2).

Falling house prices and the resulting hit to household wealth remain serious problems. Some $7.4 trillion in homeowners' equity was lost in the housing crash, with close to $500 billion of that occurring in 2011. Given the impact on consumer spending from lost housing wealth, this shaved about 0.2 percentage point from real GDP growth last year.[v]

The loss was particularly hard on middle-income households, who benefited less from rising stock prices than did their higher-income neighbors.

Chart 2: Housing Weighs on the Economy

Contribution to real GDP growth, %



Source: Moody's Analytics

Shaky house prices also make it difficult for small-business owners to use their homes as collateral. Bank lending to small businesses picked up over the past year, but it is hard to see how credit will flow freely until house prices rise again. Since small businesses are a key part of job creation, this is a significant impediment to a stronger job market.

Strapped local governments are also struggling with the impact of falling house prices on property tax revenues. Despite rising millage rates in many parts of the country, tax revenue is growing at nearly its slowest pace on record. Given the lag between market price changes and tax assessments, revenues are likely to slow even more in the coming year. Local governments will thus have little choice but to continue cutting budgets and laying off workers. Local government payrolls are off by more than 500,000 from their peak and shrinking by about 10,000 jobs per month.

Other effects of falling house prices are serious but harder to quantify, such as a reduction in labor mobility—an important way for the economy to adjust to shocks—and the erosion of retirement savings for low- and middle-income homeowners.

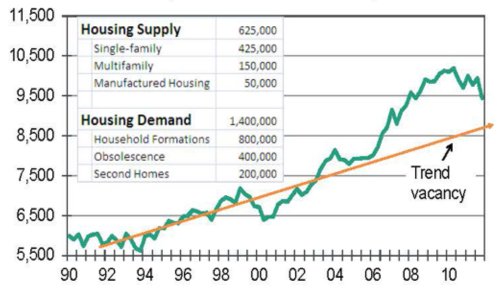
While the worst of the crash appears to be over, housing continues to grapple with big problems, including a glut of vacant homes and a mountain of properties in or approaching foreclosure. With so many home loans deeply under water, risks remain uncomfortably high that the vicious cycle of foreclosures and price declines that ravaged the economy during the Great Recession will be reignited. Aside from the European sovereign debt crisis, there is arguably no more serious threat to the current economic recovery than the troubled housing market.

Excess inventory

The rampant overbuilding that occurred during the bubble years remains a significant impediment to a housing rebound. While builders have slashed construction and have made progress working down inventory, the market still struggles with excess vacant homes; we estimate just over 900,000 are either for sale, for rent, or being held off the market (see Chart 3). This is the difference between the 9.4 million vacant homes measured by the Census Bureau's Housing Vacancy Survey and the number of vacancies—around 8.5 million—that would be consistent with a well-functioning housing market. At current levels of supply and demand for new houses, it would take until mid-2013 to work off this excess inventory.

Chart 3: Glut of Vacant Homes

Vacant homes for sale, for rent and held off market, ths



Sources: Census, Moody's Analytics

There is some evidence that the situation may not be quite as bad as these numbers suggest. It is unclear how well many vacant properties are being maintained, especially in heavily overbuilt markets such as Florida and California's Central Valley. Such houses may be unusable without significant renovation. Moreover, the excess-inventory problem is regionally concentrated. Atlanta, Florida, Nevada, Arizona, and the Central Valley are awash in vacancies; elsewhere the inventory problem is much less pronounced and will thus be resolved sooner.[vi]

Demand and supply will not improve simultaneously, moreover. It is likely that demand for vacant homes will pick up more quickly than will new construction. The principal component of demand is household formation, which has been depressed recently because of the weak job market. With fewer job opportunities, young people have been staying in school; labor force participation has plunged among those between 16 and 29 years old. While the data here are sketchy, it appears that at its low point, household formation slowed to an annualized pace close to 300,000 in early 2010. It has picked up over the past year to closer to 750,000 per year; this has fueled a surge in rental absorption but is still well below the 1.25 million households expected to be formed each year in a well-functioning economy.

As the job market comes back to life and young people return go to work, household formation should accelerate. Many young people have stayed in their parents' homes longer than in normal times, suppressing household formation; this should be reversed in the next year or two. Formations in 2013 and 2014 could be well over the 1.25 million expected in a typical year.

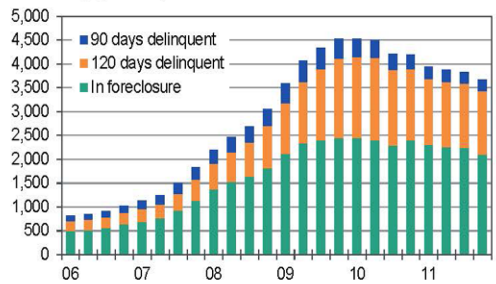
Still, it will take a number of years for housing construction to really get going. Even as demand revives and the inventory of vacant homes is worked down, it will take time for builders to obtain construction and land development loans from banks, many of which are still processing the poor loans they made during the bubble. It also will take time for builders to ramp up new-home construction, a process that includes acquiring land, obtaining permits, and getting equipment on site. Multifamily construction will come back first—it already is reviving thanks to stronger absorption, falling vacancy rates, improving rents, and more ample credit—but even under the best of circumstances, single-family home construction will not be back to full strength until the middle of the decade.

Foreclosure crisis

A more serious threat is the huge number of first mortgage loans stuck in foreclosure or more than 90 days delinquent and thus headed for eventual foreclosure. At the end of 2011, 3.6 million loans (out of 49.9 million loans outstanding) were in this predicament (see Chart 4). Most will end up in foreclosure, short sale or distress sale over the next 12 to 24 months, pushing house prices lower.

Chart 4: A Mountain of Distressed Property

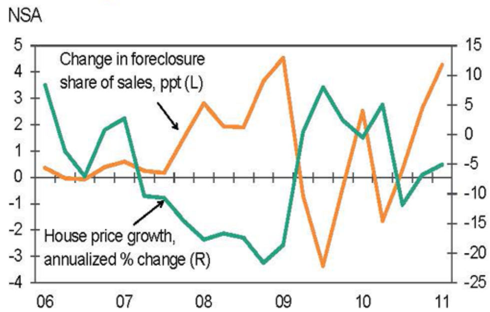
First mortgage loans, ths



Sources: Equifax, Moody's Analytics

The key to house prices in the current environment is the change in the share of home sales that involve distressed properties. Prices fall when the share rises, stabilize when the distressed share peaks, and rise when the share declines (see Chart 5). It is important to note that house prices will rise if the share of distress sales declines, even if the share remains elevated, as it will for a number of years given the large number of troubled properties.

Chart 5: Higher Distress Share...Lower House Prices



Sources: Fiserv, Zillow, Moody's Analytics

The share of distress sales is likely to rise and house prices to fall further after the nation's largest mortgage servicers and state attorneys general resolve legal issues arising from the robo-signing scandal and other foreclosure process issues. These issues have significantly slowed the pace of foreclosures and distress sales over the past year or so. Little progress has thus been made in reducing the number of troubled loans. Once the pending lawsuit is settled, which should be soon, the foreclosure process is likely to gear up again, resulting in more distress sales and more house price declines.

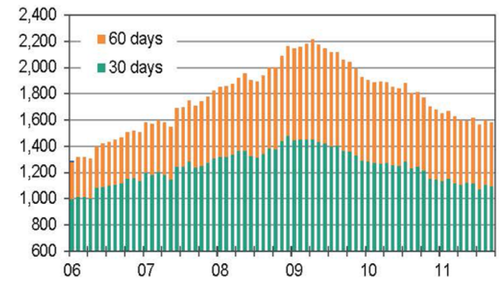
House prices are expected to fall only modestly, no more than 5% from current levels. Sturdy investor demand for distressed properties will limit the declines, particularly in the hardest-hit markets. Prices have already fallen so sharply in Atlanta, much of Florida, Nevada, and Arizona that investors can purchase distressed properties and profitably rent them out. Many of these markets actually appear undervalued when current prices are compared with household incomes and effective rents. Unlike the house flippers who sought quick profits during the bubble, today's distressed-property investors seem willing to hold on. They include both individuals and institutions with investment horizons of more than a few years.

Prices for nondistressed homes are also holding up better than they did earlier in the foreclosure crisis, according to CoreLogic and FNC. Many distressed properties may be in less desirable areas and no longer in direct competition with nondistressed properties. This suggests that damage to homeowners' wealth will be less severe, with less economic fallout.

The flow of mortgage loans entering foreclosure should also begin to slow soon, since fewer troubled loans are in early stages of delinquency. The number of first mortgage loans between 30 and 90 days delinquent is falling quickly (see Chart 6). This reflects a better job market and improvements in underwriting standards since the recession. Mortgage loans originated during the past three years are of excellent quality.

Chart 6: Early-Stage Mortgage Delinquency Is Falling Fast

First mortgage loans 30-90 days delinquent, ths, SA



Sources: Equifax, Moody's Analytics

Vicious cycle

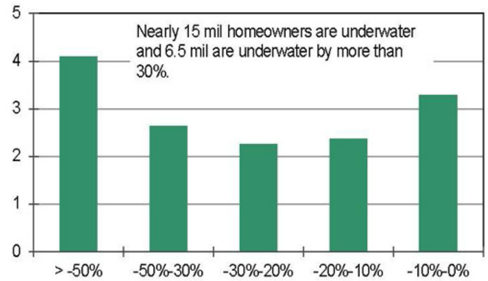
Notwithstanding our optimism that future house price declines will be modest, risks are too high that they will be more severe than anticipated. With so many underwater homeowners, it would not take much to reignite the vicious cycle that roiled the housing market and economy during the Great Recession: Falling prices pushed more homeowners under water, prompting more mortgage defaults and more distress sales and thus more price declines.

With an estimated 14.6 million homeowners under water, half by more than 30%, this is a real possibility (see Chart 7).[vii] Adding to the concern, the average underwater homeowner's debt exceeds the market value of her home by nearly $50,000. It would not take much to induce many in this situation to mail their keys back to lenders; a leaky roof or broken air conditioner might be sufficient, particularly if rental housing is available nearby for less than the cost of the mortgage. Studies based on credit file data suggest the share of strategic defaults—involving homeowners who are current on other debt obligations—has risen and now accounts for approximately one-fourth of all defaults.

Decisions to default depend critically on expectations about future house prices. If homeowners think prices will rise, they are more likely to hold on; if they believe more price declines are coming, they are more likely to give up. This can quickly become a vicious cycle, as occurred during the depths of the recession.

Chart 7: Millions of Homeowners Sink Underwater

Homeowners' equity distribution, mil of homeowners, 2011Q3



Sources: Equifax, Moody's Analytics

Only a massive policy effort broke that vicious cycle. The federal government put Fannie Mae and Freddie Mac into conservatorship and the FHA aggressively expanded its lending. Today the federal government originates more than 90% of all new mortgages. In addition, conforming loan limits were increased and three rounds of housing tax credits were enacted as part of the federal fiscal stimulus. The Federal Reserve purchased $1.25 trillion in mortgage securities to bring mortgage rates down as part of its quantitative easing initiative. The government also took part in the mortgage-loan modification effort via the Home Affordable Mortgage Program and encouraged mortgage refinancing via the Home Affordable Refinancing Program.

Although various elements of this policy response may warrant criticism, it is important to remember that the effort was devised and implemented quickly, under extreme circumstances. Moreover, in its totality, the policy response worked; the housing market stabilized beginning in 2009. Yet if housing were to begin another dark cycle, the policy response would not be nearly as aggressive. There is little political appetite for another big-government intervention in the economy, particularly given Washington's precarious fiscal situation.

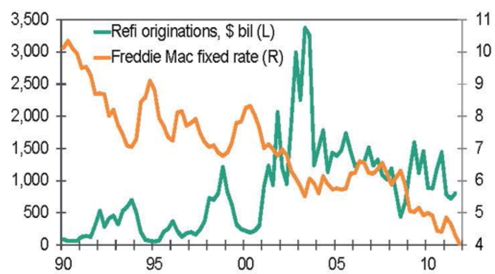
With housing and the economy still facing significant threats, and with policymakers unlikely to respond aggressively in another crisis, it is sensible to consider a number of modest additional steps now to make sure housing does not backtrack. These should include facilitating more mortgage refinancing, supporting increased mortgage loan modifications, and aggressively pursuing efforts to convert more distressed properties to rental use before they are sold and further depress house prices.[viii]

More mortgage refinancing

Policymakers should move to substantially increase the amount of mortgage refinancing.[ix] This is a particularly propitious time for homeowners to refinance, as mortgage rates have fallen to record lows. The 30-year fixed mortgage rate for prime borrowers is well below 4%, and likely to remain very low for some time given the Federal Reserve's stated resolve to keep interest rates low for the next several years. Monetary authorities are also keeping open the possibility of more quantitative easing that would likely include purchasing more mortgage-backed securities.

Given record low borrowing costs, refinancing has been disappointingly slow. In 2003, when fixed mortgage rates were between 5.5% and 6%, home loans were being refinanced at an annualized rate above $4 trillion. The current level of activity is about one-fourth of that (see Chart 8). The 2003 boom was fueled by the large number of mortgages that had been originated when rates were much higher, making a sub-6% rate very attractive. Yet even today, some two-thirds of all outstanding mortgages carry coupons above 5%. Millions more U.S. homeowners should be refinancing, significantly cutting their monthly payments. This would be a boost both for individual household finances and for the ailing economic recovery.

Chart 8: Rates Plunge, Refis Putter



Sources: MBA, Freddie Mac, Moody's Analytics

The Obama administration has worked since the introduction of HARP in mid-2009 to encourage homeowners with little or negative equity, and whose loans are insured or owned by Fannie Mae and Freddie Mac, to refinance. Originally, the administration said HARP would allow between 4 million and 5 million homeowners to reduce their interest rates to market levels. But so far, only about 1 million homeowners have refinanced using HARP, and fewer than 100,000 underwater homeowners have refinanced.

The disappointing results prompted the administration to unveil a number of important changes to the HARP program late last year. These included relaxed eligibility requirements, allowing borrowers with loan-to-value ratios (LTV) of above 80% to participate, streamlining the appraisal and underwriting process, getting most mortgage insurers to drop their recession rights, and requiring Fannie and Freddie to relax their reps and warranties. It has taken a few months for mortgage servicers and insurers to implement the new HARP rules, but the benefits of the new rules should become evident in coming months.[x] Servicers appear to be particularly enthusiastic about the possibility of reducing their put-back risk.[xi]

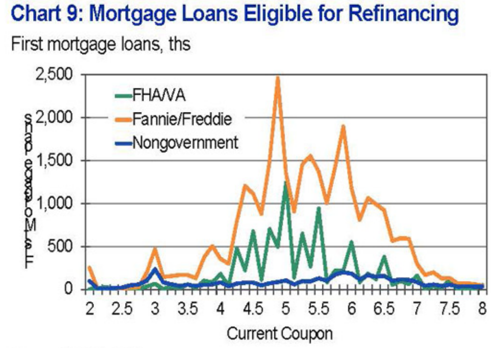
As recently as early February, the administration proposed even more aggressive steps to support refinancing, affecting all mortgage loans including those insured by Fannie, Freddie, the FHA, and nongovernment lenders.[xii] If implemented quickly, this proposal should boost refinancing, speeding the recovery in housing and beyond.

For Fannie and Freddie loans, the Obama administration proposes that the new HARP rules apply to all loans, not just those with LTVs over 80% as is now the case. For FHA/VA loans, the administration is proposing that the FHA drop refinanced loans from the "Compare Ratio" process by which the performance of lenders is assessed (analogous to Fannie and Freddie's reps and warranties). For nongovernment loans, the administration is proposing that the FHA refinance the mortgage. The administration is also proposing that taxpayers pay closing costs when homeowners agree to loans of 20 years or less, with monthly payments equal to those on their current loan. This would allow homeowners to build equity more quickly.

The administration's proposal substantially increases the pool of homeowners eligible to refinance and helps remove impediments to more refinancing. Significantly reducing the put-back risk faced by lenders on refinanced loans will encourage lenders to aggressively compete for refinancing business. Lowering borrowers' closing costs increases the incentive for them to participate as well.

Fully implemented, the administration's proposals would increase the number of homeowners eligible to refinance to nearly 28 million, covering more than half of all loans outstanding.[xiii] The plan would affect all mortgage loans on owner-occupied single-family homes for which the current mortgage rate is above 5%, and that have been current over the past six months. To qualify, borrowers would have to be no more than one month past due in the prior 12 months, be within the conforming loan limits, and have a credit score of more than 580 (see Chart 9). There would be no restriction on when the loans were originated, unlike the current HARP, which is limited to loans originated before mid-2009.

Chart 9: Mortgage Loans Eligible for Refinancing



Sources: McDash, LPS

For all this, many homeowners would still not refinance. Yet under reasonable assumptions—including mortgage rates remaining near their current 4%—we estimate that the administration's proposal would result in 6.8 million more refinancings by the end of 2013.[xiv] That number includes 3 million Fannie/Freddie borrowers, 2.5 million FHA/VA borrowers, and 1.3 million nongovernment borrowers.

There should be no cost to taxpayers for the additional Fannie, Freddie, and FHA/VA refinancings. As the FHA refinances loans of nongovernment borrowers it will take on added credit risk, the cost of which would be borne by the financial industry under the administration's plan. Since the industry will likely oppose this, jeopardizing the overall effort, Congress could instead use some of the remaining $20 billion in TARP money set aside to pay for policies targeted at addressing the housing crisis.

For the administration's efforts to be effective, the FHFA—Fannie and Freddie's regulator—will need to support the plan, and the FHA refinance plan for nongovernment borrowers will require legislation. The FHFA has been reluctant to engage in such efforts, ostensibly because it fears they will require more taxpayer support for the agencies.[xv] This argument seems increasingly specious. While the agencies would lose some interest income on their $1.2 trillion in mortgage securities and whole mortgage loans, under reasonable assumptions the cost would be offset by lower default rates on loans that are refinanced. Borrowers are more likely to stay current if their monthly payments drop by $100 or $200. Indeed, under reasonable assumptions, Fannie and Freddie would break even if the probability of default on the loans and securities they own and insure falls by about 25 basis points.[xvi]

The benefit to borrowers is meaningful. Assuming the average homeowner can refinance into a 4% fixed-rate loan, the gross saving from lower mortgage payments would come close to $18 billion a year (6.8 million borrowers x $140,000 average mortgage balance x 1.8% average rate reduction). This would provide a quick cash boost for mostly middle-income homeowners. Some would be used to repay other debt, but the bulk would likely be spent on home improvements or other needs. Assuming about three-fourths of the extra cash is spent during the year, real GDP will see a small but meaningful boost, adding 0.1 percentage point to growth this year.[xvii] The fragile U.S. recovery can clearly use all the help it can get.

More refinancing would also further the Federal Reserve's short-term goals. Monetary policymakers are considering a new round of quantitative easing—a process in which the Fed purchases long-term securities in an effort to bring down interest rates, including fixed mortgage rates. Indeed, the recent decline in mortgage rates is due in part to expectations that the Fed will resume quantitative easing. If it does, arguably the most significant benefit would involve increasing the pace of home-loan refinancing. Anything fiscal policymakers can do to support the Fed's efforts would be a plus.

While homeowners would clearly benefit from more refinancing and taxpayers would be largely unaffected, global investors in agency mortgage-backed securities would be hurt financially. As more loans are refinanced, higher-yielding MBS would be retired and replaced with lower-yielding MBS. To be precise, if a more effective HARP resulted in 6.8 million more refinancings, private investors would receive approximately $11 billion less in annual interest income.[xviii]

MBS investments are held by a wide array of institutions. Through its credit easing efforts last year, the Fed quickly became the largest owner of agency MBS, amassing $1.25 trillion or about a fourth of the total outstanding. The nation's central bank can easily absorb the lost interest income from increased prepayments, but this may put pressure on the Fed to be more aggressive in its quantitative easing efforts to forestall a counterproductive rise in mortgage rates. The interest rate spread between MBS and Treasury yields will increase regardless, but MBS yields need not rise if the Fed buys a sufficient amount of Treasury bonds.

While other private MBS investors will not be happy to get their money back when interest rates are low, they were aware of this prepayment risk when they purchased their securities. Indeed, investors are likely surprised that their securities have not been retired already, as they would have been in a more normally functioning mortgage market. The updated HARP can thus be seen as a way to correct a serious market failure. It is also important to note that MBS investors have been significant beneficiaries of the monetary and fiscal policy response to the financial panic and Great Recession. The Fed's massive purchases of agency MBS during a previous round of quantitative easing was a windfall. Myriad federal housing and foreclosure policies aiming to stem foreclosures have also significantly benefited investors through reduced prepayments.

Policymakers may be nervous that overseas investors, who constitute a sizable and growing source of capital for the U.S. Treasury, will be annoyed by faster prepayments. Policymakers may also worry about implications for the financial health of the nation's depository institutions and pension funds, who also are big investors in agency MBS. While not unreasonable, these seem marginal concerns given the magnitude of the losses that will be widely distributed among investors.

Another potentially unwelcome side effect of boosting refinancing activity today could be less labor mobility in the future. Borrowers who lock in record low mortgage rates today will be less willing to move when rates start to climb. Given that homeowners tend to be more skilled than renters, this impediment to labor mobility could aggravate the U.S. economy's current skills mismatch. However, it is difficult to know the scale of this consideration; it seems small against the sizable near-term benefits of a refinancing program. It is also worth noting that homeowners who switch from adjustable-rate to fixed-rate mortgages will be protected when interest rates ultimately rise.

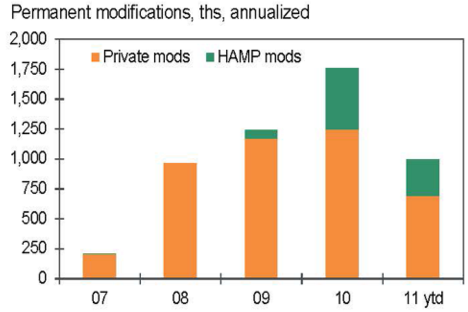
Principal reduction modifications

A more dramatic and costly policy step, but one with the best odds of ending the housing crash more quickly and definitively, would be to encourage more mortgage modifications, particularly those involving substantial principal write-downs. Principal reduction has economic positives and negatives, but is a positive on net if it is well-designed. The main concerns are moral hazard and fairness. To deal with these, modifications must be well-targeted, with clearly articulated eligibility requirements. A long vesting period and some type of clawback provision for future capital gains to guard against potential fraud would also be helpful.

HAMP was reworked in late 2010 to promote principal reduction modifications, but the change has accomplished little so far. To date, there have been fewer than 1 million permanent HAMP modifications, and very few of these have involved principal reduction. When HAMP was unveiled in mid-2009, President Obama was hoping for between 2 million and 3 million HAMP modifications.[xix] (see Chart 10)

Chart 10: Modification Efforts Flag

Permanent modifications, ths, annualized



Sources: Hope Now, Moody's Analytics

Responding to this shortfall, the Obama administration proposes more changes to HAMP to increase eligibility and extend the program through 2013. More importantly, the new program will significantly increase incentives for mortgage servicers who modify mortgages by reducing principal. For every dollar that a servicer writes down a loan, the Treasury will pay the servicer up to 63 cents. The president proposes paying for this out of the remaining $20 billion in TARP money slated for housing.

This expansion of HAMP could be particularly effective given the impending settlement between state attorneys generals and mortgage servicers over robo-signing and other foreclosure process issues. This deal is reported to include a monetary settlement of up to $25 billion, a significant share of which will be allocated to modifications, including principal reduction, of loans on the servicers' balance sheets.

For scale, suppose a total of $20 billion is allocated to principal reduction modifications, including those done via the new HAMP and the mortgage settlement. If the average amount of principal reduction per homeowner is $30,000, more than 650,000 homeowners would benefit. This is approximately equal to the number who currently satisfy the following eligibility requirements:

- Homes are owner-occupied.
- Homes were bought before December 31, 2008.
- The homeowner took no cash out in past refinancings.
- First mortgages are below conforming loan limits.
- Loan principal is reduced by no more than $40,000.

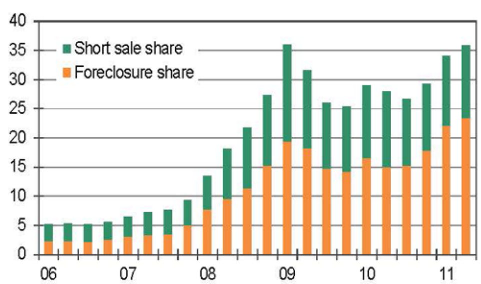
Moreover, the modification would have to result in the following conditions:

- The loan could be no more than 10% above the home's market value (to limit the probability of redefault).
- The "front-end" debt-to-income ratio (counting only housing costs) could not exceed 31%, and the "back-end" DTI ratio (counting all obligations) could not exceed 50%.

Assuming a redefault rate of 25%, this would result in almost 500,000 sustainable modifications.[xx] Along with those that would take place in any event, this is about the number needed to forestall anticipated house price declines. Without such a plan, the share of distress sales is expected to rise from more than a third to just under 40% by late 2012 (see Chart 11). House prices will decline as the share of distress sales rises. But if a modification program is implemented soon, the share of distress sales will level off and house prices will stabilize.

Chart 11: Distressed Share of Sales Are High and Rising

Share of home sales

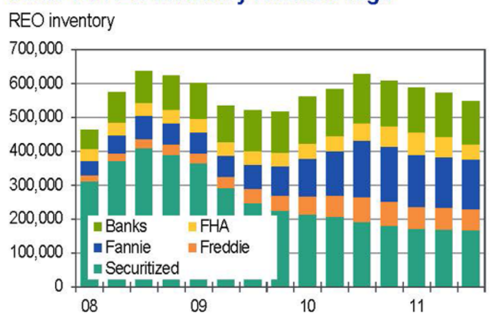


Sources: Zillow, Realtors, Moody's Analytics

REO to rental

Policymakers are also rightly focused on converting more distressed property to rentals. Reducing the number of distressed properties that go up for sale will reduce the share of such sales and thus support house prices. The number of properties classified by banks as "other real estate owned" or REO—the last stage of the foreclosure process before a distress sale—has declined over the past year, but only because the robo-signing scandals have slowed foreclosures (see Chart 12). Once a settlement is reached between the state AGs and mortgage servicers, foreclosures and thus REO properties and the distressed share of home sales will pick up again. Converting more REO property rentals will mitigate this increase and thus slow further house price declines.

Chart 12: REO Inventory Remains High



Sources: Fannie, Freddie, FHA, FDIC, Moody's Analytics

A key to doing this is getting private investors and property managers involved. Investors show healthy interest in buying distressed property for rental, fueled by the fall in house prices alongside a sharp increase in rents. Given strong rental absorption and very weak construction of rental space, rents are rising at a sturdy mid-single-digit pace and are at levels that can cover investors' costs while they wait for properties to appreciate. Most investors are not flippers looking for quick profits—given the state of the housing market this would not be a winning strategy—but have investment horizons of three to seven years. Such investors would likely be willing to rent properties purchased from Fannie, Freddie and the FHA for at least several years, selling them after house prices begin to rise again.

It is important to note that many investors are local, living in the neighborhoods where they are buying. Many have also bought with cash, given the dearth of mortgage financing. Institutional investors are also participating, but at least so far have been cautious and selective in their purchases.

The Obama administration recognizes that converting REO properties to rentals is a potentially productive way to help the housing market. Last summer they asked various housing market participants how to design an REO-to-rental program. As part of the president's recent housing initiative, the FHFA announced it would pre-qualify investors to bid on Fannie and Freddie REO-to-rental transactions. Hopefully more initiatives will soon come to fruition.

It is also important for the FHFA to fully embrace this process. Fannie and Freddie have historically not engaged in bulk foreclosure sales to investors or entered into agreements with property managers. To successfully engage in these kinds of activities will require the blessing of the FHFA and significant investment. Even then, Fannie's and Freddie's lack of experience in this area is among the most significant impediments to success.

One way to significantly increase investor interest in purchasing REO properties is to allow buyers to expense their investments for tax purposes up front. This is the same benefit received last year by businesses for investments in equipment and software. Giving investors a small tax break should boost demand, supporting prices for distressed homes and the housing market in general. It would cost taxpayers little, since the tax liabilities of investors will be greater once they have exhausted their depreciation benefits.

Conclusions

The housing crash and foreclosure crisis are not over. Home sales and housing construction are stable but depressed, and house prices remain weak. With millions of foreclosures and short sales set to hit the housing market over the next two years, house prices are set to fall further.

While house prices are declining, the recovery will have difficulty gaining traction. For most Americans, the home is still the most important asset, and consumers will be reluctant to spend while their wealth erodes. Many small-business owners use their homes as collateral to grow, and local governments rely on property taxes tied to house prices.

There are some reasons to be optimistic that the crash is winding down. House prices have fallen far enough that single-family housing is affordable and increasingly attractive compared with renting. Investors are putting up cash to purchase distressed properties. Overbuilding remains a problem, but a decreasing one given a record-low pace of new construction and increased household formation.

But this optimism will be easily overwhelmed if house price declines reignite a vicious cycle, putting more homeowners under water, accelerating foreclosures and distress sales and driving prices even lower. Only an unprecedented monetary and fiscal policy response short-circuited that cycle during the recession.

Given the balance of risks, policymakers should thus consider providing additional temporary help to the housing and mortgage markets. Reinvigorating mortgage refinancing would provide a substantial boost with no meaningful cost to taxpayers. More refinancing will mean fewer borrower defaults and more money in the pockets of homeowners, supporting the recovery through a quick and sizable cash infusion.

Facilitating more well-targeted principal reduction loan modifications would be a much larger and costlier step but would bring the housing downturn to a quicker and more definite end. The number of modifications and the amount of principal reduction necessary to stabilize house prices can be reasonably financed with funds from the impending settlement between state attorneys general and mortgage servicers, and the president's proposals to expand HAMP.

Moving more property out of the foreclosure pipeline before it goes to a distress sale would also be a big plus, reducing the pressure on housing values. Given the sharp decline in house prices and the recent increase in effective rents, the returns to private investors participating in such efforts are increasingly attractive.

Each of these policy steps has their problems, but they are worth carefully considering given that the housing downturn remains among the most serious threats to the still-fragile economic recovery.

[i] We estimate that nearly 6.5 million homeowners have lost homes through foreclosure, short sale, or deeds in lieu since the housing crash began in 2006. An additional 6 million homeowners are expected to lose homes before foreclosures return to levels consistent with a well-functioning housing market, expected in 2015.

[ii] A well-functioning housing market is defined as one consistent with an economy operating at full employment and growing at its potential rate.

[iii] The pace of new construction is supported by the annual formation of 1.25 million households, the obsolescence of 300,000 housing units, and the purchase of 200,000 vacation homes.

[iv] House prices should increase at a pace between the annual rate of growth in household income (4%) and overall annual price inflation (2%). House prices are ultimately determined by replacement costs, which equal the cost of land plus the cost of construction. The cost of land is determined by its opportunity cost, or GDP per developable acre. The growth in GDP per acre is equal to the growth in household income (assuming that the profit share of GDP remains constant). Construction costs will grow at the rate of overall inflation in the long run, although material and labor costs can fluctuate substantially in the short run. Since the share of land costs in overall house prices varies considerably from place to place (very high in San Francisco, for example, much lower in Des Moines) growth in house prices will vary considerably among regions. For the past quarter century or so (the recent boom and bust aside), house prices have grown at a rate closer to household income. As financial and other incentives for homeownership increased, households spent as much on housing as their incomes would allow. These incentives have likely peaked and may well decline; therefore households will devote less of their income to housing, and prices are likely to increase at rates closer to inflation.

[v] There is a long literature with regard to the wealth effect. For a description of my estimates and how they are incorporated into the Moody's Analytics model of the U.S. economy, see "The Wealth Effect," Mustafa Akcay. Regional Financial Review, November 26, 2008.

[vi] The Housing Vacancy Survey may also overstate the problem. Recent data from the 2010 census suggest there are fewer rental vacancies than the survey implies. The Census Bureau's Housing Vacancy Survey is based on a sample that, given the 2010 census data, appears to be biased.

[vii] CoreLogic estimates there are closer to 11 million underwater homeowners. The Moody's Analytics data are based on actual mortgage debt outstanding from Equifax credit files, while CoreLogic's estimate is based on debt outstanding at origination. The Moody's estimate of negative equity is nearly the same as CoreLogic's in California, much lower in Florida, and higher most everywhere else. CoreLogic may have some difficulty measuring debt outstanding in rural or exurban areas where homeowners generally have little equity even in good times (since house prices there do not rise much) and go into small negative-equity positions in difficult times. The Moody's estimate is much higher in Texas, for example. CoreLogic data are also unavailable for a half-dozen states.

[viii] The Federal Reserve's recent white paper on housing advocates similar steps. See "The U.S. Housing Market: Current Conditions and Policy Considerations," January 4, 2012. http://federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf

[ix] Calls for policymakers to enable mortgage refinancing have steadily increased since late 2010. See "Restringing HARP: The Case For More Refinancing Now," Mark Zandi and Cris DeRitis. Moody's Analytics Special Report, October 7, 2010. http://www.economy.com/mark-zandi/documents/HARP_100710.pdf

[x] See "Improved HARP Will Expand Refinancing and Boost Recovery," Mark Zandi and Cris DeRitis. Moody's Analytics Special Report, October 31, 2011. http://www.economy.com/mark-zandi/documents/2011-10-26-Zandi-Improved-HARP-Will-Expand-Refinancing-Boost-Recovery.pdf

[xi] Put-back risk is the chance that Fannie and Freddie will require the servicer to take back a loan that was improperly originated. There is also a risk that mortgage insurers will rescind insurance on a poorly underwritten loan. The cost to servicers of having loans put back has been considerable.

[xii] A fact sheet describing the president's housing plan can be found at http://www.whitehouse.gov/the-press-office/2012/02/01/fact-sheet-president-obama-s-plan-help-responsible-homeowners-and-heal-h.

[xiii] This is based on an analysis conducted by LPS using the McDash servicing database and the LPS-AA HPI.

[xiv] This is a very conservative estimate of the number of homeowners who will refinance, excluding all eligible Fannie/Freddie/FHA/VA borrowers with LTVs of less than 100% and nongovernment borrowers

with LTVs of less than 80%. The working assumption is that these borrowers have already had the opportunity to refinance and are thus unlikely to use the new programs.

[xv] Taxpayers have already put more than $150 billion into Fannie Mae and Freddie Mac since they were put into conservatorship in September 2008.

[xvi] The break-even change in the default rate equals the lost interest income divided by the product of the mortgage debt owned and insured and the loss from default, which is assumed to be 50% of the mortgage balance.

[xvii] This assumes the proposed changes to HARP are implemented by early next year. The assumed spendout rate is consistent with that of the 2001 tax rebate and the refinancing wave early in the last decade. See Johnson, et. al. "Household Expenditure and the Income Tax Rebates of 2001," American Economic Review, vol. 96, no 5. pp. 1589-1610. The spendout would likely be greater given that homeowners will view lower mortgage payments as a more permanent increase in real incomes.

[xviii] This excludes the interest income that would be lost by Fannie, Freddie, and the Federal Reserve.

[xix] There have been nearly 5 million total modifications, including those done under HAMP, by the FHA and in the private sector since the modification effort began in earnest in 2007. HAMP has arguably facilitated more private modifications by requiring private servicers to invest in their own modification efforts. Hope Now provides the most comprehensive accounting of the modification effort. See: http://www.hopenow.com/industry-data/2012-01-13-HOPENOW%20Data%20Report-(November)%20DraftV3.pdf

[xx] The redefault rate could be even lower given that this is comparable to the redefault rate on HAMP modifications.

PREPARED STATEMENT OF CHRISTOPHER J. MAYER

PAUL MILSTEIN PROFESSOR OF REAL ESTATE, FINANCE, AND ECONOMICS, COLUMBIA BUSINESS SCHOOL

FEBRUARY 9, 2012

Good afternoon Chairman Johnson, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me to speak today. My name is Christopher J. Mayer. I am the Paul Milstein Professor of Real Estate at Columbia Business School. I have spent the last 18 years studying housing markets and credit while working at the Federal Reserve Bank of Boston and serving on the faculties of Columbia Business School, the University of Michigan Business School, and the Wharton School of the University of Pennsylvania. I also serve as Visiting Scholar at the Federal Reserve Bank of New York.

The Federal Reserve recently issued a white paper documenting many of the frictions in the housing finance system and suggesting how such frictions have had a negative impact on the housing market and the economic recovery. The Federal Reserve points out that “Obstacles limiting access to mortgage credit even among creditworthy borrowers contribute to weakness in housing demand, and barriers to refinancing blunt the transmission of monetary policy to the household sector.”

Despite record low interest rates, mortgage activity has fallen precipitously. According to the Mortgage Bankers Association, the dollar volume of mortgages originated to purchase homes in 2010 (the last full year of data) has fallen to the same level as in 1992 (*see,* Figure 1, at the end of this testimony). Although one might have expected large numbers of refinancings because of low rates, refinancing activity in 2010 was, in fact, at the second lowest annual level since 2001 (Figure 2). So far, through the 3rd quarter of 2011, mortgage lending is down almost 19 percent from the same period in 2010. By comparison, according to Equifax Origination Credit Trends, new consumer lending is up 11.1 percent on a year-to-date basis in November 2011 from the previous year, showing increases in nearly every category including auto lending, credit cards, consumer finance, and student loans.

Other housing data released since the white paper was published continue to highlight the negative picture of the housing market that the Federal Reserve discusses relative to the rest of the economy. S&P/Case-Shiller indexes for 20 cities in November fell 1.3 percent from October and 3.7 percent for the full year, both larger decreases than anticipated and stoking fears that home prices might start falling again if foreclosures pick up, as they inevitably must. Lender Processing Services reports that 8.15 percent of mortgages are delinquent and 4.12 percent of mortgages are in some stage of foreclosure; both numbers that are nearly identical to June 2011. The share of mortgages that were current 6 months earlier but seriously delinquent now is higher than it was in June 2011. In other words, even as the labor market has started to improve, the housing market remains mired in difficulties.

Stepping back, it is important to understand the role of Government interventions in the housing market and the unintended consequences. After housing prices went into a free fall in 2007, private mortgage credit collapsed shortly afterwards. Newly issued private first mortgage securitizations, which once were nearly a trillion dollars per year, fell to almost zero. Government sponsored entities Fannie Mae and Freddie Mac (the GSEs) along with the Federal Housing Administration (FHA) quickly came to dominate the market. Yet soon the bond market became leery of lending to the GSEs, which did not have an explicit guarantee on their debt. With their solvency in doubt, the Federal Government backstopped the GSEs by putting them in conservatorship in September 2008. The Federal Housing Finance Agency (FHFA), an independent Government agency and previously the GSE’s regulator, became the conservator, taking over management of the GSEs. As well, the Government provided an explicit guarantee on their debt. The Government began further backing the GSEs when the Federal Reserve announced at the end of 2008 that it was beginning the purchase of what eventually became nearly $1.25 trillion of GSE securities.

Fannie Mae and Freddie Mac Under Conservatorship

In 2008, Congress passed the Housing and Economic Recovery Act (HERA). Under HERA, which tasked the Director of the FHFA to ensure the GSEs meet a number of conditions, including: [1]

1. “each regulated entity operates in a safe and sound manner . . . ”

[1] *See,* H.R. 3221-11. I have abbreviated the rules to focus on the relevant parts of the legislation for this testimony. This is not a complete list of all legislative requirements.

2. “the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets . . . ”
3. “the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest.”

Soon after taking over conservatorship of the GSEs, Director James Lockhart restated the agency’s mission: [2]

> Provide effective supervision, regulation and housing mission oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to promote their safety and soundness, support housing finance and affordable housing, and support a stable and liquid mortgage market.

As well, GSEs were required to start to reduce the size of their retained portfolio of mortgages and mortgage-backed securities (MBS). While many critics and observers also expected or hoped that FHFA conservatorship would set the stage for the eventual wind down and replacement of the GSEs, no such mandate was given to the FHFA. In fact, Director Lockhart noted the strategic goal under conservatorship, “FHFA preserves and conserves the assets and property of the Enterprises, ensures focus on their housing mission, and facilitates their financial stability and emergence from conservatorship.” Nowhere was there a goal to eliminate the GSEs.

Unfortunately for taxpayers, homeowners, and the economy, in the more than 3 years since FHFA has taken over conservatorship of the GSEs, the enterprises have continued to act as profit maximizing private firms, taking advantage of their market power in the mortgage market to earn profits rather than working to make the market more efficient. In doing so, the GSEs have taken a very narrow, and arguably, ineffective and harmful approach to managing their activities. These actions have resulted in enterprises that are arguably no easier to wind down today than they were 3 years ago. This is despite the fact that almost all commentators and policy makers have suggested that the GSEs as currently constructed do not represent an attractive way to finance U.S. housing in the future.

Maybe the single biggest problem with the ongoing operation of the GSEs has been to failure to adequately address critical conflicts of interest in their operations. The evidence suggests that the conflict of interest between the businesses of providing mortgage guarantees and managing a large retained portfolio of mortgages and MBS have led to the obstacles to normal credit conditions. This conflict of interest was raised in recent reporting by National Public Radio and ProPublica. [3] In its white paper, the Federal Reserve noted that “ . . . easing some of these obstacles could contribute to the gradual recovery in housing markets . . . ” Even without considering the overall economy, GSEs should be concerned with the health of the housing market, since they now hold the risk for more than one-half of all outstanding mortgages. Thus, absent a conflict of interest, it would appear to directly benefit the GSEs to remove some of the obstacles the Federal Reserve discusses.

There are plenty of examples of how this conflict of interest might have led the GSEs to take actions that padded their portfolio profits, even while harming the mortgage market and the larger economy. Many credit market decisions by the GSEs seem to be driven by a desire to block refinancing. [4] Fannie Mae raised upfront fees on all new loans just weeks after the Federal Reserve announced its MBS purchase program, with Freddie Mac following suit two months later. These new fees applied even in cases where borrowers’ mortgages were already guaranteed and their refinancing not impose any additional risk. The GSEs have taken steps to reduce competition between servicers, despite borrowers’ many complaints about poor service by their existing servicers. Shrinking lending, increasing legal liability, and other GSE policies appear to have contributed to a lack of competition to originate mortgages, leading to retail spreads on mortgages that remain near at all-time highs. The GSEs have failed to address critical problems in the mortgage insurance industry, leaving many consumers locked into high interest rate mortgages and making mortgage modification more challenging and less effective. Since refinancing and mortgage modification as well as lower retail spreads on mortgages reduce the cost of mortgage guarantees by reducing defaults, the only seemingly plausible rea-

[2] FHFA Strategic plan, 2009–2014.

[3] See the recent story from National Public Radio and ProPublica, *http://www.propublica.org/article/freddy-mac-mortgage-eisinger-arnold.*

[4] In response to recent allegations of conflicts of interest, the FHFA has pointed out that refinancing represents a large portion of the GSEs overall business. As I discuss below, this fact is not inconsistent with the allegations of a conflict of interest. Many of the restrictions on refinancing did not impact all borrowers, but instead reduced refinancing by borrowers with high mortgage rates that may also be held in GSE portfolios.

son for such policies is to protect high interest payments on mortgages and MBS held in the GSE's portfolio.

The reports by National Public Radio and ProPublica highlighted how these conflicts of interest may also have influenced portfolio decisions at Freddie Mac. Instead of selling off the MBS that it inherited when it entered conservatorship, Freddie Mac appears to have created and held complex, highly leveraged mortgage derivatives that are risky and nearly impossible to sell. In addition, Freddie Mac created new and complex long-term financing for its MBS positions (called Mortgage-Linked Amortization Notes, or MLANs) rather than choosing to sell these securities into the open market and reduce the size of its portfolio business.[5] These transactions highlighted the appearance of a conflict of interest since the transactions were structured so that the enterprise lost valuable interest payments if borrowers with very high interest rates were able to refinance their mortgages, a policy that is substantially under the control of Freddie Mac. Whether intended or not, these transactions also make it harder to unwind Freddie Mac and its portfolio in the future.

While seemingly consistent with the strategic goal listed above of conserving and preserving assets to emerge as an ongoing entity, the policies described above appear to violate a number of the GSE's other mandates, which are to "foster liquid, efficient, competitive, and resilient national housing finance markets" and to operate in a manner "consistent with the public interest." From the first quarter of 2008 to the first quarter of 2011, the market share of the top five mortgage originators has grown from 56 percent to 65 percent. As well, according to Bloomberg (Figure 3) the spread between retail and wholesale mortgage rates has widened by at least 0.75 percent (75 basis points) between its average from 2000 to 2007 and its level at the end of 2011. These facts suggest that conservatorship has resulted in less competitive and less efficient mortgage markets.

The Dueling Business Interests of the GSEs: A Conflict of Interest?

To better understand these issues, it is important to look at the historical context in which the enterprises arrived into conservatorship. When the FHFA took over the management of Fannie Mae and Freddie Mac (GSEs), the enterprises had two principal businesses: mortgage guarantees and portfolio management. The mortgage guarantee business involves collecting premiums and insuring bondholders against credit losses. When a borrower defaults on a mortgage, the GSEs must buy the mortgage out of a pool at par, so bondholders are made whole. The portfolio business involves owning and managing a large balance sheet made up of mortgage-backed securities (MBS) and mortgages. Both businesses were considered to be in serious financial trouble when the GSEs entered conservatorship.

The guarantee and portfolio businesses have always involved an inherent conflict of interest—the GSEs know more about the mortgages in the MBS than other parties. One study by researchers at the University of California at Berkeley and Barclays argued that the mortgage-backed securities market was a market for lemons.[6] The article showed that securities that Freddie Mac sold to the market were of lower quality than those it didn't sell. Traders have always recognized that the GSEs were more informed than they were and market prices reflected this friction. Financial economists would note that the existence of some traders using nonpublic information inherently leads to less liquid and efficient markets, as other traders must account for adverse selection when bidding on securities.

Most public policy concern about the growth of the GSEs portfolio was not about conflicts of interest, however, but risk. During the 2000s, the retained bond portfolio grew rapidly, taking advantage of their implicit guarantee by taking on additional risk on behalf of taxpayers. The GSEs even began to purchase securities with risky subprime mortgages that were specially designed for them to acquire.

In 2008, the FHFA inherited the management of firms with $1.1 trillion of MBS, hundreds of billions in mostly failed mortgages, and a bankrupt guarantee business. As well, with the demise of private securitization and the fragile state of the financial services sector, the GSEs and the FHA were guaranteeing more than 90 percent of new mortgages, a condition that continues today. Without competition in new mortgage origination, the conflict of interest between mortgage guarantees and portfolio management once again rose to the forefront. After all, actions that might lead to even a small percentage change in the value of the portfolio would have a material impact on profits of these formerly semi-private companies.

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[5] *http://www.businessweek.com/news/2012-01-17/freddie-mac-sees-selling-40-billion-of-debt-tracking-mortgages.html*

[6] Downing, Chris, Dwight Jaffee, and Nancy Wallace. 2009. "Is the Market for Mortgage-Backed Securities a Market for Lemons?" *Review of Financial Studies,* 22(7):2457–2494.

Soon after conservatorship, in December 2008, Fannie Mae announced LLPAs (loan level pricing adjustments), up front fees that would be paid by all borrowers on newly originated mortgages. These fees, when combined with adverse market delivery charges, could equal more than three percent of the mortgage amount, to be paid up front. Freddie Mac soon followed with its own fees, although it never posted its fees online the way Fannie Mae did.

While such fees have sometimes been defended as an attempt to add risk based pricing to mortgage originations, they were also applied on an equal basis to borrowers who were refinancing mortgages that the GSEs already guaranteed. The Federal Reserve white paper referred to such fees as "hard to justify" when applied to refinancing their own mortgages. As well, imposing new, large up-front fees in the middle of a serious recession and stock market decline when down payments were scarce had the practical effect of reducing demand for mortgages among affected borrowers. A seemingly preferable alternative would have been to increase the annual guarantee fee (so-called "g-fee") on mortgages for new purchases, which would likely have had a smaller negative impact on demand. A fee structure that decreased demand for new mortgages also would have cut the demand to purchase homes, helping to contribute to a further decline in home prices. Falling home prices materially increased losses in the GSE's mortgage guarantee business. However, from the perspective of the portfolio, an equivalent increase in the g-fee rather than a higher up-front borrowing cost (LLPAs) might have allowed a much larger wave of refinancings, possibly leading to portfolio losses. These large up-front fees were not a market outcome nor were they mandated in any way by conservatorship, but were a barrier imposed by the GSEs themselves, seemingly designed to protect their own portfolios from prepayments, the very outcome that the Federal Reserve's MBS purchase program sought to create.

The high up-front fees when applied to mortgages they already guaranteed was just one of many steps the FHFA and the GSEs have taken since conservatorship that have had the effect of preventing refinancing of many mortgages. As early as September 2008, Glenn Hubbard and I have argued for the Government to facilitate widespread refinancing to reduce defaults, help stabilize the housing market, and stimulate the economy.[7] In our own analysis, Alan Boyce, Glenn Hubbard, James Witkin and I have shown how a slightly higher g-fee on refinancings would create a structure whereby the GSEs could more than recoup any portfolio losses. David Greenlaw (Morgan Stanley), Mark Zandi (Moody's Analytics), Bill Gross (Pimco), and many economists made similar arguments in the intervening years, but with little success.

In March 2009, the President announced the HARP (Home Affordable Refinance Program). The program was an attempt to streamline refinancings, but eventually resulted in fewer than one million refinancings over a period of nearly 3 years. While HARP officially applied to borrowers with a loan-to-value ratio (LTV) of up to 125 percent, technical barriers prevented take-up by all but a few borrowers with LTVs above 105 percent. And up-front GSE fees (LLPAs) still applied to HARP mortgages. As well, under HARP, only the borrower's existing servicer could effectively pursue a new refinancing. Even today under the new so-called HARP 2.0, existing servicers have a large advantage over new servicers in pursuing a HARP refinancing for a given borrower.

HARP also excluded borrowers with LTVs of less than 80 percent. While some such borrowers might have had an easier time pursuing a refinancing, many of these borrowers were still subject to up-front fees and other barriers. LLPAs were charged for borrowers with LTVs in excess of 60 percent and FICO scores below 760. Reps and warranties liabilities likely prevented many such borrowers from getting attractive quotes from other lenders. Also, many borrowers with seemingly low LTVs had second liens, so that these borrowers would likely have an elevated risk of default and thus could benefit from lower mortgage payments.

Finally, all of the exclusions from HARP had an additional negative effect on taxpayers and the overall economy. For example, Joseph Tracy and Joshua Wright of the Federal Reserve Bank of New York point out that refinancings are not simply a zero sum game and might instead " . . . stabilize the housing market and support economic growth."[8]

From the perspective of the mortgage guarantee business, it is difficult to understand why the GSEs would limit refinancing on mortgages that they already guaranteed. A widespread refinancing program that lowered payments for risky mort-

[7] See a history of our research on widespread refinancing along with our current proposals on our Web site: *http://www4.gsb.columbia.edu/realestate/research/housingcrisis.*

[8] *http://libertystreeteconomics.newyorkfed.org/2012/01/why-mortgage-refinancing-is-not-a-zero-sum-game.html*

gages would almost surely reduce defaults.[9] In fact, from the perspective of the mortgage guarantee business, one might have expected the GSEs to go out of their way to refinance the riskiest borrowers, who would otherwise be at greatest risk of default. Yet the barriers imposed by the GSEs had exactly the opposite effect, severely limiting refinancing by the riskiest borrowers. The fees on refinancing were highest on mortgages where the borrower had a low FICO score or high LTV. Mortgages with high loan-to-value ratios were locked out of refinancing altogether.

Looking back, the costs of these actions have become clear. According to my own calculations using data from Lender Processing Services, about one-sixth of all GSE guaranteed mortgages with a mortgage rate above 6 percent in 2009 defaulted, compared to defaults by about one in fifty mortgages with rates below 5 percent. Almost surely a program to refinance high mortgage rate borrowers would have lowered this default rate for this population, saving the GSEs from some large losses from their mortgage guarantee business and reducing the number of foreclosures and short sales that have contributed to falling house prices and thus even larger future costs from mortgage guarantees. In fact, the Congressional Budget Office's recent paper on found that about for every 1,000refinancings that took place, 38 defaults would be prevented.[10] According to the CBO, such a program would have saved the GSEs billions of dollars in lower guarantee costs. A program that facilitated millions of refinancings might have prevented hundreds of thousands of defaults.

It appears only possible to understand this behavior by looking at the GSEs' portfolio management business. In fact, the CBO pointed to possible portfolio losses when considering the costs and benefits of a widespread refinancing program. While the GSEs have never disclosed much detail about their portfolio holdings, many of their purchases of mortgage-backed securities seem to have taken place in the mid-2000s. The mortgages in these mid-2000s pools have mortgage rates that are 5.5 percent or above. These loans have much lower mortgage balances, which indicate lower income households, and may be more likely to be under financial stress. In other words, many of the mortgages inside the securities held in GSE portfolios may also have been those at the greatest risk of default. Refinancing mortgages for responsible borrowers who were current on their mortgages, but also at great risk of default, might well have imposed losses on the GSE portfolios while saving significantly more for their credit guarantee businesses.

Let me put the hypothesis directly. The possibility of protecting their portfolios explains why the GSEs have been so resistant to refinancing certain mortgages. If not for the conflict of interest between the portfolio and mortgage guarantee businesses, why else would the GSEs have imposed so many barriers to refinancing?

Did Freddie Mac "Bet Against Refinancing?"

Last week, National Public Radio and ProPublica reported that Freddie Mac created risky securities called Inverse IO Floaters that had the appearance of betting against household refinancing. These securities involve creating a concentrated risk position that pays off only as long as the underlying mortgages continue making payments. If the mortgages refinance, the payments stop and the securities lose significant value.

The FHFA responded with a statement arguing against the premise of the story. It claimed that "Freddie Mac's retained portfolio investment in inverse floaters did not have any impact on the recent changes to the Home Affordable Refinance Program (HARP). In evaluating changes to HARP, FHFA specifically directed both Enterprises not to consider changes in their own investment income as part of the HARP evaluation process." As well, it argued "Of Freddie Mac's $650 billion retained portfolio, only $5 billion is held as inverse floaters." As well, FHFA points out that about 80 percent of its recent business is refinancing mortgages.

It is important to understand what the statement says and what it does not. This statement does not imply that Freddie Mac's credit decisions prior to HARP 2.0 in November 2011 were unaffected by its portfolio. In other words, the statement does not deny that the conflict of interest between lending and portfolio management might have impacted Freddie Mac's past practices. In fact, as argued above, the retained portfolio appears to be the only plausible reason to impose many of the lending restrictions that the GSEs have imposed over time. What remains puzzling, as well, is why Freddie Mac and not Fannie Mae imposed new and harsher restrictions

[9] Early research on the HAMP program showed the mortgage modifications that lowered mortgage payments had a strong impact on reducing defaults. *See,* Federal Reserve Bank of New York Staff Report #417, originally published in December 2009, for example.

[10] *http://www.cbo.gov/ftpdocs/124xx/doc12405/09-07-2011-Large-Scale_Refinancing_Program.pdf*

on refinancing some mortgages under HARP 2.0. If not for the portfolio, why would Freddie Mac impose new restrictions on HARP 2.0 refinancings?

A recent posting by Alan Boyce on the Web site *www.zerohedge.com* helps explain why FHFA's statement might be true but that the conflict of interest might still have materially impacted lending.[11] For example, Mr. Boyce shows how the Freddie Mac might have simultaneously been refinancing some borrowers while also protecting its portfolio. The highest rates of refinancing have been for borrowers with relatively low mortgage rates, large loan balances, high FICO scores and low LTVs originated between 2009 and 2011. These loans were made after conservatorship and at a time that Freddie Mac was reducing it's MBS holdings. Refinancing such mortgages may be good business, but it does not change the GSE risk profile much, because these mortgages are already unlikely to default. But, of course, Freddie Mac may not own many securities that contain recently originated mortgages.

NPR/ProPublica identified $3.4 billion of inverse IOs, which were backed by the interest payments on about $19.5 billion of mortgages. FHFA said that these risky derivatives were in fact larger, amount to $5 billion in size, which could have been backed by $26 to $30 billion of loans. The FHFA notes that inverse IO floaters represent only a small portion of Freddie Mac's portfolio, implicitly suggesting that such a small stake cannot possibly drive their lending restrictions. These trades took place in a 6 month time period and had the effect of reducing the total balance sheet of Freddie Mac by almost exactly the amount required by Congress, not an insignificant sum. In addition, FHFA does not describe the characteristics of the rest of Freddie Mac's $224 billion holdings in its own MBS. Is the remainder of Freddie Mac's portfolio also composed of high interest rate mortgages that Freddie Mac has spent more than 3 years imposing restrictions and prohibitions on refinancing? The entire Agency MBS market is trading at a premium, which means that every bond is well above par. It cannot be the case that taking an illiquid and highly levered position in inverse IOs can provide any hedge value for the rest of their portfolio. In fact, such a position would represent additional risk, in the same direction as its other holdings. Portfolio holdings may also explain why Fannie Mae has pursued refinancing restrictions that are nearly as strict as Freddie Mac. Fannie Mae owns nearly as much MBS as Freddie Mac.

Mortgage Modifications Under Conservatorship

Rather than pursue a widespread refinancing program to help reduce credit losses, the GSEs have attempted to manage the defaults of risky mortgages once they occur. The problem has been that the GSEs have also been slow and less effective at adopting loss mitigation practices that the private sector has identified.

Private lenders, at least those who service mortgages in their own portfolio, were first to adopt widespread mortgage modification programs and have much lower redefault rates than the GSEs. (This is not to say that the industry responded quickly; only that the industry responded more quickly than the GSEs.) Consider data from the latest OCC Mortgage Metrics Report.[12] In 2008 and 2009, the redefault rate on mortgage modifications by the GSEs was almost 50 percent higher than mortgage modifications pursued by lenders on their own mortgages. In 2008, for example, the 12-month redefault rate was about 58 percent for GSE modifications versus 40 percent for private lender modifications on their own portfolio loans. In 2009, the GSEs performed even worse on a percentage basis for the same measure (42 percent versus 25 percent for portfolio loans). By 2010, the GSEs 12 month redefault rate had caught up to that of portfolio loans. But in 2011, redefault rates for GSE modification are once again much higher than modifications of portfolio loans.

In looking at the recent data, one striking feature stands out. Many portfolio lenders, as well as private servicers, have turned to principal reductions to better manage defaults. Understanding what private investors and lenders do with their own loans is very instructive because it helps set a benchmark for behavior that is unaffected by the many conflicts of interest in securitization.[13] According to the OCC data, portfolio lenders pursue principal reductions for more than 18 percent of mortgage modifications on their own portfolios. The FHFA still refuses to allow any principal reductions based on its calculations that more progressive modification and principal reduction programs will cost taxpayers money.

[11] *http://www.zerohedge.com/contributed/qa-alan-boyce-freddie-mac-and-inverse-floaters*

[12] *http://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2011/mortgage-metrics-q3-2011.pdf*

[13] *See, for example,* Tomasz Piskorski, Amit Seru, and Vikrant Vig. 2010. "Securitization and Distressed Loan Renegotiation: Evidence From the Subprime Mortgage Crisis", *Journal of Financial Economics* 97, 369–397.

In addition to the fact that private lenders often pursue principal write-downs with their own funds at risk, other studies also support the value of principal write downs that reduce LTVs as a tool for modifying mortgages. A 2009 study by the Federal Reserve Bank of New York concluded "The data indicate that the redefault rate declines with the magnitude of the reduction in the monthly payment, but also that the redefault rate declines relatively more when the payment reduction is achieved through principal forgiveness as opposed to lower interest rates. [14] As well, a recent study by Laurie Goodman supports the same conclusion, noting "Controlling for payment relief, we find that principal reduction modifications are more effective than either rate modifications or capitalization modifications. These differences by modification type are larger for modifications on prime/Alt A/option ARM loans than for subprime loans." [15]

Another problem with all of these studies, and an issue that does not appear to be explicitly modeled by the FHFA analysis, is the risk of moral hazard. Private portfolio lenders are certainly be aware of this risk and have developed ways of minimizing moral hazard. Nonetheless, Government backed lenders like the GSEs may face a higher risk of moral hazard than private lenders would. This would be a place, once again, where the GSEs might benefit from examining the practices of private portfolio lenders.

For some GSE mortgages, the existence of mortgage insurance (MI) appears to be a barrier to principal write-downs. However, the value of such MI is likely dubious. The GSEs have as much as $150 billion of insurance from various MI companies, but more than 80 percent of those potential claims are underwritten by MI companies that are either insolvent or have a credit rating of BB- or worse. The suspect nature of these receivables gives the GSEs incentives to delay loss resolutions as much as possible and may impact the extent to which the GSEs efficiently manage losses and foreclosures.

Why Not More Private Capital and Expertise for the GSEs?

Another concern about the current process of how the GSEs have managed the housing crisis has been the lack of steps to bring in private capital and expertise in their businesses. It is important to note that the existing mandates for conservatorship do not require or even suggest that the GSEs bring private capital into their businesses. Of course there is a mandate to reduce risk, but that could be done without sharing the risks with private firms.

Nonetheless, the GSEs have not taken advantage of places where private capital and expertise might be valuable in reducing losses or helping to stabilize housing markets. For example, the fact that private portfolio lenders appear to have much lower redefault rates on mortgage modifications of nonperforming loans (NPLs) suggest that the GSEs might profitably sell NPLs to specialized servicers. Private portfolio lenders sell certain NPLs to such specialized servicers. One might have expected the GSEs to do the same.

It is critically important to examine new ideas to help attract private capital and ideas to address the housing crisis. In my testimony before the Senate Subcommittee on Housing, Transportation, and Community Development of this Committee I detailed a number of such proposals, including how to sell non performing mortgages and why sales of REO to long-term businesses dedicated to building a business in renting single family homes. [16] I also discussed the potential for shared appreciation mortgages to help resolve the current glut of seriously delinquent mortgages.

Conclusion

I believe that the largest failure of conservatorship has been the unwillingness of the FHFA to adequately address the conflicts of interest it inherited when it took over management of the GSEs.

Consider the problem of how the GSEs would have managed a portfolio of MBS with above-market interest rates—securities that might sell at a price above the par value of the securities. For example, a pool of MBS with a 6 percent coupon might sell for $1.10 for each $1 of principal with such a high coupon. Given that the GSEs had more information than buyers about their own intentions with regard to refinancing, as well as greater information about the underlying mortgages and their expected performance, buyers might be quite wary of purchasing MBS at market prices from the GSEs. Buyers could be concerned about the potential that the GSEs

[14] *http://www.newyorkfed.org/research/staff_reports/sr417.pdf*
[15] Amherst Mortgage Insight, 12/01/2011.
[16] Chris Mayer serves as an advisor to Pathway, a start-up firm in the business of purchasing houses for long-term rental.

might then turn around and take action that would result in widespread refinancing. Buyers might also be worried that mortgages inside the MBS were at imminent risk of default. In either case, the securities would pay off at par ($1.00), leaving the buyer with an appreciable loss ($0.10). Aware of the conflict of interest, buyers might appropriately diminish their bids for agency MBS sold by the GSEs above par.

Under conservatorship, the FHFA could have appointed an independent trustee to manage the sale of the MBS over time, with the explicit mandate to maximize the returns for taxpayers. If the trustee were truly independent, this plan would have mitigated the conflict of interest and maximized the sale proceeds from the pool of MBS. Put differently, taxpayers likely would have received higher proceeds from the sale of MBS had the GSEs turned over management of their portfolio to an independent, third party because buyers would have paid more for the MBS absent a potential conflict of interest.[17]

Of course, the GSEs might have instead tried to earn even higher profits by keeping their portfolio and imposing frictions on refinancing. Even if imposing mortgage market frictions were to have maximized short-run profits on their portfolio, effectively conserving and preserving assets, it would have had other consequences in making a less efficient, less competitive, and more illiquid mortgage market and working against the public interest.

Nonetheless, such a policy would have ignored another option—widespread mortgage refinancing—that can and should have been a profitable business. My own analysis, conducted with Alan Boyce, Glenn Hubbard, and James Witkin, shows that refinancing should be profitable for the GSEs. By charging a slightly higher guarantee fee and creating a small fund to cover any possible losses from reps and warranties relief, refinancing could have been a way to help recapitalize the GSEs and help minimize taxpayer losses. Combining mortgage refinancing with an independent trustee would result in a win-win for taxpayers, mortgage borrowers, homeowners, and the larger economy.

It is not too late to achieve that win-win scenario. The FHFA still has the authority to follow such a prescription. However, current policies do not make such a policy shift appear likely.

Instead, Congress should consider changing the mandate of conservatorship to address its flaws. Legislation should mandate that an independent trustee be appointed to wind down the GSE's retained portfolio of MBS. The GSEs could continue to retain nonperforming loans that they have bought back from securitizations as is necessary to perform their mortgage guarantee business. Independent management of the retained portfolio will make the eventual privatization or replacement of the GSEs considerably easier. Legislation should also mandate other steps to move towards attracting private capital into the mortgage market, including ideas such as trial programs for the sale of NPLs to third party servicers, the sale of REO to private investors, and provisions that allow the GSEs to provide responsible amounts of leverage for owners of single-family home portfolios in the rental business on a temporary basis.[18] Legislation should also ensure that the GSEs remove all of the obstacles limiting access to mortgage credit as identified in the Federal Reserve white paper. All borrowers should have access to refinancing without restrictions or qualifications other than being current on their mortgage and any refinancing programs should be available to be offered by any qualified originator to any qualified borrower.

Until we fix the housing market, it will be hard for the economy to fully recover. In this testimony, I have addressed a number of reasons that the lack of GSE reform continues to hold back the housing market and the economic recovery. I believe that immediate action is necessary to address fundamental flaws in the structure of the GSEs. Conservatorship as it now stands is laden with conflicts of interest between lending and portfolio management and holds back the reintroduction of private capital. These steps can occur now, even without a consensus on what the future of the U.S. housing finance system will look like.

I appreciate the opportunity to address you today and look forward to answering any questions that you might have.

[17] Some might argue that it is necessary to have an investment portfolio to ensure the solvency of the guarantee business. However, since the GSEs are insolvent, the U.S. Treasury already serves the role of liquidity provider under conservatorship. As the GSEs return to solvency, they may want to acquire assets that help meet capital and liquidity needs. However, there is no reason for the GSEs to make such investments in their own MBS, which only amplifies the GSEs exposure to various mortgage market risks. The trustee would use the proceeds from the sale of the assets of the GSEs (MBS) to pay down the GSE's liabilities.

[18] Any loans made available on portfolios of single-family homes might have a sunset provision so that lending is reduced over time as the private lending market recovers.

Figure 1: Mortgage originations according to the Mortgage Bankers Association

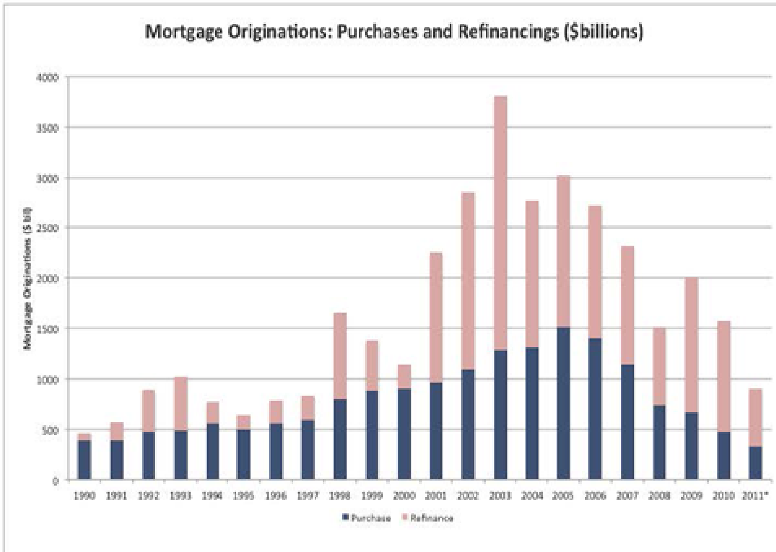

Figure 2: Mortgage refinancings according to the Mortgage Bankers Association

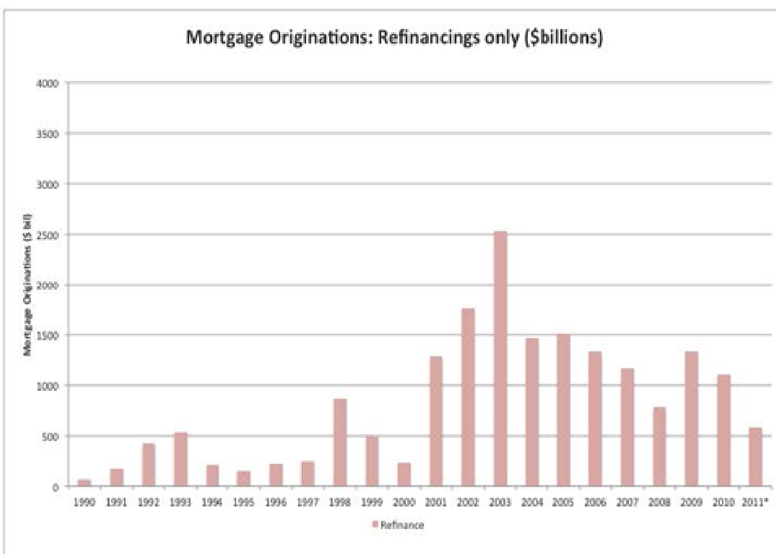

Figure 3: **Spreads between Primary and Secondary mortgage markets, Bloomberg**

According to this figure, spreads between retail and wholesale mortgage rates averaged about 25 basis points between 2000 and 2008, but have ballooned to 100 basis points or more after conservatorship.

PREPARED STATEMENT OF THE HONORABLE PHILLIP L. SWAGEL

PROFESSOR OF INTERNATIONAL ECONOMIC POLICY, UNIVERSITY OF MARYLAND
SCHOOL OF PUBLIC POLICY

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Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on housing policy and the state of the housing market. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a visiting scholar at the American Enterprise Institute and a senior fellow with the Milken Institute's Center for Financial Markets. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

The continued weak state of the housing market and the toll of millions of foreclosures already, millions more families still at risk of losing their home, and trillions of dollars of lost wealth all reflect the lingering impact of the collapse of the housing bubble and ensuing financial crisis. A range of policies have been undertaken over the past several years aimed at the housing market—a recent summary from the Department of Housing and Urban Development lists 10 separate policy actions. [1] These can be grouped into two broad categories. What might be seen as "backward-looking" policies seek to avoid foreclosures on past home purchases through actions such as incentives for mortgage modifications and refinancing. By avoiding foreclosures, these policies both assist individual families and help reduce the supply of homes for sale (and in the overhang of the so-called "shadow inventory") and thus reduce downward pressures on home prices that in turn affect household wealth and the broad economy. In contrast, "forward-looking" policies seek to boost demand for home purchases, such as with the first time homebuyer tax credit and the Federal Reserve's purchases of mortgage-backed securities (MBS).

The common feature of these housing policies is their limited effectiveness. To be sure, these policies have done something: MBS purchases resulted in lower interest rates for families buying a home or refinancing a mortgage; some 930,000 homeowners have benefited from permanent mortgage modifications through the HAMP program; and so on. But relative to the scale of the weakness in home prices and housing market demand, and especially compared to the tragically huge number of foreclosures, the set of housing market policies to date appears to have underperformed compared to expectation set at each policy unveiling. Moreover, these programs have involved considerable costs for taxpayers, with the benefits accruing mainly to a relatively small group of recipients. And on top of the millions of foreclosures not prevented by the policies of the past several years, there is likely another huge wave of foreclosures set to take place in the next year or two, with many of these representing foreclosures that were delayed but not ultimately prevented by policies to date.

This experience is important to keep in mind as the Congress contemplates a range of new and expanded housing policy proposals from the Administration, along with a white paper from the Federal Reserve that covers similar ground. Broadly speaking, the proposed actions look to provide homeowners with reduced monthly payments through Government-assisted refinances; to lower principal mortgage balances; and to speed the pace at which vacant homes become rentals. The goal, as with all policies throughout the crisis, is to have fewer foreclosures and stronger consumer spending. These policies are well-intentioned.

Unfortunately, there is every reason to believe that the new policy proposals for streamlined refinancing and principal reduction are likely to have the same modest impact—and at an even worse tradeoff in terms of cost to taxpayers for each foreclosure avoided than for the policies to date. Simply put, we have learned that mortgage modification programs are difficult to implement and execute because of the intrinsically one-at-a-time nature of the transactions involved. And the expansions of some programs, such as considerably increased payments from the Government to motivate reductions in mortgage principal, face less promising conditions now for being effective than was the case when many of these policies were launched in early 2009. Three years of a weak job market have forced many of the borrowers who might have been helped by reduced payments or a lower mortgage balance into foreclosure.

There are other approaches that can be taken to help heal the housing market and speed the recovery of home prices and construction while reducing the pain for

[1] See the appendix of the January 2012 HUD-Treasury Housing Scorecard: *http://portal.hud.gov/hudportal/documents/huddoc?id=JanNat2012__Scorecard.pdf.*

American families. This testimony first provides a critical analysis of recent policy proposals and then discusses alternative steps that the Congress might consider. The goal of these policies is for the housing sector to once again contribute positively to the U.S. economy and to American society—to have a housing system that works for families looking to buy homes, for investors with funds to lend, and for taxpayers who deserve a stable financial system and protection from another expensive bail-out.

Mass Refinancing Proposals

It is useful to consider a specific example that raises the question of whether the latest policy proposals from the Administration will perform differently than previous initiatives. The White House fact sheet for the Administration's refinancing proposal for a single family, owner-occupied principal residence promises that there will be "no barriers and no excuses" (top of page 3) and no new appraisal or tax forms involved in enabling eligible homeowners to refinance their mortgages into an FHA-guaranteed loan with lower monthly payments. Without access to tax forms, however, it is not clear how lenders are meant to verify that a home is indeed owner-occupied—the natural mechanism would be to look at the address on the homeowner's 1040 tax form. Indeed, the lender could even just examine the address on the IRS form 4506 by which the borrower requests that a copy of the tax return be sent to the lender; this would be less intrusive than having the lender examine the 1040 itself but is again off-limits in the new proposal. A lesson of the past several years is that unverified mortgage applications (so called "no doc loans") are convenient but do not end well for either lender or borrower.

The alternative of having the lender send someone out to the home also runs counter to the stated policy proposal—there are to be no appraisals, and the need for possibly repeated site visits to confirm the owner-occupied status seems to be exactly the barriers and red tape that are not allowed (not to mention the intrusiveness of having someone peek through the windows to figure out who is living inside).

On the other hand, lenders clearly will not be willing to allow borrowers to simply attest that they are refinancing an owner-occupied property. After all, this was a common misrepresentation during the housing bubble and it would be outrageous for lenders not to check carefully for loans receiving a Government-backed guarantee such as with the new refinancing proposal involving the Federal Housing Administration (FHA). Moreover, the Administration has launched an investigation into possible abusive behavior in mortgage origination and servicing; presumably this investigation and the similar effort launched in 2009 will deter lenders from allowing potential fraud. But this leaves the problem of how to comply with the contradictions between the proposed policy and the rhetoric by which it has been introduced.

This is just one type of hurdle that implementation of the latest proposal for refinancing of non-GSE loans is likely to face—the desired ease of the refinancing is defeated by the conditions of the proposal itself. Perhaps there is some workaround in the offing for this and the other inevitable problems of implementation that have plagued past efforts, but it is now more than 2 weeks since the proposals were launched by the President in his State of the Union address and there is no legislative text to consider these important details. Similarly, the Fed's white paper on housing proposals includes a broad discussion of the possible beneficial impacts of widespread refinancing, but does not get into the operational details that are crucial to achieve actual policy outcomes. [2]

The lower monthly payments for homeowners that would result from the proposed FHA-based refinancing scheme for non-GSE loans and the expansion of the previous HARP (Home Affordable Refinance Program) for GSE loans announced in October 2011 are meant to both reduce foreclosures by improving affordability and to boost the economy through increased spending by families with greater free cash flow as a result of lower mortgage payments. That is, refinancing would be a sort of stimulus analogous to sending a monthly check to qualifying households. It is clear that mortgage credit was too easily available in the run-up to the crisis, and a good argument can be made that the pendulum has swing too far in the other direction now so that some creditworthy borrowers do not have access to mortgages for home purchases or refinancing. An important lesson of the current situation, however, is to highlight the problem of having the Government so intricately involved in setting mortgage standards. It would be preferable for private suppliers of capital to fund housing and to take on the risks and rewards of credit decisions. This provides an

[2] This is in some ways reminiscent of the 2008 Hope for Homeowners program that likewise had only modest impact in reducing foreclosures.

important motivation for moving forward with housing finance reform. With Fannie Mae and Freddie Mac in Government control under conservatorship at present, it is inevitable that public officials will be involved in the choice of credit standards. The driving force for these decisions should be to find the appropriate balance between protection for taxpayers against overly risky loans while maintaining access to credit for homebuyers and rebuilding a responsible private mortgage market—and not to have these decisions motivated by a desire to implement a backdoor fiscal stimulus.

Indeed, stimulus is likely the best way to view the impact of the two mass refinancing proposals involving HARP 2.0 for GSE-backed mortgages and the FHA for non-GSE loans. Both refinancing proposals would benefit borrowers with high loan-to-value (LTV) mortgages, including underwater borrowers whose mortgage balances are greater than the value of their home and who thus have an incentive to walk away from their home and allow a foreclosure. The current proposals, however, are restricted to borrowers who have been in their homes since at least mid-2009 and have been nearly current on their payments for a year (6 months with no late payments and no more than one 30-day late payment in the preceding 6 months). In other words, the refinancing assistance would go to borrowers who have shown that they want to stay in their home and have done so for several years in the face of declining home prices and a weak job market. To be sure, these borrowers will benefit from the lower mortgage payments. But the targeted population for the refinancing has already shown that they are resistant to foreclosure, meaning that the program will avoid relatively few incremental foreclosures per dollar of taxpayer expense. This leaves stimulus as the main motivator for mass refinancing.

As noted in the Fed's white paper and in recent analysis provided by the FHFA in a letter to Representative Elijah Cummings, both refinancing proposals involve costs to taxpayers because the U.S. Government is a beneficial owner of mortgages through MBS holdings of both the Federal Reserve and the GSEs. This is not to say that U.S. Government asset holdings should come before homeowners—not by any means. The point is that the costs of the refinancing proposal must be weighed against the benefits, keeping in mind that the principal benefit is through a relatively targeted fiscal stimulus going to particular homeowners (and not to renters, who tend to have lower incomes than homeowners). One could imagine policy makers calling for another round of taxpayer-funded fiscal stimulus such as through providing checks or other tax benefits, but this should be debated openly. It is hard to imagine that a new stimulus would involve the relatively narrow targeting of the population of homeowners with high LTV's who bought homes at a particular time period and who have been able to afford their monthly payments.

In a time of tight fiscal constraints, one could also imagine seeking to focus costly Government programs on homeowners who could be seen as most in need of assistance and for whom refinancing programs might be most effective. The refinancing proposals are limited by the amount of the mortgage but one could further restrict this Government assistance to people with desired income ranges. The White House has recently defined the middle class as households with the median income plus or minus 50 percent.[3] With median household income around $52,000, this would imply limiting the refinancing program to households with incomes of no more than around $78,000—the top of the White House definition of middle class. Alternately, one could use the approximately $64,000 median income of family households (that is, leaving out individuals, who tend to have lower incomes). This would give a maximum income for the middle class as defined by the White House as $96,000—rounding up would then give $100,000 as the maximum income limit for eligibility for the Administration's FHA refinancing proposal. One could imagine applying this income limit to all FHA programs in order to best focus the taxpayer-provided subsidy implicit in FHA activities to households most in need.

It should be noted as well that the February 2011 report to Congress on "Reforming America's Housing Finance Market" by the Treasury Department and HUD stated that the "FHA should return to its precrisis role as a targeted provider of mortgage credit access for low- and moderate-income Americans and first-time homebuyers."[4] The report notes that the FHA market share (around 30 percent in early 2011) is already substantially above what Treasury and HUD see as the historical norm of 10 to 15 percent. The Administration's refinancing proposal thus represents a policy reversal that both goes in the wrong direction for housing finance reform and increases the taxpayer exposure to losses by the FHA when recent anal-

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[3] *See, http://www.whitehouse.gov/sites/default/files/krueger_cap_speech_final_remarks.pdf.*

[4] *See, http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf.*

yses indicate that the agency is likely to require a taxpayer bailout of $50 billion or more as a result of its existing obligations.[5]

The Administration proposes to offset the costs of the FHA refinancing proposal with a tax on large banks. As Treasury Secretary Geithner noted at a press conference last week, "there are pockets where credit is tighter than it needs to be, including mortgage finance and small business." The bank tax would expand these pockets, with costs of the tax passed through to borrowers in the form of higher interest rates and reduced availability of credit.

It is the case, as noted in a recent analysis from the Federal Reserve Bank of New York, that foreigners have meaningful holdings of U.S. mortgages in the form of mortgage-backed securities and would bear some of the cost of the refinancing proposals.[6] Given the U.S. fiscal imbalance and ongoing current account deficit, it is likely that the United States will rely on inflows of foreign capital for the foreseeable future. Policies that are seen as unexpected or unfair to foreign investors might then result in reduced demand for Treasury securities and other dollar assets and thus higher financing costs for American borrowers including the United States Government. This is not a reason to avoid a refinancing proposal, but the potential impact on future interest rates should be taken into account in evaluating the costs and benefits.

Similar considerations apply to domestic suppliers of capital for housing finance. Buyers of mortgages and mortgage-backed securities plainly take on refinancing risk—the compensation demanded for this risk accounts for part of the spread between yields on GSE-backed MBS and Treasury securities. Continued expansions of refinancing proposals, however, could give rise to the belief that mortgages going forward have embedded in them a new feature that gives borrowers easier access to a downward adjustment of interest rates than was believed to be the case in the past. This regime change would then translate into market demands for higher yields on mortgage-related securities and thus higher interest rates going forward. In other words, current homeowners would benefit from refinancing but future ones would pay more. This is akin to the impact of so-called "cramdown" proposals that would change the bankruptcy code to allow reductions in the principal balance of mortgages: current homeowners would benefit from having reduced debt but future homeowners would face higher interest rates and reduced availability of credit. Relatively risky future borrowers, who tend to have lower incomes, would be most adversely affected.

As noted above, there are reasons for concern about the impact and cost-benefit calculus of mass refinancing programs. Nonetheless, it is possible for the Administration to move forward with some aspects without Congressional action. The expanded HARP refinancing is moving forward though financial firms' computer systems are reportedly not yet fully ready for the new program. Some FHA guidelines could be adjusted as well to streamline the appraisal process and include some additional mortgages (though the expansion to underwater loans would require Congressional action). In other words, there are steps that could be taken without waiting for the inevitable rejection of the proposed bank tax.

Expansion of the Home Affordable Modification Program (HAMP)

The HAMP program involves Government payments to incentive mortgage modifications that lower homeowner payments and thus seek to prevent foreclosures. Lenders (typically servicers acting on the behalf of the beneficial owners of mortgages) have an incentive to make such modifications to avoid the considerable costs involved with foreclosure, but many institutional features slowed the modification process—to widespread frustration, including at the Treasury Department when I served as Assistant Secretary. The difficulty with a modification is to find the right targeting, amount, and structure of the modification that balances effectiveness with cost. A lender will not want to modify a loan for a borrower who can afford their original payments or for a borrower who could not afford the lower payments resulting from a modification that has an economic value equal to the cost of foreclosure. The presence of underwater borrowers is an important consideration, since an underwater borrower has an incentive to walk away from a home even if the payments are affordable and the lender will not recover the full value of the loan in a foreclosure. But a modification involving principal reduction is especially costly for the

[5] *See,* Joseph Gyourko, "Is FHA the Next Housing Bailout?" November 11, 2011. *http://www.aei.org/papers/economics/financial-services/housing-finance/is-fha-the-next-housing-bailout/*

[6] *See,* Joseph Tracy and Joshua Wright, "Why Mortgage Refinancing Is Not a Zero-Sum Game", January 11, 2012. *http://libertystreeteconomics.newyorkfed.org/2012/01/why-mortgage-refinancing-is-not-a-zero-sum-game.html*

lender and gives rise to important concerns about strategic behavior and spillover effects such as having other homeowners seek unnecessary principal reductions. A further complication is that the weak economy of the past several years has meant that some homeowners who could initially afford the lower payments of a modified loan might suffer an income decline such as from a job loss and then "redefault" on the modified loan (that is, default). It has been said that this combination of factors leaves a potentially narrow aperture through which to make a successful modification.

HAMP uses taxpayer dollars to tip the balance toward increased modifications. Under certain conditions, the Treasury puts in money to pay for part of the cost of the modification. The selection criteria are crucial to the outcome of the policy and involve profound challenges. It is natural to focus taxpayer dollars as tightly as possible on incentivizing incremental modifications rather than providing a windfall for ones that lenders would have done on their own and to avoid as much as possible providing an incentive for homeowners to stop paying their mortgages in order to qualify for assistance. At the same time, implementing a tighter screening to focus on the right set of borrowers translates into fewer incremental modifications.[7] These considerations presumably went into the cost-benefit calculations that were done with the original HAMP program, which was initially predicted to lead to three to four million modifications by the end of 2012 but had chalked up somewhat less than one million permanent modifications through December 2011.

A key feature of the Administration's recent HAMP proposal is to substantially increase the taxpayer-provided payments to lenders that reduce principal as part of a modification for underwater borrowers. This is a relatively costly way of reducing monthly mortgage payments compared to reducing a borrower's interest rate. If the focus of modifications is on affordability, it would be more effective to extend the term of a loan and reduce interest payments rather than writing down principal. Still, one could justify a focus on principal reduction if the goal is to avoid foreclosures by homeowners who can pay their mortgage but choose not to because they are underwater. The key issue is whether this is a cost-effective approach.

A concern about the expanded HAMP incentives recently announced by the Administration is that this is a policy that would have been much more cost-effective in terms of a lower cost to taxpayers for each foreclosure avoided in early 2009. Three years later, underwater borrowers who are still in their homes have demonstrated their attachment to it. To be sure, a principal reduction will benefit homeowners. But the cost to taxpayers will be much larger with the expansion of HAMP payments, and the impact in terms of foreclosures avoided is likely to be much modest than in 2009 given that the target population has made it this far. This leaves a high cost-benefit ratio from the HAMP expansion—presumably a much higher cost-benefit ratio than was judged to be prudent when the program was designed in 2009.

A natural question then is to consider what is different today than in 2009 that results in the apparent imperative to reduce foreclosures in 2012 regardless of the cost effectiveness of the policy tools involved. This is a worrisome approach to policymaking and to the stewardship of taxpayer resources.

Pilot Program to Transition Real Estate Owned (REO) Property to Rental Housing

The aftermath of the bubble has left the U.S. economy with too many homes for sale or in the so-called "shadow inventory" of homes that will be for sale once prices firm. The announcement by the FHFA of a pilot program to transition REO properties to rentals is a welcome step to speed up the adjustment of the housing market to post-bubble conditions. Facilitating purchases of vacant homes by firms that can manage them as rentals will help speed up the market adjustment, at least modestly. This program will not be helpful in all parts of the country, but it will be most useful in areas in which foreclosures and vacant homes are especially acute. The inventory of REO properties held by Fannie Mae and Freddie Mac has been declining as properties are sold while inflows of new REO dwellings have slowed as the result of legal uncertainties surrounding the foreclosure process. But there is likely to be a wave of foreclosures in the pipeline and having this program ready will be useful. At the same time, it will be important to ensure that buyers of REO properties bring capital to the table rather than relying heavily on the GSEs for financing. With Fannie and Freddie under taxpayer control, this would constitute yet an-

[7] For more discussion, *see,* Phillip Swagel, April 2009, "The Financial Crisis: An Inside View", *http://www.brookings.edu/economics/bpea//media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009_spring_bpea_swagel.pdf.*

other Government involvement in the housing sector. GSE financing of institutional buyers would increase the firms' balance sheets and thus taxpayer exposure to risk.

The importance of putting vacant homes to use can been seen in the combination of rising rental costs and declining prices for home sold under "distress" such as following a foreclosure. [8] Overall indices of home prices such as the S&P/Case-Shiller index declined to post-bubble lows in the most recent data for November 2011, while the FHFA purchase-only price index rose in November and has moved slightly above the low point of March 2011. Downward price pressures involved in distressed sales likely contribute to differences between these price indicators. This conclusion is bolstered by recent press reports citing RealtyTrac as calculating that bank-owned foreclosures and short sales sold at a discount of 34 percent to nondistressed properties in the third quarter of 2011.

As discussed in the Fed white paper, the use of short sales and deeds-in-lieu of foreclosure can reduce losses for lenders and provide a better financial outcome for borrowers (and with greater dignity than a foreclosure). Recent press reports indicate that use of these tools is growing, along with payments by lenders to homeowners willing to move out rather than go through the foreclosure process. With the foreclosure process taking 24 to 36 months in States with a judicial foreclosure process, quite large payments could be rational on the part of lenders. [9] The Treasury's Home Affordable Foreclosure Alternatives (HAFA) program similarly provides modest payments to market participants (servicers, homeowners, and investors) to choose short sales over foreclosure. Given the substantial private incentives for these short sales to take place it is not clear that the HAFA program is needed.

Housing Market Adjustment and Alternative Policy Approaches

Housing markets naturally adjust slowly because the typical homebuyer must sell their existing home at the same time that they buy a new one, while the stock of homes evolves slowly given that homes tend to last for 50 years or more. The adjustment has been especially slow in the wake of the crisis and recession as the result of reduced household formation that has diminished the natural growth in demand for housing.

The goal of policy moving forward should be to facilitate the ongoing adjustment and quicken the recovery of both housing prices and construction. By definition, a recovery commences only after the market hits bottom. It is desirable to lift off the bottom quickly. Fostering a stronger overall economy is perhaps the most important element of this, since a stronger economy will boost housing demand, including through increased household formation. Other policies could be useful as well, notably actions that facilitate a more rapid market adjustment and that strengthen demand.

Rhetoric about not wanting the market to hit bottom is a combination of empty and factually incorrect—after all, a housing market recovery by definition will start only after the market hits bottom. What is desirable is for the recovery to start immediately—that is, for the bottom to have been reached already.

In considering housing policy going forward, it is important both to avoid policies that will prolong the housing downturn or lengthen the time at which the market rests on the bottom. This implies that it would be valuable to resolve legal and regulatory uncertainty facing mortgage servicers and originators as quickly as possible. To be sure, past wrongdoing should be punished, notably including inappropriate foreclosures on servicemen and servicewomen. On the other hand, a lengthy period of uncertainty will affect the willingness of banks to take on housing-related risks. This concern has practical relevance for the Administration's recent proposals. Bank A, for example, will naturally hesitate to refinance a loan originally made by Bank B even with an FHA guarantee if there is a concern about the possibility of future litigation. The same applies to concerns about the ability of banks to foreclose on borrowers in default—if a mortgage is no longer a securely collateralized asset, then there would be widespread ramifications to the detriment of future homebuyers. Imagine the cost of financing a home purchase with an unsecured loan facility such as credit cards.

There are important institutional and legal overhangs slowing the housing recovery, including lawsuits and regulatory actions involving the MERS title system, settlement discussions related to so-called robosigning, putbacks of bad loans to origi-

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[8] For longer discussions from which this is drawn, *see,* "The Housing Bottom Is Here" on *http://www.calculatedriskblog.com/2012/02/housing-bottom-is-here.html* and Prashant Gopal, February 7, 2012, "Banks Paying Homeowners To Avoid Foreclosures", Bloomberg News. *http://www.bloomberg.com/news/2012-02-07/banks-paying-homeowners-a-bonus-to-avoid-foreclosures-mortgages.html.*

[9] *See,* Gopal, *op cit. http://www.bloomberg.com/news/2012-02-07/banks-paying-homeowners-a-bonus-to-avoid-foreclosures-mortgages.html*

nators by the GSE, and perhaps others. Again, there should be appropriate consequences for past wrongdoing and steps to avoid repetition. But there is also a value in a rapid resolution of these uncertainties so that the mortgage financing system can once again operate effectively to the benefit of U.S. homebuyers and homeowners. A desire to punish the financial industry sits awkwardly with the desire for a housing recovery. It is important to keep in mind as well that some foreclosures are unavoidable—just as hundreds of thousands of foreclosures took place in years with a strong housing market before the recession. It is important to have a foreclosure process that is accurate and fair and that can move forward responsibly but without unnecessary delays. Foreclosures are difficult and tragic events for households. Yet some foreclosures are inevitable. A housing rebound ultimately requires that adjustments including unavoidable foreclosures take place.

Government policies could also play a positive role in improving industry weaknesses that have been highlighted in the various judicial actions. The MERS titling system, for example, arose in part to compensate for the varying information systems by which property title information is kept, generally at the county level. A useful initiative would be to develop standard formats for these data. This would preserve local control over intrinsically local decisions and information, but facilitate nationwide transmittal and analysis of information. Similarly, better coordination of information regarding second liens would facilitate some additional modifications based on bargaining between owners of the primary mortgage and second lien.

Finally, moving forward with housing finance reform remains vital for a sustained housing market recovery. It is now a year since the Treasury Department and HUD released a report on housing finance reform and concrete action is long overdue. Uncertainty about the future of the housing finance system, notably the role of the Government, will make private providers of capital hesitate to fund mortgages. This leaves Government officials to make crucial decisions regarding credit availability that are better left to market participants with incentives based on having their own capital at risk.

I have written at length elsewhere about steps for housing finance reform, including the future of Fannie Mae and Freddie Mac. [10] The steps involved in moving forward with reform involve a combination of several policy levers: bringing in private capital to takes losses ahead of taxpayers; reducing the scope of any guarantee; and increasing the price or reducing the quantity offered of the guarantee. Moving forward in these dimensions would help increase the role of the private sector in housing finance and reduce Government involvement and taxpayer exposure. Importantly, these steps could be taken without a firm conclusion about whether there will be a Government guarantee on housing at the end. Enough progress in utilizing these policy levers would eventually lead to a housing finance system that is entirely private, but the path to a private system would involve a mix of private capital and incentives backstopped by a secondary Government guarantee. This means that starting with reform that involves a secondary Government guarantee does not rule out ending up with a fully private housing finance system. The key is to move forward expeditiously in order to provide increased certainty about future market conditions and thereby bring private capital back into housing finance. A useful additional step would be to make transparent the budgetary impact of GSE activities. The use of the TARP to compensate the GSEs for costs related to the Administration's housing proposals, for example, obscures the underlying reality that the financial consequences of activities of both the TARP and the GSEs show up on the public balance sheet. H.R. 3581, the Budget and Accounting Transparency Act that passed in the House of Representatives earlier this week, provides a step forward in ensuring desirable clarity in budget treatment. [11] It would useful as well for the GSEs to make available loan-level data that facilitates analysis of market conditions and helps private participants to enter the housing finance market.

Recent news reports indicate that Freddie Mac is developing a pilot program under which private owners of capital would purchase a security that absorbs losses on a pool of loans ahead of Freddie Mac itself. This would have Freddie in a senior position and outside investors in a first-loss position. Such a structure would have the GSEs lay off housing risk on private market participants while obtaining a market-based indication of the return market participants require to take on housing

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[10] *See,* Phillip Swagel, "The Future of Housing Finance Reform", October 2011 paper for the Boston Fed Annual Research conference, *http://www.bos.frb.org/economic/conf/LTE2011/papers/Swagel.pdf,* and Phillip Swagel, "Reform of the GSEs and Housing Finance", Milken Institute White Paper, July 2011. *http://www.milkeninstitute.org/pdf/HousingFinanceReform.pdf*

[11] For more discussion, *see,* Chris Papagianis and Phillip Swagel, "Put Fannie and Freddie on Federal Books", Bloomberg View oped, January 22, 2012. *http://www.bloomberg.com/news/2012-01-23/put-fannie-and-freddie-on-federal-books-papagianis-and-swagel.html*

credit risk. Such a pilot program would thus test the appetite of the private market for first-loss risk on housing assets in exchange (presumably) for higher returns, indicate the market's assessment of the value of the Government guaranteed on mortgages, and illuminate the path leading to a reduced role of the Government in housing finance. We have learned that it is difficult for the Government to price its guarantee for taking on risk, making it extremely useful to have a market-based indication. One could imagine applying such a framework to FHA loans as well to reduce Government exposure and protect taxpayers compared to the current model under which the FHA does not share risk.

Conclusion

A revitalized housing sector and an end to the sadly elevated number of foreclosures would mark salient progress in moving past the consequences of the housing bubble and financial crisis. Government policies can usefully contribute to the needed adjustment. But it is essential to be clear about the costs associated with proposals such as those from the Administration that would expand efforts to use taxpayer funds to avoid foreclosures. It is far from clear that these efforts will be effective and even less apparent that they will have a positive impact commensurate with the taxpayer resources involved. It would be better instead for Congress to consider steps that would hasten the housing market adjustment, facilitate the return of private capital into housing finance, and bring the housing sector more quickly to the point at which home prices and construction activity lift off the bottom into recovery.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM PHILLIP L. SWAGEL

Q.1. Last November, Congress passed legislation making loan limits for FHA-insured loans higher than the loan limits for privately insured loans purchased by the GSEs for the first time in history. In December, Congress increased the GSE guarantee fee by 10 basis points, which has the effect of making privately insured loans bought by Fannie and Freddie more expensive than loans insured by the FHA.

Aren't these actions going to further move the FHA far beyond its core mandate of serving low to moderate income borrowers who otherwise would not have access to home ownership?

A.1. Yes, higher loan limits for FHA and higher fees on GSE-backed loans both make FHA lending relatively more attractive. This is in addition to the lower downpayments required for FHA-backed loans than for GSE-backed mortgages. Having FHA provide a guarantee for people buying homes with mortgages of up to $729,750 is far beyond its core mandate to serve low to moderate income borrowers. It is hard to understand why helping people buy homes with a mortgage of $729,750 is an appropriate use of Government resources.

Q.2. And in so doing, don't these moves supplant privately insured loans with FHA-backed loans, thereby driving private capital away from the housing market and putting taxpayers at risk for losses that otherwise would be borne by the private sector?

A.2. FHA guarantees mean risk for taxpayers; indeed, one of six FHA-backed loans is delinquent. Were it not for the increased FHA loan limits, the private sector would handle mortgages larger than the conforming loan limit for Fannie Mae and Freddie Mac. FHA activities thus displace private sector risk-taking and private capital.

Q.3. Given that the FHA is severely undercapitalized and teetering on the edge of a massive bailout, shouldn't the FHA be focused on managing and containing its significant risk exposure, and not on increasing its market share and financial exposure?

A.3. As documented by Joseph Gyourko and Edward Pinto in research released by the American Enterprise Institute (AEI), FHA is in severe financial difficulty. As Pinto notes, the agency is on track to end 2012 with only $3 billion in reserves, considerably worse than the $11.5 billion in reserves projected in November 2011 (*http://www.aei.org/files/2012/08/20/-fha-watch-no-8-august-2012__142920761624.pdf*). The agency is likely insolvent if measured by private sector standards rather than governmental accounting methods. The FHA should focus on managing and containing its risk, since FHA losses ultimately would require a costly bailout by taxpayers.

Q.4. What actions should Congress take to mitigate these risks and level the playing field?

A.4. Congress should refocus FHA on a core mission of assisting homebuyers with low- and moderate-incomes. This could be done by reducing the limit for mortgages to qualify for an FHA guarantee and by imposing income tests on borrowers receiving FHA assistance. These steps would help reduce the FHA market presence back to the roughly 10–15 percent historical market share. It would be useful as well to require FHA to provide more realistic measures of its financial condition so that Congress and the public have a full understanding of the agency's financial condition and the risks borne by taxpayers.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®

Introduction

On behalf of more than 1.1 million REALTORS® who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry, thank you for giving us an opportunity to share our thoughts on improving the housing sector, and thus spurring an economic recovery.

It's no secret our Nation's housing markets remain depressed and continue to suffer. While no one thought the crisis would carry on so long, markets are slowly recovering, but remain in need of immediate policy solutions to address the myriad challenges in order to stabilize housing and support an economic recovery. REALTORS® have long maintained that the key to the Nation's economic strength is a robust housing industry. And, we remain steadfast in our belief that swift action is needed to directly stimulate a housing recovery.

REALTORS® Plan To Improve Housing

REALTORS® are eager to work with Congress and the Administration to put a plan into action that helps significantly reduce monthly mortgage payments by reducing the barriers to low-cost, streamlined refinancing for millions of homeowners as an alternative to defaulting on their mortgage loans. Moreover, improving access to simple, low-cost refinancing and streamlining the process will help hardworking families who have also stayed current on their mortgage payments, which also goes a long way to helping keep more families in their homes.

With the mantra of helping the Nation's homeowners maintain their homes, in late 2011, NAR worked with two well-respected policy think tanks—the Progressive Policy Institute (PPI) and the Economic Policies for the 21st Century (e21)—to organize and conduct a housing solutions policy. "New Solutions for America's Housing Crisis" brought together policy leaders, industry representatives, Members of Congress, thought leaders and the media to present ideas and make actionable recommendations intended to stimulate the growth necessary for a sustained recovery in housing and extend an ensuing positive effect on job creation and the broader economy.

Crafted from the conference's discussions are recommendations that REALTORS® respectfully submit as examples of relatively easy solutions that can help the housing sector recover. In recent weeks, some of these ideas have been suggested as solutions by the Administration and Federal Reserve. REALTORS® appreciate their thoughtfulness in identifying a plethora of fixes that we believe will make an immediate, positive impact.

Do Not Risk Weakening Our Nation's Housing Markets Any Further

There are a number of proposed rules and recent congressional actions that actively thwart the housing recovery. Rectifying these issues will offer confidence and reassurance to investors and consumers, and bring them back into the marketplace.

1. Re-craft the Qualified Residential Mortgage rule mandated by the Dodd-Frank Act to include a wide variety of traditionally safe, well documented and properly underwritten products. Requiring a 20 percent down payment coupled with stringent debt-to-income ratios and rigid credit standards—as defined under the proposed rule by six Federal regulators—would be detrimental to prospective home buyers, especially first-time and middle-income buyers.
2. Restore higher loan limits supported by the GSEs to provide additional liquidity in housing markets and to assure mortgage financing options while stabilizing local housing markets.
3. Resist proposals that call for changing the tax rules that apply to home ownership now or in the future. Without a doubt, now is not the time to change the mortgage interest deduction or any other housing incentives. Making gradual or targeted changes would send the wrong signal further undermining confidence and further depressing home values.
4. Reject further g-fee increases as a means to offset the costs of a payroll tax extension. Additionally, we urge you to reject measures that would increase Ginnie Mae's g-fees or FHA mortgage premiums (both single- and multi-family) that will disproportionately harm low- and moderate-income borrowers, first-time homebuyers, renters with modest incomes, and others when those funds are diverted to the Treasury and used as an offset to pay for a 10-month extension of the current law. Diverting these fees away from their intended purpose

is a *de facto* tax increase on homebuyers and raises costs on the very same Americans the underlying bill sought to help.

Restore Vitality to Our Communities and Neighborhoods by Reducing the Foreclosure Inventory

REALTORS® are more than business owners within local communities—we are residents. As foreclosures mount, REALTORS® are not just impacted by reduced sales, we are also impacted by depressed home values that reduce Government services and further deteriorate communities. Therefore, efforts to mitigate foreclosures and restore communities are paramount to our members.

1. Support S.170, The Helping Responsible Homeowners Act, sponsored by Senators Barbara Boxer (D-CA) and Johnny Isakson (R-GA). Their bill would remove refinancing limits on underwater properties for borrowers that have been paying on time, and would eliminate risk-based refinancing fees charged by Fannie Mae and Freddie Mac.
2. Support bipartisan Senate efforts calling for improvements to the Home Affordable Refinance Program (HARP). Led by Senators Barbara Boxer (D-CA), Johnny Isakson (R-GA) and Robert Menendez (D-NJ), the time is appropriate to enhance HARP and provide refinancing opportunities to at-risk borrowers as an alternative to defaulting on their mortgage loans.
3. Direct Fannie Mae, Freddie Mac and servicers to prioritize short sales above foreclosures.
4. Support all necessary foreclosure/loss mitigation efforts to keep American families in their homes. Realogy Corporation's President and CEO, Richard Smith, has proposed a debt for equity approach to help underwater borrowers in trouble keep their homes and lower their monthly payments while lenders take a smaller hit than they would have with a default and foreclosure. Realogy Corporation is a leading provider of real estate and relocation services representing world-renowned brands and business units that include Better Homes and Gardens® Real Estate, CENTURY 21® , Coldwell Banker® , Coldwell Banker Commercial® , The Corcoran Group® , ERA® , Sotheby's International Realty® , NRT LLC, Cartus and Title Resource Group.
5. Ensure that any plans by Government agencies to sell foreclosed properties in bulk are done on a limited scale, are carefully tailored and appropriate for the markets in which they occur, and provide flexibility should market conditions not ultimately favor rental conversion of properties.

Open Opportunities for Private Capital To Return to the Mortgage Marketplace To Foster New Demand Among Responsible Homebuyers

Reforming the secondary mortgage market is essential to ensuring a reliable source of mortgage lending for consumers in all types of markets and is integral to the Nation's economic and housing recovery. NAR supports efforts to increase private capital in the housing finance market and reduce the size of the Government's involvement. Below are two quick fixes that we believe will immediately encourage the return of private capital.

1. Open up the FHA Section 203(k) rehabilitation loan program to investors to encourage purchasing of foreclosed property. This will facilitate the rehabilitation of the existing housing stock and help reduce the inventory of foreclosed homes.
2. Require the GSEs to temporarily suspend investor financing limitations, especially the limit on the number of mortgage loans allowed for any one investor/borrower (currently 4 for Freddie Mac and 10 for Fannie Mae). This will give small, private investors the opportunity to absorb some of the excess inventory, resulting in the stabilization of prices for existing real estate-owned (REO) properties.

Support a Secondary Mortgage Market Model That Includes Some Level of Government Participation

Though REALTORS® agree that a properly functioning housing finance market requires reducing the Government's participation and increasing private capital, full privatization is not an effective option.

REALTORS® oppose proposals that call for full privatization of Fannie Mae and Freddie Mac. This is not an effective option because private firm's business strategies will focus on optimizing their revenue/profit generation. This model would foster mortgage products that are more aligned with the businesses goals than in the best interest of the Nation's housing policy or the consumer.

Conclusion

Home ownership matters. It represents the single largest expenditure for most American families and the single largest source of wealth for most homeowners. The development of home ownership has a major impact on the national economy and the economic growth and health of regions and communities. Home ownership is inextricably linked to job access and healthy communities and the social behavior of the families who occupy it. We recognize the serious public debate as to which tax and spending policies will best support the sound fiscal management that our Nation requires. However, we urge caution against dismantling or eliminating vital resources for housing that provide important economic, social, and societal benefits.

The National Association of REALTORS® sees a bright future for the housing market and the overall economy. However, our members are well aware that the future we see rests on the industry's and the economy's ability to successfully navigate some significant obstacles. Congress and the housing industry must maintain a positive, aggressive, forward looking partnership if we are to ensure that housing and national economic recoveries are sustained.

I thank you for this opportunity to present our view on improving the housing market. As always, The National Association of REALTORS® is at the call of Congress, our industry partners, and other housing stakeholders to help facilitate a sustainable housing and national economic recovery.

STATEMENT SUBMITTED BY TIM C. FLYNN, CEO, NATIONAL VALUE ASSURANCE, LLC

A Unique Strategy for Addressing the Enterprise REO Inventory Imbalance

A solution designed to be immediately deployable and without cost to taxpayers!

The purpose of this submission is to present a new and compelling strategy that will significantly reduce, or even eliminate the excess REO inventory that is owned by the Enterprises. This strategy is best described as the ability to provide qualified homebuyers, who intend to be owner occupants, with the contractual assurance that their home purchase will not be subject to the value degradation that has been experienced by almost all homebuyers in America over the past 6 years. In a phrase, we are referring to the strategy as "homebuyer's price (value) protection."

Over the past 2 years, the inability of the American housing economy to absorb it's excess housing inventory and install a solid bottom to the downward spiral in home prices has been a great disappointment. This is especially true in the case of the Federal Reserve, which through various policy initiatives, has facilitated the lowest costs for mortgage financing in the Nation's history. Most regulators and policy makers believed that home affordability was the key to resolving the Nation's housing problem. This strategy proved ineffective, and the need to find a solution continued with increasing intensity. Policy makers and the Fed are now defaulting to one of the only remaining options: a bulk sales strategy discussed in the January 4 white paper.

The principal contention of this document is that the Enterprises, neighborhoods, and taxpayers would be better served by occupying these REO's with qualified buyers rather than "bulk purchase owners." We contend that this can be accomplished quickly and efficiently with a "homebuyer's price (value) protection" program. We disagree with the conclusion that if the most favorable home affordability metrics in history couldn't attract buyers, then individual qualified buyers were not present in sufficient numbers to significantly impact REO inventory. In our opinion, the major barrier to attracting qualified home buyers in this market is crowd psychology. It's about fear—the fear of losing principle value on the largest investment most families will ever make.

Our strategy represents a substantial departure from traditional thinking. The January 4, 2012, Fed white paper, entitled "The U.S. Housing Market: Current Conditions and Policy Considerations", did not include the concept of homebuyer's price protection in its analysis and subsequent recommendation to Congress. It is our contention that the implementation of this strategy into the Enterprises REO marketing plan will result in a dramatic reduction of inventory and an optimum return of capital to the taxpayer. It will also foster a rapid, if not immediate, perceived bottom to the downward spiral in home prices.

We have created a model utilizing homebuyer's price protection that projects a present value benefit in excess of $42 billion dollars, or in our estimate, 36 percent in excess of the reasonable financial returns from any "bulk sales" tactic that is being considered and seems to be gaining momentum.

Certainly the financial implications are an important consideration, but as suggested in both the August 15th RFI issued by the Enterprises and the Fed white paper, another critical consideration is to protect the value and integrity of affected neighborhoods. On this point, there is universal agreement that the most desirable occupants for the REO inventory are qualified owner occupants.

Our model that generated the above result assumed a 100 percent utilization of one strategy versus another. We clearly understand that the characteristics of the Enterprise REO inventory require multiple approaches to attain a satisfactory result for taxpayers. However, it is clear and financially irrefutable that the most beneficial solution for all related parties is to install owner occupants into as many REOs as possible and the only way to accomplish this is to use a form of homebuyer's price protection.

Thank you.

STATE OF THE HOUSING MARKET: REMOVING BARRIERS TO ECONOMIC RECOVERY—PART II

TUESDAY, FEBRUARY 28, 2012

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

The Committee met at 10:07 a.m., in room SD–38, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I will call this hearing to order.

I thank our witnesses for joining us. Today's hearing is part two of our examination of the state of the housing market and steps that can be taken in the near term to remove housing market barriers to economic recovery.

This Committee has undertaken a bipartisan, in-depth look at long-term housing finance reform. I hope to continue this effort with additional hearings and by working with Ranking Member Shelby and Committee Members to seek bipartisan consensus. In today's hearing, we will focus on the immediate problems confronting the housing market and the larger economy, which is a critical first step in finding a long-term solution.

In January, the Federal Reserve released a white paper entitled, "The U.S. Housing Market: Current Conditions and Policy Considerations." In this paper, the Fed stated that continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery.

As I stated during our February 9 hearing on this topic, I share the concern that ongoing challenges in the housing market are acting as a drag on the economic recovery. I want to find practical solutions to help overcome them.

Today's hearing provides a good opportunity to discuss the current housing market environment with regulators and the Administration's top housing official. I would like to hear from our witnesses about potential solutions, both legislative and administrative.

In addition to the Federal Reserve's recent white paper, other analysts, regulators, and the Administration have offered up options and proposals to address barriers to housing and economic recovery. Earlier this month, the Administration outlined a new housing plan to give more families the opportunity to refinance at today's low rates. Just yesterday, the Federal Housing Finance Agency announced its first pilot sale in an initiative to address the large volume of real estate-owned properties held by the Government Sponsored Enterprises.

At our February 9 hearing, the witnesses and a number of Committee Members on both side of the aisle cited helping families refinance at today's low interest rates as a powerful example of an action that would help bolster the housing market and stabilize housing prices. This is particularly true for mortgages held by the GSEs. I would like to see the FHFA take additional steps to facilitate refinancing for families currently stuck in higher-interest mortgages held by Fannie and Freddie. I look forward to hearing more from Acting Director DeMarco on steps that FHFA is planning to take to speed up these refinancings.

Without a robust housing market recovery, our economy will continue to drag and millions of Americans will continue to struggle to make ends meet. I look forward to continuing to work with our witnesses and Members of the Committee to find workable solutions to improve the housing market and lead us further down the road to prosperity.

With that, I turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Welcome, again, Mr. Secretary.

Mr. DONOVAN. Good morning.

Senator SHELBY. This is the second hearing this Committee has held this year to examine the Nation's weak housing market. Each witness before us today has a proposal to revive the housing market and help struggling homeowners. Some of these proposals would require Congressional action.

As I stated during our last hearing, I believe that this Committee should come together and craft common sense legislation to address the serious problems weighing on the housing market today. Hopefully, today's witnesses will identify some potential solutions to these problems and give the Committee some options for its consideration.

Our first panel will be HUD Secretary Shaun Donovan, who will discuss the President's most recent housing proposal. The centerpiece of that plan, as I understand it, would allow underwater borrowers with loans held in the private sector to refinance with an FHA loan. To subsidize the additional risk placed on the FHA fund, the President has proposed using money from a bank tax. As we have not yet received many of the details or any analysis of this plan, I look forward to hearing more from the Secretary as to who this plan may help and the Administration's estimate of its impact on the housing market as a whole.

Because the President has proposed a new use for the FHA, I would like Secretary Donovan to update us on the status of the FHA fund. The President's budget predicted that FHA would require a taxpayer bailout this year were it not for the funds it would receive from the recent mortgage settlement. And given the repeated assurances from the Secretary and multiple FHA Commissioners as to the strength of the fund, this revelation is troubling, although not unexpected for those of us here who have predicted insolvency for the FHA for quite some time. Hence, today's discussion should also include what changes should be made, Mr. Secretary, I hope, to FHA to ensure that the taxpayer is not on the hook for FHA losses.

We also, I believe, we need to learn more about the settlement that is providing these funds to the FHA. To date, Congress and the public have been given only broad outlines of the terms of the settlement, and as a result, there are many unanswered questions about how the settlement was reached and how it will operate. The most important question, I believe, is how will this money be distributed, Mr. Secretary. In particular, is there a connection between how much harm a homeowner suffered and the amount of compensation a homeowner receives?

Although having the settlement compensate as many people as possible may make sense politically, settlement funds, I believe, should compensate homeowners who suffered actual harm and deter future violations of the law. The settlement, however, appears to come up short on both counts, but we will wait and see.

For example, the Administration's press release indicates that homeowners who were improperly foreclosed upon will receive only about $2,000, and as a result, homeowners who were wrongfully foreclosed upon will still likely have to pursue the remainder of their claims in court or through financial regulators. In contrast, many homeowners who suffered no legal harm appear to be eligible for compensation under the settlement, as well. I hope Secretary Donovan today can provide more clarity on how the Administration will determine who will be compensated under the settlement and for what.

Our second panel today, Mr. Chairman, as you pointed out, will discuss two recent papers by the Federal regulators on reforming the housing market. Federal Reserve Governor Duke will be discussing the white paper that was recently sent to Congress by Chairman Bernanke. This paper reviewed numerous proposals but concentrated on measures to convert bank-owned real estate to rental property.

FHFA Director DeMarco will be discussing the new strategic plan he recently released outlining the future of the conservatorships of Fannie Mae and Freddie Mac. The conservatorship has already lasted over 3 years. The longer it continues, the greater the risk is, I believe, that taxpayers will suffer additional losses as Fannie and Freddie's uncertain future erodes their ability to retain high-quality personnel and make essential infrastructure investments.

But given the FHFA's limited legal authority as conservator, only Congress, I believe, can determine the future of Fannie and Freddie. I regret that Congress did not take action with regard to these companies years ago. I look forward to learning more about what FHFA intends to do until Congress does act and what additional steps Congress should take to end the conservatorships of Fannie and Freddie.

I believe the testimony of all three of today's witnesses reveals that there is a great deal to be done to both revive the housing market and reform the GSEs. It is always my hope that this Committee does not delay any further in moving bipartisan legislation to help struggling homeowners and to reform our housing market.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby.

Are there any other Members who wish to make a brief opening statement? Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman. I appreciate you holding this hearing. I think it is incredibly important. It has long been our top priority in the Housing Subcommittee that I am privileged to chair to restore the housing market to full health so that we can get the broader economy moving more quickly. And we have made some progress in knocking down barriers that are slowing the housing market rebound, but there is a lot more to do.

So I welcome the Secretary. I am looking forward to hearing more about the Administration's plan. Many of those items are items that the Subcommittee has proposed. That includes helping homeowners refinance more easily, which I am currently working on a bill to implement. It also creates national servicing standards so that banks are held accountable for following foreclosure laws and fixing the vacant homes that are blighting our neighborhoods and turning some of them into affordable rentals in those places that make sense.

But last, I am really concerned, and I look forward to Mr. DeMarco's appearance, Mr. Chairman. The FHFA has shown a dismal lack of initiative in the housing crisis and needs to be far more aggressive in taking steps that could both help homeowners and taxpayers, particularly on the question of refinancing and principal reduction. We can either achieve that through foreclosure or we can achieve it through refinancing and principal reduction. It seems to me that there are greater benefits for both the housing market and American families through that—via that process than what we have seen today, and I think that we can do that without sacrificing taxpayers' interest, because Fannie and Freddie's financial health is directly tied to how quickly the housing market recovers. So I look forward to the opportunity to hear from Mr. DeMarco as well as the Secretary.

Chairman JOHNSON. Any other Members?

[No response.]

Chairman JOHNSON. Thank you.

I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now, I would like to briefly introduce our first panel witness. Secretary Shaun Donovan is the 15th Secretary of the Department of Housing and Urban Development. Secretary Donovan has served in this capacity since January 2009. Secretary Donovan, you may proceed with your testimony.

STATEMENT OF SHAUN DONOVAN, SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. DONOVAN. Thank you, Chairman Johnson, Ranking Member Shelby, Members of the Committee. Thank you for this opportunity to testify about how the Administration's housing initiatives are helping remove barriers to economic recovery.

Thanks in part to the partnership of this Committee, this is a very different environment than the one we faced when President Obama took office. Back in January 2009, America lost 818,000 jobs. Housing prices had fallen for 30 straight months and foreclosures were surging to record levels month after month.

Today, more than 13 million homeowners have refinanced their mortgages since April 2009, putting nearly $22 billion a year in real savings into the hands of families and into our economy. Because we provided responsible families opportunities to stay in their homes, more than 5.6 million mortgage modifications have been started in the last 3 years and foreclosure notices are down about 50 percent since early 2009. Because we helped communities struggling with concentrated foreclosures, today, vacancy rates are down and property values are up in areas where we focused Neighborhood Stabilization dollars. Most important of all, our economy has added private sector jobs for 23 straight months, totaling 3.7 million jobs.

Mr. Chairman, this represents important progress, but there is more to be done. Three key barriers hold back the recovery of our housing market, which is key to our broader economic recovery. The first is keeping more families in their homes. While the number of homeowners at risk of losing their home is down significantly, there are still too many families that face hardships and are underwater, and their unaffordable monthly payments put them at an increased risk of default, dragging down markets, reducing labor mobility and consumer spending.

Indeed, as economist Mark Zandi said, there is no better way to quickly buoy hard-pressed homeowners than helping them take advantage of the currently record low fixed mortgage rates and significantly reduce their monthly mortgage payments. That is why last fall, the President announced critical changes that would help more families with loans backed by Fannie Mae and Freddie Mac to refinance. Thanks to this work, another 300,000 families have already filed applications for refinancing and stand to save an average of $2,500 per year, the equivalent of a good-sized tax cut.

Similarly, we have also been taking steps to make FHFA streamlined refinance available to more borrowers with loans insured by the FHA, allowing them to refinance into a new FHA insured loan at today's low interest rates without any additional underwriting. This not only reduces homeowners' monthly mortgage payments, but also risk to FHA.

Still, there is no reason why families with FHA loans or loans backed by the GSEs should be the only ones who get help. Millions of homeowners who have done the right thing and paid their bills cannot refinance because they are underwater and owe more than their homes are worth, leaving them stuck paying higher interest rates that cost them thousands of dollars more a year and putting them unnecessarily at risk.

That is why in his State of the Union Address President Obama announced a plan that will give every responsible homeowner in America the chance to take advantage of today's record low interest rates. Any borrower with a loan that is not currently guaranteed by the GSEs or insured by FHA can qualify if they are current on their mortgage, meet a minimum credit score, have a loan that is within FHA's conforming loan limits, and are currently employed. While this program would be run by FHA, it would be financed from a completely separate account from FHA's MMI Fund. Indeed, by financing this proposal through a dedicated funding source, it will have no impact on FHA's MMI Fund. We look forward to working with Members of this Committee to craft legislation to accomplish these goals and establish a broad-based refinancing program.

At the same time we provide relief to responsible homeowners and keep families in their homes, we also need to attack the second barrier to our housing recovery, the overhang of properties that are at risk of or already in foreclosure. While targeted support to markets struggling with foreclosures, blight, and abandonment has reduced vacancy rates, increased home prices, and shrunk the inventory of homes for sale, an overhang of properties at risk of or in foreclosure continues to drag down property values and harm the hardest-hit communities. With the rental market recovering faster, we need to think creatively about ways we can dispose of this shadow inventory.

With about a quarter-of-a-million foreclosed properties owned by HUD and the GSEs, this August, HUD joined with FHFA and Treasury to seek new and innovative ideas for absorbing excess inventory and stabilizing prices. Yesterday, the FHFA in conjunction with Treasury and HUD announced the first major pilot sale of foreclosed properties to be repurposed into rental housing. This marks the first of a series of steps that the FHFA and the Administration will take to develop a smart national program to help manage REO properties and ease the pressure of these distressed properties on communities and the housing market.

While expanding REO to rental is a critical tool, in the hardest-hit markets where prices have dropped the most and the most vacant and abandoned buildings are found, more needs to be done to jump-start construction and reduce vacancy rates. That is why President Obama has proposed Project Rebuild. Building on the Neighborhood Stabilization Program, Project Rebuild would allow commercial redevelopment essential to neighborhood revitalization to be funded directly and expand the ability of the private sector to participate with localities, ensuring there is the expertise and capacity to bring these neighborhoods back in a targeted way. Most important of all, it would create 200,000 jobs in the places that need the most.

The third barrier to recovery, Mr. Chairman, is access to credit. While we stabilize the market and put an end to the worst abuses that caused this crisis, uncertainty over making loans has made it too difficult to get a mortgage today. Reducing this uncertainty is why we recently published our indemnification rule to clarify standards in FHA's Lender Insurance Program and continue to work with Congress to ensure FHA direct endorsement lenders are subject to the same rules and regulations. And it is why we believe it is important for the Federal Housing Finance Agency to make clear the rules of the road for GSE lenders with well defined, straightforward reps and warranties that will further reduce uncertainty around repurchase risk.

And, Mr. Chairman, a clear example of our efforts to clear away all of these barriers to recovery is the historic $25 billion mortgage servicing settlement reached by the Obama administration and an unprecedented coalition of 49 State Attorneys General that spanned partisan and geographic lines. The product of 16 months of intensive negotiations, the settlement addresses the harm mortgage servicing abuses have done to homeowners and the housing market more broadly. It keeps more families in their homes by providing tens of billions of dollars in relief for struggling homeowners, much of which will come in the form of principal reduction for distressed homeowners.

Keeping these families in their homes not only improves their prospects, but also those of their neighborhoods who have watched their own property values plummet by $5,000 to $10,000 each time a foreclosure sign goes up on their block. Indeed, that is why we recently tripled the incentives for cost effective mortgage modifications through the HAMP program that include a write-down of the borrower's principal balance and, for the first time, made these incentives available to Fannie Mae and Freddie Mac. We believe this is good for taxpayers and families alike.

The settlement attacks the shadow inventory by reducing the number of homes that will need to go to foreclosure and by establishing a clear foreclosure process, helping families who are waiting to buy vacant homes and lifting neighborhood home prices as a result. And it reduces uncertainty that impedes access to credit by providing clear and fair servicing standards that build upon the new protections in our Homeowner Bill of Rights.

That means at the same time the new Consumer Financial Protection Bureau is putting in place a single, straightforward set of common sense rules that families can count on when they are buying a home, the standards in this settlement will give people the confidence that lenders and servicers are adhering to a specific set of rights should they ever lose a job or have a medical emergency that puts their home at risk. No more lost paperwork. No more runaround. No more excuses. And by forcing banks that service a majority of all mortgages in the country to fix the types of problems we uncovered during our investigations, these new protections set the stage for servicing standards reform more broadly.

And so, Mr. Chairman, as you can see, we have made very important progress in recent months to get our housing market back on track, putting in place the most significant principal reduction effort in history and establishing critical consumer protections that hold powerful institutions accountable for their actions, helping our housing market recover and giving every homeowner the dignity, respect, and fair treatment they deserve.

But for all this progress, we still need Congress to act to ensure that every responsible family in America, regardless of who owns their loan, has the opportunity to refinance. We still need to continue our work together to create a robust private housing system of housing finance and protect the FHA fund for the future. And we still need a balanced National Housing Policy that ensures Americans have choices in housing that make sense for them and their families. That is the goal of all of this work and it is fundamental to creating an economy that is built to last. I look forward to working with Congress to make it possible.

And with that, I look forward to taking your questions. Thank you.

Chairman JOHNSON. Thank you for your testimony.

As we begin questions, I will ask the Clerk to put 5 minutes on the clock for each Member.

Secretary Donovan, some have stated concern about the potential risk to taxpayers from the President's proposal to refinance non-Government-backed loans through a new FHA program. What policy do you believe FHA can adopt to ensure that any risk to the FHA and taxpayers is paid for?

Mr. DONOVAN. Mr. Chairman, a very important question. First and foremost, I think the focus of this program, this proposal, is on borrowers who are paying, who have come through this entire crisis even though they are underwater and continue to be responsible and make their payments. Those are already low-risk loans, and by lowering their payments further, on average, about $3,000 a year, we would make them even less risky. So that is the first important focus.

Second, as I mentioned in my testimony, we would set up an entirely separate fund to—that would not affect FHA's finances in its MMI or other funds and would identify a dedicated source of funding to offset risk in those loans.

Third, we would also impose and look forward to discussing with Congress a set of standards around what loans could refinance. For example, we have proposed a cap of 140 percent loan-to-value so that whoever owns the loans currently is required to do principal reduction and reduce the risk on those loans even further as they are refinanced.

But the last thing I would say, and this is perhaps the most important, is the single most important thing we can do to protect the taxpayer is to ensure that existing investments of FHA, Fannie Mae, Freddie Mac, any Government-backed entity, that those investments improve in value. And by stabilizing the housing market more broadly, by putting billions of dollars into the pockets of homeowners that can help to boost the economy more broadly, we believe that these steps on refinancing can lift the overall housing market and, therefore, lower losses on legacy books of loans in the FHA and at the GSEs.

Chairman JOHNSON. Mr. Secretary, a key component of the multi-State Federal servicer settlement is that a uniform set of servicer standards will be put in place for the five largest banks. In your opinion, how will this part of the settlement affect the foreclosure and loss mitigation process that servicers engage in, and what benefits will be provided to the housing finance sector as a whole? What is the time line for implementation of these standards?

Mr. DONOVAN. A very important piece of the settlement, as you recognize, is establishing these standards, and one of the things I would point out, we worked very closely with the FHFA, and I want to compliment them on their work on that, to make sure that these standards did not just cover FHA and non-GSE loans, but also would cover GSE loans. So it is comprehensive in terms of the types of loans that it covers. And just the five servicers that have signed on at this point—there are others that we continue to negotiate with—but just the five represent a majority of all loans serviced in the country. So it is very important just to have those five signed on.

The three key benefits that I would identify in terms of the servicing standards, one is that homeowners will be able to depend on getting real help to stay in their homes, as required by FHA standards and, frankly, in a way that will benefit the investors in those loans, as well. We found in our investigations significant noncompliance with our requirements for FHA in terms of loss mitigation and other standards, and so protections like, for example, not being foreclosed on while your application for assistance is being evaluated by the bank is one of the standards. Having a single point of contact at the banks so that you are not shuffled from person to person, your paperwork lost, et cetera. So those are important consistent standards that are there that will help homeowners.

Second of all, by establishing these standards, we expect to speed up not just the process of getting help to homeowners, having fewer families falling into foreclosure, but right now, the foreclosure process itself is dragging on across many, many States and is hurting neighbors where homes are sitting vacant in those communities. And so clarifying and having a single foreclosure process across the country is a very important step in terms of getting relief to housing markets, as well.

And then, finally, I would point out that investors in these loans will also now have a more consistent set of what they can expect in the way that loans are serviced and the kinds of steps that will be taken to protect their investment, just as they will the taxpayers' interest in the FHA.

Chairman JOHNSON. Secretary Donovan, can you provide additional detail on how the elements of the servicing settlement coordinate with the Administration's housing plan.

Mr. DONOVAN. I would be very happy to do that. I think two specific points that I would make beyond the servicing standards that we just spoke about. These servicing standards, I think, are a good starting point for the broader work that we are doing across all the regulatory agencies to create uniform servicing standards by regulation, and so that is a first important step. But two other points are very critical here. One is that the settlement would make available to non-GSE, non-FHA borrowers some amount of refinancing for current borrowers. So it is, if you will, a downpayment, so to speak, on the broader proposal that the President laid out in the State of the Union Address. So that refinancing piece is important.

Second, it is, as I said in my testimony, the most important step that we have taken thus far of the crisis, to get real significant principal reduction started. But by combining that with increasing our incentives for principal reduction through the HAMP program, making those incentives available to Fannie Mae and Freddie Mac, we think that the settlement could have a catalytic effect in really showing, demonstrating that principal reduction is positive, not just for homeowners and communities, but is also positive for investors. When it is done in a net present value positive way, in a way that increases returns to investors, we think it could set a new standard along with these other steps that we have taken to make principal reduction more widespread as a solution to our housing challenges.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you.

Secretary Donovan, in 2009, right here, you told this Committee, and I will quote, “Based on current projections and absent any catastrophic home price decline, FHA will not need to ask Congress and the American taxpayer for extraordinary assistance. There is no need for any bailout.” Those are your words.

Despite this reassurance, OMB predicted that were it not for the funds that FHA is to receive in the mortgage settlement, FHA likely would have required a taxpayer bailout this year. As Secretary of HUD, you are ultimately responsible for ensuring the solvency of FHA regardless of unexpected events or erroneous projections. Without any caveats or qualifiers, can you assure this Committee that the American taxpayer will not need to bail out the FHA fund?

Mr. DONOVAN. Senator, I wish I had a crystal ball——

Senator SHELBY. I know that.

Mr. DONOVAN. ——of exactly how the housing market would perform the rest of this year and beyond. The fact is that I am confident, and I remain confident, that we are taking responsible steps to protect the FHA fund and, at the same time, to ensure that our housing market continues to recover.

And specifically to your question about the numbers in our budget, as OMB made clear, those numbers were outdated at the time that they were published. We did not include in our budget additional premium increases that were announced yesterday because we were waiting to see the outcome of the servicing settlement and the recoveries that we would make there from our increased enforcement activities.

Senator SHELBY. What will the additional fees do for you? How much money will it bring in, roughly?

Mr. DONOVAN. If you include both the—actually, not including the premium increases that were included in our budget, the additional changes that we announced yesterday will net us over a billion dollars more between fiscal year 2012 and 2013.

Senator SHELBY. OK. Secretary Donovan, there has been very little information provided to the public regarding how the Administration determined that the settlement compensates fairly homeowners who have legal claims. In your review, how many borrowers did you find that had been improperly foreclosed upon?

Mr. DONOVAN. Senator, I think this is a very important point about the investigations that we did. One piece of it was on improper foreclosures.

Senator SHELBY. OK.

Mr. DONOVAN. But we also—we began our investigation at FHA in the summer of 2010 looking at, more broadly, at servicing problems, not just in the foreclosure process but more broadly in the servicing problems. And before even the word “robo-signing” became a publicly used term, we were more than a year into those investigations.

Senator SHELBY. OK.

Mr. DONOVAN. And so, to be clear, what we found in the case of some institutions, as high as 60 percent error rates in servicing FHA loans, a whole range of different types of errors. And then equally high rates of problems in foreclosures with certain institutions.

We will be actually making public a number of those investigations, redacting sensitive information that may be there, but we will be making those available publicly this week——

Senator SHELBY. Would you furnish that——

Mr. DONOVAN. ——and that we would be happy to share more detail on the——

Senator SHELBY. With the Committee.

Mr. DONOVAN. ——specifics of those reports with the Committee.

Senator SHELBY. With this Committee.

Mr. DONOVAN. Yes.

Senator SHELBY. Does a borrower under the settlement need to have suffered any legal harm to be eligible for a refinanced mortgage or principal reduction under the settlement?

Mr. DONOVAN. There are different pieces of assistance that come from the settlement. There is direct compensation that is available that really coordinates with assistance that is made available by the OCC and the Fed through their process which came out of the very same investigations. So there is direct assistance there.

But one of the things that we found, Senator, as we went through and investigated this is that there were many, many harms to those who had FHA loans, for example, who, because their paperwork was lost, did not get help or did not get help as quickly. And in that case, it is very difficult to say precisely what would have happened had they gotten help on time. And so without the ability to say exactly what the amount of harm is in each of those cases, we had to set some standards for those who were harmed to help those homeowners. So, honestly, there is no precise way to measure exact harm in all of these processes that we had.

The other thing, frankly, that we found, as I said in my testimony, is that if you live next door to a foreclosure, if there was somebody wrongly foreclosed on, that harms your neighbor who has done absolutely nothing wrong. And so we felt having a settlement that provided broader help to those housing markets that have been hardest hit through, for example, refinancing for borrowers who are current, was a—had a real connection to the type of harm that we saw as we went through these investigations.

Senator SHELBY. But should not compensation as a principle be based on harm, in other words, somebody suffering harm?

Mr. DONOVAN. I could not agree more——

Senator SHELBY. OK.

Mr. DONOVAN. and again, the number of families that I have seen who have done everything right, who have paid their mortgages, and because there was a wrongful foreclosure next door, because somebody lost their home that should not next door, their own house prices have been harmed as a result.

Senator SHELBY. Mr. Secretary, shifting around a little bit, about a month ago, President Obama told the American people that he was sending this Congress a plan to address the troubled housing market. Subsequently, he has given speeches urging Congress to, quote, “pass his plan.” Today, it is my knowledge, as of this morning, Congress has not received that plan. We have not received it here. It has not been supplied to the Committee. When will the Administration’s housing plan be sent up for us to consider?

Mr. DONOVAN. Senator, I think it is fair to say that we have shared a plan of the program that we would like to see enacted. We have had a series of meetings with your team, with others on the Committee——

Senator SHELBY. ——no more than——

Mr. DONOVAN. We do not at this point have specific legislative language——

Senator SHELBY. OK.

Mr. DONOVAN. ——but we want to make sure that we get the input of Members of this Committee and others in Congress before we settle on a final legislative proposal.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Yes. Thank you, Mr. Chairman, and I want to thank you for bringing the folks together at this hearing to determine what is happening in our housing market. I think we heard some good news, recent data, and I think you have presented some good news, Secretary Donovan, on the housing market, but I think we all realize we have got a ways to go.

One important step toward a healthy market is resolving and addressing the missed contact, which you addressed, that hurt homeowners, that pushed them into foreclosure. And while I appreciate the efforts of the State Attorney Generals and HUD and the Department of Justice to hold mortgage servicers accountable through this settlement, I still have questions how this settlement is going to help Montana or rural America specifically.

I understand that Montana is going to receive a portion of the funds, and I know that Attorney General Bullock will put those to good use with that flat payment, but it is not going to be nearly enough to compensate, but it is a step. The bulk of the settlement is targeted toward struggling homeowners through refinancing as well as a menu of options, including principal reduction, forbearance, and short sales. Each of the parties of the settlement were required to meet dollar targets through these options and receive varying amounts of credit based on what sort of assistance is provided to original homeowners. I am getting there.

As I understand it, the servicers the servicers are the party which will have complete discretion in determining which loans are modified, provided that they meet dollar obligations. So the question is, is what guarantee—since the servicers are making the call, what guarantee is there that any of the troubled homeowners in Montana will see a benefit from this settlement?

Mr. DONOVAN. Senator, we would be happy to share with you specifics on what our estimates are of that help to Montana homeowners. But I think you asked a very important question, particularly given the experience we have had with past settlements where what was promised was not delivered. And there are three specific ways that we have built into this settlement to make sure that what has been promised will actually be delivered.

First of all, there are substantial financial penalties for not reaching those specific numeric goals. Again, this is not, like in some past settlements, a promise to knock on a door, to send a solicitation to offer something to a homeowner. There are very specific targets of what they actually have to deliver in each of these categories, and if they do not, any amount that they do not provide is converted to a cash penalty with a 25 percent or a 40 percent penalty on top of that amount.

Senator TESTER. OK.

Mr. DONOVAN. Second of all, there is a very strong monitoring system that has been put into place that will include a State Monitoring Committee. They have the ability to go into court, and both the monitor can levy fines up to $5 million for any violations and, beyond that, can go back into court for other remedies.

Finally, and I think this is one of the most important aspects, we have built into the settlement a requirement that any principal reduction or any other help to homeowners has to be successfully working for 90 days to be able to count. In other words, it is not just that you have reduced principal, but that you have done it in such a way that we can assure that that homeowner has actually benefited and will continue to be able to stay in the home, and that, I think, is very important in terms of creating sustainable modifications for these families.

Senator TESTER. OK. And just correct me if I am wrong. Is there—I mean, there are bigger incentives where there are a lot of foreclosures, especially compared to rural areas of this country, Montana being one of them, where we have had our share of foreclosures, too, but not nearly as many from a numeric standpoint. Is there anything that will require the servicers to go into rural areas, or will they just focus on—or could they just focus on the urban areas?

Mr. DONOVAN. So this was a—this is an important question as we went through the settlement negotiations. Had we established individual targets for every State around the country——

Senator TESTER. Right.

Mr. DONOVAN. ——we could have ended up—if you multiply 15 States by 14 servicers, we could have ended up with 700 different targets——

Senator TESTER. Understand——

Mr. DONOVAN. ——which was not practical. What we did put in, though, is a specific requirement that there can be no actions that any of the servicers take that harm any particular geography. So the monitor does have the ability to go and say, wait a second. You are not reaching out to rural borrowers. You are not treating rural borrowers in the same way that gives them access to the same benefits. And we think that that protection will be strong enough to make sure that, whether it is Montana borrowers or other rural borrowers, do not get treated in a different way than anyone else around——

Senator TESTER. OK, and that monitoring system is the State Monitoring Committee that you had talked about in a previous question?

Mr. DONOVAN. There is a full-time monitor who has been appointed who has very broad authorities to oversee. There is a Monitoring Committee, including Federal and State officials, that will have an ability to oversee the monitor. And then there is the Federal District Court in D.C. that will oversee the settlement. Should there be any disputes with the monitor, they can be resolved in the Federal District Court.

Senator TESTER. And so—not to put words in your mouth, and my time has run out—but you feel confident that there are protections in place—and it can go either way, by the way. They could all focus on rural America. That has not traditionally been the way it has been. So you feel confident that there are entities in place that can force the settlement to go into rural America.

Mr. DONOVAN. I do feel strongly that that is true. But I would also say, Senator, do not take my word for it. Forty-nine different State AGs, including yours, signed on——

Senator TESTER. Yes.

Mr. DONOVAN. ——and many, many other rural States felt confident that this would benefit their States.

Senator TESTER. And there is no doubt that the payment that those AGs are going to get is going to go to those States. I am talking about——

Mr. DONOVAN. Absolutely.

Senator TESTER. OK. Thank you, Mr. Chairman.

Mr. DONOVAN. Thank you.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for being here.

With the AG settlement, what is the differentiation that is being made between second lien holders and first lien holders? It is my understanding that it appears that first lien holders are going to be taking hits while second lien holders are not, which is incredibly perverse. I would like for you to enlighten us——

Mr. DONOVAN. Yes.

Senator CORKER. ——if that is the case.

Mr. DONOVAN. A very important question, and there have been some mistaken reports about this, so I am glad you asked the question. There are two different ways that we are making sure that lien priority is respected.

First of all, the credit for the write-offs of second liens is different from the write-off for first liens. We are recognizing——

Senator CORKER. Let me just ask it a different way.

Mr. DONOVAN. Yes.

Senator CORKER. I do not want this to take that long. You are going to make sure that second liens are totally extinguished first, is that correct, before first liens are taking any heat, which is the way law works.

Mr. DONOVAN. The minimum—we are basically using the standards for the HAMP program. The minimum is that it is at least *pari passu,* and any seriously——

Senator CORKER. So equal——

Mr. DONOVAN. If I could just finish, any seriously delinquent second has to be completely written off in the——

Senator CORKER. So you are going to do *pari passu,* equal-equal——

Mr. DONOVAN. Equal——

Senator CORKER. ——and even though contract law would say that first lien holders have priority, you are going to *pari passu.* You are going to let the second lien holder have equal rights to the first lien holder, is that what you are saying?

Mr. DONOVAN. Senator, it is actually not correct that law requires—if a second lien is current, for example, there is no requirement that says it has to be totally written off. These are standards that are in place for the HAMP program and that work. I think they absolutely respect lien priority. It is at least *pari passu,* but if it is significantly delinquent, it has to be written off entirely in any of these transactions.

Senator CORKER. How many of the homes—you all are really interesting when you use the word "improperly" foreclosed. What percentage would be your guess of loans that were improperly foreclosed on over a technicality and over those that actually were not making payments or behind, or maybe they were making payments and were not behind but were foreclosed upon?

Mr. DONOVAN. I think this is a very important point, because I think the perception is somehow that the settlement was all about folks who lost their homes that should not have, and the percentage, as I think you imply, rightly, there are a very few folks who actually lost their home that should not have because of some error in the—still——

Senator CORKER. It would be very good if you all would actually say that instead of continuing down this rhetorical path that you——

Mr. DONOVAN. Senator, I——

Senator CORKER. ——and in your testimony alluded to on the front end.

Mr. DONOVAN. I am not sure—I would be interested in your point on the testimony, but what we did find was very significant and very pervasive errors in the servicing process more broadly that have real impacts on families. And we have taken criticism, why is it only $1,500 or $2,000, the compensation, because most of the errors did not cause somebody to lose their home wrongly. Most of the errors were smaller errors that might have delayed help for a month or fees that should not have been charged, and that is why the predominant help that we are providing is a smaller number.

Senator CORKER. Yes.

Mr. DONOVAN. But if somebody did lose their home wrongly, they should obviously be compensated, and we have set up a system that can do that, as well.

Senator CORKER. Do you think it is a good idea for someone with a credit score of 580, just out in the private sector, to come on the FHA's balance sheet? Do you think that is good public policy?

Mr. DONOVAN. What I will tell you is the large majority of the homeowners with 580 credit scores that we are making loans to are successful homeowners——

Senator CORKER. Yes.

Mr. DONOVAN. ——and I do not believe we should take away the ability for somebody who can be a successful homeowner to be one. We obviously have to make sure that we are implementing risk controls. That is why when we first came in we raised the downpayment requirement for low credit score borrowers, and we have taken a series of other steps to protect that. But I think if you look at the performance of our new books of loans, what you see is the best credit quality in the history of FHA and I think we are—you know, given that we have to find a balance between protecting the fund and helping homeowners get access to a home, and, frankly, making sure that the housing recovery continues.

Senator CORKER. You know, every now and then, a guy comes along, or a person comes along in public service that you really are excited to be here and you think that they are going to be here really putting forth their honest opinions about things and really be here about good public service. You are one of those people.

Mr. DONOVAN. Thank you.

Senator CORKER. You and I have talked often. I am really disappointed in the overly political approach that you have taken, and you and I talked about a GSE proposal and you put forth a white paper a long, long time ago that had a multiple choice.

I just want to tell you that I hope at some point you will recover from the mode that you are in right now and that you will actually bring forth solutions to our housing programs, including a real GSE reform bill. I just want to tell you, I am personally disappointed and I hope we will begin addressing the real issues that we have here in our country in housing in a way that is fair to all Americans, and I hope to talk to you soon.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and Mr. Secretary, I want to thank you for your leadership.

Mr. DONOVAN. Thank you.

Senator REED. I think most people acknowledge that this Attorney General's settlement, although ably led by Attorney General Miller of Iowa, would probably not have come together without your personal involvement, and that is an extraordinary achievement.

Mr. DONOVAN. Thank you.

Senator REED. I think the paralysis that we have seen around here, maybe it has been broken, because now, at least, we have taken a step forward. There is tangible relief to homeowners. It is not perfect. Seldom do we do perfect things here. But it is progress and we have not seen a lot of progress over the last few years.

Not only that, you have led the way with proposals to expand the effectiveness of the HAMP program to make it more useful, to apply it to a broader spectrum of Americans. All of those have been practical solutions to this gnawing problem of a housing market that was collapsed, frankly, not on your watch but on your predecessor's watch, and you have been trying to rehabilitate it. We have seen some modest progress, but not enough.

Now, one of the things I think is interesting, and I think you have sensed it, too, is that if you look at the people who are the commercial banks that hold loans in their portfolio that are—and bound by fiduciary obligations to make money for their shareholders, they are actually writing down principal as a way to keep people in their homes. In fact, yesterday, the American Banker reported 80 percent of homeowners who received a modification from these commercial banks saw their principal cut, and yet we have not seen that by the GSEs and by others, although I think you have made progress in the HAMP program by giving further financial incentives. Could you talk about this issue of principal reduction as the way to keep people in their homes?

Mr. DONOVAN. Senator, thank you for asking about this because I think it is—if I look at the sort of range of tools that we have tried to use through the last few years in the housing crisis, principal reduction is the one tool that we have made perhaps the least progress on until recently. And there is growing evidence that, particularly where someone is deeply underwater, if they are looking at, you know, 10, 15 years of paying their mortgage without being able to start building equity again, that at some point, that will have a real impact on their ability to keep going and keep paying their mortgage.

So the ability to begin to sort of break the logjam, if you will—there are so many frictions that we see in this system that we have to principal reduction, to be able to break through some of those frictions to get interests aligned among all the trustees and the owners of the loans and others is one of the things that we have been focused on, particularly over the last few months. And I think between the settlement itself as well as these other incentives that we are providing, that those are very important steps that we hope can jump-start more principal reduction happening, which, again, we do think is good both for homeowners and communities, but also for investors in those loans where it can allow people to pay, stay in their homes, and increase the value of those mortgages.

Senator REED. As a follow-on point, one of the perceptions, and I think this is borne by people throughout this country, is that we have gone to extraordinary lengths to provide support for financial institutions, mainly through Federal Reserve policy of lowering interest rates very close to zero. And yet many homeowners cannot take advantage of that because their property values have deteriorated so much.

But if, in fact, through these principal reductions they can refinance, that would be a tremendous boom to them. And as I think it is reflected by the commercial banking experience, it is a lot smarter for a bank to keep someone in their home paying rent and maybe even have a principal kicker at the end than to foreclose, maintain the property, pay property taxes on the property, and in many cases watch the property deteriorate despite all of that. That logic seems to be compelling to most people back home, but it is having a—you are having a hard time persuading lots of people here, is that fair?

Mr. DONOVAN. Well, look, I do think that given the scale of the housing declines that we saw across the country, we are in a little bit uncharted territory in terms of what this means. It is one of the reasons why the settlement, we think, is important, because it can establish a track record for principal reduction. But there is increasing data available, we believe, that shows that this principal reduction can be good not only for homeowners and communities but for investors, as well.

The other thing I would just say is we have a very big opportunity with interest rates where they are today. Typically, any homeowner who is less than about 130 percent loan-to-value by refinancing to today's low interest rates can get back above water in

5 years or less just through plowing their savings from refinancing into rebuilding their equity. And that is something we want to encourage with our plan. It is why we have proposed eliminating closing costs and providing other incentives to folks to choose to take their savings from refinancing and plow it back into rebuilding their equity.

Senator REED. Thank you.

Chairman JOHNSON. Senator Johanns.

Senator JOHANNS. Thank you, Mr. Chairman.

Mr. Secretary, it is good to see you again. I was looking at your written testimony, and let me quote something that you wrote. You did not say this in your oral testimony, but it is here in front of me. You say on page one, near the bottom, "Today, because the Obama administration moved to keep interest rates low and restore confidence in Fannie Mae, Freddie Mac, and the Federal Housing Administration," then you go on to talk about homeowners refinancing.

Mr. Secretary, on both points, you do not seriously believe that it was the Obama administration that kept interest rates low, do you? I always thought that was the Federal Reserve function.

Mr. DONOVAN. What I would say—I think it is perfectly fair to point out the Federal Reserve had taken very significant steps. There were additional steps that the Administration took, particularly through Treasury, early on in the Administration to keep interest rates low, as well. So if you read as us taking full credit for that, it is certainly not accurate. There are steps that we took, however, that contributed to keeping interest rates low.

Senator JOHANNS. Now, on your second point, I have not run into a single person since I joined the Senate 3-plus years ago that came up to me and said, "You know, Mike, thanks for your efforts back in Washington. I now have confidence in Fannie and Freddie." Do you really believe that, that confidence has been restored in these gigantic operations that have been nothing but a liability for taxpayers?

Mr. DONOVAN. Senator, there is no question that there are additional steps that need to be taken and we continue to take, and certainly as we laid out our plan for what should be done with Fannie and Freddie, we said very clearly that it is structurally a model that we should discontinue. It is not the right model for the future.

On the other hand, in the midst of the crisis, we were very dependent on ensuring that a new homeowner trying to buy a home, because private capital was not available in the midst of the crisis, that we needed to ensure at least that new loans were available. And so when we talk about confidence that those loans will stand the test of time, we took very difficult steps to stand behind, to back those loans, to make sure that interest rates continue to be at a level that folks could buy homes.

So when we talk about confidence, what we really meant is confidence that the backing of Fannie and Freddie would be good for homeowners that were looking to buy homes or refinance.

Senator JOHANNS. Well, let me ask you about that, because I think you are making my point. How much today would the taxpayers be on the hook for when it comes to Fannie and Freddie? Everything, right?

Mr. DONOVAN. There is no question that taxpayers are at risk for those loans being made. What I would also say, though, is all the evidence that we have is that the new loans being made are safe, good loans. The exposure that taxpayers have is to the legacy loans that were made before they went into conservatorship, and this is——

Senator JOHANNS. And how much——

Mr. DONOVAN. and I think this is where the confidence issue is important. The single most important thing we can do to protect taxpayers is ensure that those old loans, which we cannot make go away, perform in a way that improves their value rather than has their value decline. And in that sense, improving the housing market more broadly, keeping confidence in the securities that are issued by Fannie and Freddie is critical going forward.

Senator JOHANNS. How much are those legacy loans? If you are the average taxpayer out there and you are tuned into this hearing and you want to know how much you are on the hook for, how much is that?

Mr. DONOVAN. I am sorry, Senator, I do not have a number in front of me. Perhaps—I know that FHFA will be testifying on the next panel. I am sure that they would have more specific details. But it is obviously substantial, in the over a trillion dollar range.

Senator JOHANNS. To me, that is not a confidence builder. The average taxpayer is out there saying, are you kidding me? I am on the hook for that, too, in addition to the massive national debt?

Let me, if I might, ask you a quick question about the investigations. When you talk about servicing errors, could that be something like the failure of Mike Johanns to sign one of the pieces of paper that you get at a closing?

Mr. DONOVAN. We did not look at closing specifically, but there are clearly failures to properly review and sign documents in the servicing and in the foreclosure process.

Senator JOHANNS. What percentage of all of that would you say was due to just outright fraud? I want to take advantage of this poor innocent person sitting in front of me.

Mr. DONOVAN. I would say the minority of those errors that we found, I would say, could be linked directly to outright fraud. On the other hand, the extent of the errors, as I said, up to 60 percent error rates, serious error rates, in the worst of the companies that we reviewed, did real damage to families and to communities. So what I want to make sure people understand about these investigations, what we found were not just trivial errors that had no impact on families. These were significant errors that had real impacts, cost families real money, caused some families to lose their homes that should not have. And, frankly, we felt they needed to be held accountable. They were violations of FHA's rules, among other things, and that is why we took them so seriously.

Senator JOHANNS. Mr. Chairman, thank you.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman, and Mr. Secretary, thank you for your service. I think you have done an extraordinary job.

Mr. DONOVAN. Thank you.

Senator MENENDEZ. I want to follow my colleague, Senator Johanns, line of question. What is the time frame in which this explosion at Fannie and Freddie took place, of the challenges we are facing now in terms of taxpayer exposure? What is the time frame in which that took place?

Mr. DONOVAN. Well, their market share really took off sort of in the middle of the 2000 decade, in the 2005 range, and they were obviously taken into conservatorship before the Administration came into office in 2009.

Senator MENENDEZ. So——

Mr. DONOVAN. And so it is really those legacy loans in that period that are at issue.

Senator MENENDEZ. So everything you just described with Senator Johanns was largely—that explosion took place somewhere in the time frame of 2005 leading up to conservatorship prior to 2009?

Mr. DONOVAN. That is correct.

Senator MENENDEZ. So largely during the Bush years is when this explosion took place. So I find it ironic at times that we hear about these concerns, which are legitimate—they are legitimate concerns, I share them—but there was no one putting the brakes on during that period of time to make sure that these institutions did not follow the marketplace in excesses.

Let me ask you about principal reduction. I know that my colleague, Senator Reed, began on this. When you look at loans that are in the banks' own private portfolios, the banks are finding it profitable to give principal reductions to about 20 percent of their own loans, while, ironically, the Government is not allowing principal reductions on any loans. Do you think, or do you believe that it should be completely taken off the table as an option in literally all cases, as the FHFA has done with Fannie and Freddie?

Mr. DONOVAN. Clearly, given our focus in the servicing settlement and the work we are doing elsewhere in HAMP that I described, we believe principal reduction is an important tool in the tool kit, if you will, that should be available where it can be the most help to homeowners.

Senator MENENDEZ. So, clearly, if the private sector is looking at 20 percent and saying, this makes sense for us, and we always hear about how the private sector can lead us in a way, it seems to me that they are leading in a way in which 20 percent has already been principally reduced. So it is an indicator, at least.

In that context, I have introduced a bill that basically promotes shared appreciation mortgages at the FHFA and FHA as a creative solution to the housing crisis, in part, and principal reduction problems. In essence, a shared appreciation mortgage or debt for equity is basically when lenders reduce principal now in exchange for getting a percentage of future increases in home prices. It seems to me that a lot of things are resolved in that process. The homeowner can be kept in their home, be a responsible—continuing to be a responsible borrower. The question of moral hazard is largely resolved because the appreciation value to the lender is there. And so, therefore, they have opportunity to recoup equity. Do you believe that we could see such a pilot program at FHA?

Mr. DONOVAN. First of all, I want to compliment you on the work on this legislation. It is a creative solution, I think, that you have come up with to what can be a very complex problem of misaligned incentives between homeowners and lenders. We have done a lot of work with your team and look forward to continuing to do that. I do think that it is something that could be valuable as a tool going forward.

I also would just say, on your earlier point, I do think the fact that where—and this is what is increasingly being found—where principal reduction is happening, it is happening more frequently in the portfolios of banks with their own loans, and I think that does show that where the barriers to principal reduction are removed, which is exactly what we are trying to do through HAMP, through the servicing settlement, that more principal reduction will make sense because it is better for those investors. If banks are doing that with their own portfolios, I think it shows they have clearly made the decision. It protects their own investments. So your point is a very important one. I want to make sure it does not get lost.

Senator MENENDEZ. And my final question is, how do you anticipate that the settlement that was entered into with all the AGs will interact with the appeals of foreclosures that are being implemented by the consent orders between the OCC and the Federal Reserve and the major servicers? It seems that there are two parallel tracks going on. I want to clarify what that means for homeowners.

Mr. DONOVAN. Yes. This is a great question because there has been a lot of misunderstanding when you think about this——

Senator MENENDEZ. I only ask great questions.

[Laughter.]

Senator MENENDEZ. I am kidding, of course.

Mr. DONOVAN. And this relates to some of the earlier discussion with Senator Corker and otherwise. What we have to recognize is that many of the sort of harms that were done here did not lead to somebody losing their home, but it might have been a fee that was imposed that should not have or a month delay in getting help which cost a homeowner a month's payment. And we wanted to make sure that homeowners did not have to go through a lengthy process of putting together documentation, maybe even getting a lawyer that might cost more than the help they would actually get. So we created through the settlement almost like a class action process, where somebody can come in very simply, in a very efficient, streamlined process, and get help that averaged sort of $1,500 to $2,000.

For someone who was harmed much more significantly, the OCC and the Fed have set up a separate process where they can come in, demonstrate exactly what that harm is, and get full restitution. If they lost their home and it was a cost of $100,000 to them, they can get that restitution.

Those two processes work in concert, if you will, to make sure that there are options available. Somebody taking $1,000 or $1,500 or $2,000 from the settlement does not stop them from pursuing the longer, more detailed process. And, frankly, neither of them stops a homeowner from going into court if they feel like they have been wronged and their harm has not been adequately addressed.

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

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you, Mr. Secretary——

Mr. DONOVAN. Thank you.

Senator MERKLEY. ——for the hard work you are doing to try to figure out the strategies in a very, very complex mortgage world.

One thing I wanted to draw attention to was your commentary over the Mutual Mortgage Insurance Fund, where you note that there is a series of basis point insurance premium increases and then some additional changes announced yesterday, and you conclude that with these additional revenues, the capital reserve is estimated to have sufficient balances to cover all future projected losses without triggering a mandatory appropriation under the Federal Credit Reform Act.

Essentially, since 2009, as you observe, we have been under the 2 percent reserve ratio and kind of hanging by the seat of our pants, but as I read this, I get the feeling that the adjustments that have been made, that there is a little bit of a sigh of relief that we are not going to have a major solvency problem in MMI, that it is looking fairly decent minus a major unexpected downturn in the economy.

Mr. DONOVAN. Yes. I would not say it is a sigh of relief at this point from my perspective. I think we have to remain very vigilant, because, frankly, the single most important thing that drives the reserves of the fund and whether they are adequate is what the performance of the housing market is going to be more broadly. And given the expected direction of the market, given what we have seen lately in terms of the most recent numbers, we have taken steps between the settlement and the additional premium increases that should protect us this year. But, obviously, we are going to continue to watch very closely, and if there are other unexpected changes in the market, we will react accordingly.

Senator MERKLEY. In any event, it is good news and I appreciate the vigilance going forward.

Mr. DONOVAN. Thank you.

Senator MERKLEY. Turning to HARP 2.0, I appreciate the Administration really working hard to have the FHFA have this program. How many actual HARP 2.0 loans have they actually closed, if you will?

Mr. DONOVAN. So the estimates that we have at this point are that about 50,000 loans have actually closed and that there are about 300,000 applications that have been filed. Recognize that the improvements—the HARP 2.0 improvements really started to go into effect only in mid- to late-December and that the most important change, perhaps, particularly for the hardest-hit communities is the ability to refinance above 125 percent loan-to-value. That was completely unavailable before HARP 2.0. That only started to go into effect really this month.

So what I will tell you is we are encouraged thus far in terms of the response. There are higher than we expected response rates coming in terms of homeowners saying, yes, I want to participate, and particularly in that above 125 percent loan-to-value. So we are encouraged by those numbers so far.

Senator MERKLEY. So that is good, because I had not heard that 50,000 had closed, so I think that is great news, and that there is a whole pipeline coming into effect.

When folks come into my casework team with housing challenges, there is always a bit of a lottery as to whether or not their loan is owned by Fannie or Freddie and, therefore, whether they are eligible for HARP 2.0. So the work the Administration is doing to try to find a strategy to address the non-GSE is important and very difficult.

I did want to ask you about one feature that you mentioned, which is if a family does a 20-year loan, keeping their payments higher and essentially gaining equity faster, they are incentivized by having their closing costs covered. And the reason I found this interesting is at first glance, it felt counterintuitive to me in this sense, that one of our goals is to reduce strategic defaults. So if your monthly payments are lower, you therefore have less incentive, if you will, to walk away and go to a rental. And second is to decrease financial defaults, and if your monthly payment is lower, you therefore are much less likely to financially default if your income changes, you lose a part-time job or new job that pays less.

And so in some ways, I would have thought that maybe the incentive would work the other way, encourage people to have the lower monthly payment and, therefore, more robust or more resilient finances. So I just thought I would have you share just a little bit more of the thinking that went into that strategy.

Mr. DONOVAN. Clearly, that is an option that is up to the homeowner. They can make that choice, and they could even take a portion of the savings and plow it into rebuilding equity. It is not an all or nothing proposition.

We simply felt that given the substantial challenges that negative equity provides, that—and the likely natural sort of short-term focus that many homeowners would have on reducing those payments, that we wanted to ensure that those homeowners took seriously the option of rebuilding equity, as well. Again, the numbers do show that it is not just payment reduction that matters, but also how deeply underwater a family is to be able to do that.

Senator MERKLEY. Thank you, and just a very short closing question, which is it is my understanding that the AGs still do not have all of the details in writing for the settlement, and it is a little surprising that they have been asked to sign on before having all the details in writing because, like every contract, the details make a difference. When are the AGs going to have all the details, and is it possible that when folks look at those details, some that have said, "Yes, I am in," might say, "Hmm, I am going to rethink that"?

Mr. DONOVAN. The documents were finalized in terms of all the significant aspects of the agreement when they signed on, and so they had those documents. What is being finalized, and, in fact, we expect the documents to be registered in court this week and then they would become public—but what was being finalized, for example, each State has the option to decide how to direct their own funding through the AGs. There are a series of individual qui tam actions that were being finalized in particular States. Those had to be reflected in the documents.

So I would put it more in the dotting "I"s and crossing "T"s rather than in any significant terms of the settlement that are being finalized in terms of the documents. And again, they have been finalized. We expect them to be registered in court this week and become available publicly.

Senator MERKLEY. Thank you.

Mr. DONOVAN. Thank you.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman.

Secretary Donovan, thank you for being here today.

Mr. DONOVAN. My pleasure. Thank you.

Senator HAGAN. The premium changes announced by FHA this week are expected to increase receipts to the FHA by $1 billion and, obviously, improve the fund's capital position. Can you discuss how and when we will know what this move—whether this move has proven to be sufficient to restore the fund's capital position?

Mr. DONOVAN. To be honest, Senator, we really will not know until the end of the fiscal year. We will be watching it very carefully and we will have early signs of that. But the—it really will depend on the volume of business that comes in and the trajectory of home prices over the remaining year, and we will have a new actuarial report available to Congress in the fall that will redo those projections based on these new premiums as well as where we expect the fund to go.

Senator HAGAN. The FHA is limited in statute from taking certain emergency actions that could restore the fund's capital position if an appropriation from the Treasury Department became more likely. Can you discuss some of those limitations and what additional authorities might benefit the FHA in its efforts to avoid a draw on the Treasury?

Mr. DONOVAN. Well, first of all, I would just say this Committee has been very helpful, has given us in the past few years greater statutory authority to raise our premiums. We are using that authority here.

But what I would also say is while we are focused on premiums for new loans, it is very, very important that we continue to take steps to make sure that prior loans that were made that did not meet our standards can be held to account and that we are enforcing effectively. We have dramatically increased our enforcement. In fact, the settlement is the single biggest recovery the FHA Fund has ever made from our enforcement.

But there are additional steps. For example, we have limited authority to go after lenders on a national basis. We are required to go after them on a sort of region by region basis, which we do not think is as efficient. We have legislation that is, in fact, reflected in the House bill right now that we would like to continue to work with the Committee to get done this year that would increase our enforcement authorities on that issue and on a number of others, as well.

Senator HAGAN. Thank you. Last year, the FHA was seeing improvements in mortgage delinquency rates in early period delinquencies. What is the FHA seeing in delinquency rates today and are those rates improving?

Mr. DONOVAN. Yes. So what we are seeing on the sort of early delinquencies, 30-day, 60-day, continues to improve and really tracks what is happening, probably most of all, in the jobs market and the improvement we have seen there.

We have seen our serious delinquencies and in foreclosure tick up somewhat and that is really due to two factors. One is that because of the problems that we found in servicing our loans with a number of the institutions, some of them have held off on foreclosing and presenting claims to us, and so that has kept those loans in the foreclosure process longer. And so instead of having—it has also made our claims go down, which is a good thing, but it has increased the number that are in the foreclosure process and seriously delinquent. And so that has sort of had them tick up.

The other thing, frankly, is just simply that we have had very large books of business in the last couple years. There is a natural sort of seasoning process that happens with loans and you do not generally see them start to have delinquencies or defaults until they are typically kind of 2 years old. And so these very large books are—the delinquencies are increasing for those. But, frankly, we looked very carefully at how those loans are performing relative to past years. We are still very confident that those new loans are performing extremely well. But as an average, it has kind of driven the delinquency rates up somewhat because they are just so much larger, those books, than the prior years, which were much worse loans.

Senator HAGAN. The FHA announced the discretionary up front premium increases and changes to annual premiums that were mandated by law in December. Can you discuss how these changes will impact the borrowers who will be refinancing under FHA?

Mr. DONOVAN. So in the budget was reflected a ten basis point increase across the board for these loans, for all FHA single-family loans. What we also did, though, which I think is important, we implemented or are implementing a higher premium increase for larger loans. We want to make sure that the higher loan limits that FHA has are seen as temporary and that we are encouraging private capital to come back into the market more broadly, but particularly in those larger loans, so that as we transition back to our lower loan limits, private capital is already filling that space.

Yesterday, we announced an additional 75 basis point increase on the up front premium that complements the other changes that were in the budget. In total, if you combine the ten basis point annual premium and the 75, for our typical loan, you are going to see an increase that is about $15 a month for the average homeowner. So that is when you combine them. The annual premium is close to $10 a month. The up-front will add about $5 a month. So that is the impact. And we think given where interest rates are, we have tried to balance the health of the fund with making sure that we do not impede the recovery of the housing market.

Senator HAGAN. Thank you.

Mr. Chairman, I did want to state that North Carolina's Commissioner of Banks, Joe Smith, I am pleased to see that he has been named—I cannot remember his exact title——

Mr. DONOVAN. He is the monitor for this——

Senator HAGAN. ——the monitor for the fund, so——

Mr. DONOVAN. He will do a terrific job.

Senator HAGAN. ——we have an excellent individual in that position. Thank you.

Mr. DONOVAN. Thank you.

Chairman JOHNSON. I would like to thank Secretary Donovan for his testimony and for being here with us today. We appreciate your testimony, Mr. Secretary.

With that, I would like to call forward the second panel for this hearing.

[Pause.]

Chairman JOHNSON. The second panel of witnesses that we have here today are no strangers before this Committee and need very little introduction.

Governor Elizabeth Duke is a member of the Board of Governors of the Federal Reserve System. She has served in this position since June of 2008.

Mr. Edward DeMarco is the Acting Director of the Federal Housing Finance Agency. He has held this position since September of 2009.

Governor Duke, you may proceed with your testimony.

STATEMENT OF ELIZABETH A. DUKE, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. DUKE. Thank you. Chairman Johnson, Ranking Member Shelby, Members of the Committee, thank you for inviting me to talk about the current situation in housing markets.

The Federal Reserve has a keen interest in the state of housing and has been actively engaged in analyzing issues in the housing and mortgage markets. Issues related to the housing market and housing finance are important factors in the Federal Reserve's various roles in formulating monetary policy, regulating banks, and protecting consumers of financial services.

In particular, the failure of the housing market to respond to lower interest rates as vigorously as it has in the past indicates that factors other than financial conditions may be restraining improvement in mortgage, credit, and housing market conditions and, thus, impeding the economic recovery.

Federal Reserve staff have been actively working to understand the reasons behind the impairment in housing and mortgage markets and the tradeoffs involved in designing policies that would remove obstacles to normal market functioning.

On January 4, 2012, the Federal Reserve released a staff paper titled, "The U.S. Housing Market: Current Conditions and Policy Considerations," which is attached at the end of my written statement. The paper provides information on current conditions in the housing market and analytic background on some housing market issues. Although the paper does not include recommendations for any specific policy actions, it does lay out a framework for discussion, outlining some options and tradeoffs for policy makers to consider. My testimony today will be drawn from this paper.

Six years after aggregate house prices first began to decline and more than 2 years after the start of the economic recovery, the housing market remains a significant drag on the U.S. economy. In a typical economic cycle, as the economy turns down, households postpone purchases of durable goods such as housing. Once the cycle bottoms out, improving economic prospects and diminishing uncertainty usually help unleash this pent-up demand. This upward demand pressure is often augmented by lower interest rates, to which housing demand is typically quite responsive.

The current economic recovery has not followed this script, in part because the problems in the housing market are a cause of the downturn as well as a consequence of it. The extraordinary fall in national house prices has resulted in $7 trillion in lost home equity, more than half the amount that prevailed in early 2006. The substantial blow to household wealth has significantly weakened household spending and consumer confidence.

Another result of the fall in house prices is that around 12 billion households are now underwater on their mortgages. That is, they owe more on their mortgages than their homes are worth. Without equity in their homes, many households who have experienced hardships, such as unemployment and unexpected illness, have been unable to resolve mortgage payment problems through refinancing their mortgages or selling their homes. The resulting mortgage delinquencies have ended in all too many cases in foreclosure, dislocation, and personal adversity. Neighborhoods and communities have also suffered profoundly from the onslaught of foreclosures as the neglect and deterioration that may accompany vacant properties makes neighborhoods less desirable places to live and may put further downward pressure on home prices.

An ongoing imbalance between supply and demand exacerbates these problems in the housing market. For the past few years, the actual and potential supply of single-family homes for purchase has greatly exceeded the effective demand, in part because of the large number of homes that have come back onto the market after moving through the foreclosure process. The elevated pace of foreclosures, unfortunately, is likely to be sustained for quite a while and, therefore, will continue to put downward pressure on home prices.

At the same time, a host of factors have been weighing on housing demand. Many households have been reluctant or unable to purchase homes because of concerns about their income, employment prospects, or the future path of home prices. Tight mortgage credit conditions have also prevented many households from purchasing homes. Although some retrenchment in lending standards was necessary and appropriate given the lax standards that prevailed before the crisis, current lending practices appear to be limiting or preventing lending even to creditworthy households.

In the paper, we discuss the benefits and costs of a variety of policy options that have been proposed to respond to difficult housing issues, including increasing credit availability for households seeking to purchase a home or to refinance an existing mortgage; exploring the scope for further mortgage modifications, including encouraging short sales and deeds in lieu of foreclosure in cases where foreclosure cannot be avoided; and expanding the options available for holders of foreclosed property to dispose of their inventory responsibly. Any policy proposals, though, will require wrestling with difficult choices and tradeoffs as initiatives to benefit the housing market will likely involve shifting some of the burden of adjustment from some parties to others.

I greatly appreciate the leadership that the Senate Banking Committee has shown on the profound challenges facing the housing market. For its part, the Federal Reserve will continue to use its policy tools to support the economic recovery and carry out its dual mandate to foster maximum employment in the context of price stability. In its supervisory capacity, the Federal Reserve will continue to encourage lenders to find ways to maintain prudent lending standards while serving creditworthy borrowers.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

Chairman JOHNSON. Thank you, Governor Duke.

Mr. DeMarco, you may proceed with your testimony.

STATEMENT OF EDWARD J. DEMARCO, ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

Mr. DEMARCO. Thank you, Mr. Chairman. Chairman Johnson, Ranking Member Shelby, Members of the Committee, I am pleased to be invited here today to discuss the actions FHFA is taking in our role as conservator for Fannie Mae and Freddie Mac to aid recovery of the U.S. housing market.

My written statement responds to the Committee's request for a description of FHFA's work as conservator of Fannie and Freddie, or the Enterprises, as I will refer to them, to address barriers to housing recovery, including preventing foreclosures through loss mitigation, facilitating refinancing at today's low interest rates, and initiating an REO sales program. My written statement also summarizes the recent strategic plan for conservatorship that I submitted to you last week.

In contrast to how they are sometimes portrayed, the Enterprises are playing a leading role in providing assistance to homeowners seeking to avoid foreclosures. On a nationwide basis, Fannie Mae and Freddie Mac own or guarantee 60 percent of the mortgages outstanding, but they account for a much lower proportion, 29 percent, of seriously delinquent loans. And let me add here, there was a little discussion in the prior panel regarding market share. During the period 2005 to 2007, the Enterprises' market share was actually generally declining. More of this was—more mortgage activity was being financed through the private label market, which is, of course, where a good bit of our difficulties today are and where a lot of troubled loans reside.

Even though the Enterprises have a smaller share of seriously delinquent loans than other market participants, they account for about half of all HAMP modifications. Between HAMP modifications and their own proprietary loan modifications, Fannie and Freddie have completed over one million loan modifications since the fourth quarter of 2008.

We have also made great strides in improving mortgage servicing standards. The Servicing Alignment Initiative, which FHFA announced last year, focuses servicers' resources and attention on moving all borrowers in trouble into alternatives to foreclosure and to do so quickly, efficiently, and aggressively. The Servicing Alignment Initiative aligned the requirements of the Enterprises to remove inconsistencies that could cause servicer confusion and delay.

Fannie and Freddie are also at the forefront of refinance activity for current borrowers. Since April 1 of 2009, the Enterprises have completed more than ten million mortgage refinances. The Home Affordable Refinance Program, or HARP, provides refinancing opportunities to borrowers that might otherwise be unable to refinance due to house price declines. Changes to this program that we announced last October are still being implemented, but early indications are promising.

Just yesterday, we announced the first transaction in our Real Estate Owned, or REO, Initiative Pilot Program. This transaction includes approximately 2,500 properties divided into eight subpools by geographic area. We also want to enhance the opportunity for smaller-scale investors to bid on properties and obtain financing should initial efforts to market these properties to owner-occupants fail.

Now, at FHFA, we are faced with a fundamental task of directing the operations of two companies that account for roughly three-quarters of current mortgage originations and have approximately $5 trillion in outstanding obligations and credit guarantees. To the question from the earlier panel, that is the answer. Five trillion dollars is what the American taxpayer is standing behind through the Treasury Department's Senior Preferred Stock Purchase Agreement. Our task in overseeing this is complicated by the very uncertain future of the Enterprises.

Now, last week, I submitted to Congress a strategic plan for the next chapter of conservatorship. The plan sets forth three strategic goals. Build—build a new infrastructure for the secondary mortgage market. Contract—gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations. And maintain—maintain foreclosure prevention activities and credit availability for both new and refinanced mortgages.

Achieving these strategic goals will fulfill the statutory responsibilities Congress assigned to FHFA as conservator and also prepare the foundation for a new, stronger housing finance system. Although that future may not include Fannie and Freddie, at least as they are known today, this important work in conservatorship can be a lasting positive legacy for the country and its housing system. Properly implemented, we believe this strategic plan should benefit homeowners by ensuring continued emphasis on foreclosure prevention and credit availability, taxpayers by furthering efforts to limit losses from past activities while simplifying risk management and reducing future risk exposure, market participants by creating a path by which the Enterprises' role in the mortgage market is gradually reduced while maintaining market stability and liquidity, and finally for lawmakers by building a foundation on which you may develop new legal frameworks and institutional arrangements for a sound and resilient secondary mortgage market of the future.

Thank you again for the opportunity to be here and I would be happy to answer any questions you may have about my testimony or about our strategic plan.

Chairman JOHNSON. Thank you, Mr. DeMarco.

Governor Duke, we have heard arguments that the market should be left to hit bottom. The Fed's white paper seems to indicate that there are barriers or frictions to the market healing itself. Governor Duke, can you discuss some of the barriers your staff has identified. Are there any risks to permitting housing prices to fall further?

Ms. DUKE. Thank you. Yes. The bulk of our work was on trying to identify barriers for the market to seek its own level. One of the most obvious signals is the difference in the rental market and the owner occupied market. Right now, you have prices falling and vacancies falling in the owner occupied market, and then you have lower vacancies and higher prices in the rental market, which indicates that the market wants to move housing from owner occupied to rental.

Some of the frictions that are involved in this are difficulties in aggregating the properties together in getting the properties for rental, financing for these properties, and in some cases, regulatory barriers to facilitating a movement to rental in these properties. So that is why there is a strong discussion of REO to rental.

Other barriers that we identified were barriers to refinancing, primarily loans that were underwater, high loan-to-value loans, and so we discuss some of the changes that might be made in order to facilitate refinancing of those loans.

Chairman JOHNSON. Mr. DeMarco, at our last housing hearing, Democrats, Republicans, and experts stated that there is more FHFA can do and should be doing to expand refinancing opportunities. Yes or no, will you act without delay to take additional steps to provide more Americans with the opportunity to refinance at historically low market rates? If so, what steps will you take?

Mr. DEMARCO. Mr. Chairman, I believe we have already taken those steps through the changes we announced to the HARP program in October. The program actually became effective in December and we are seeing just the first fruits of that. So if there are additional changes to the HARP program that anyone would like to suggest to us, I would be quite pleased to immediately take a look at it and see if we can implement them, if that is going to help further this process along. But I believe the steps we took in creating the HARP 2.0 program, if you will, was a very responsive and responsible set of actions and I am very encouraged by the early indications from the marketplace regarding this program.

Chairman JOHNSON. Mr. DeMarco, your plan is currently a high-level document without much detail. You have indicated that you will be conducting additional analysis to implement the plan to contract the role of the GSEs. What is your time line for doing so? In this analysis, how will you account for factors that are important to the operations of a healthy secondary market?

Mr. DEMARCO. So, Mr. Chairman, you are right. What we sent up here was a strategic plan. It is meant to set the broad goals, the things that we want to achieve in this next period of conservatorship. Now that we have established those goals, the next step is to develop specific operating plans, to examine particular options for how we go about achieving those goals, and it is in that process that we will develop specific time lines with regard to particular actions.

But I will say this, Mr. Chairman. You asked with regard to the second goal, the contracting. There are several things there that I would fully expect that during this calendar year, you are going to see activity from Fannie and Freddie in that regard. We have already begun with one, and that is raising guarantee fees. We have already had our first announcement of that, actually, the end of December, based upon the legislation Congress enacted. But we are also proceeding with both loss sharing as well as additional guarantee fee increases and looking to see if we cannot get some additional transactions in which private mortgage insurance companies start undertaking additional credit risks to the extent they have got the capacity to do so. I would like to see all of that begin this year.

Chairman JOHNSON. Mr. DeMarco and Governor Duke—Mr. DeMarco, you have stated in your testimony that the secondary market for mortgages would not exist if not for the Enterprises. Could you state what might happen if the Enterprises' activities were to be terminated immediately? Governor Duke, could you also comment on this?

Mr. DEMARCO. Well, Secretary Donovan would certainly be a busy man.

Chairman JOHNSON. Yes.

Mr. DEMARCO. In the absence of Fannie and Freddie, if we literally, Mr. Chairman, to your question, simply turned off the lights tonight and did not startup again, there is no immediate infrastructure for secondary market transactions outside of FHA and Ginnie Mae securitization. So it would take market participants a while to be able to step in and redo this. Certainly, some lending would go on. Banks would book some of this in portfolio. But I think the near-term impact would clearly be to constrain mortgage credit.

Chairman JOHNSON. Governor Duke, could you also comment on this scenario?

Ms. DUKE. Well, first of all, I would agree with Mr. DeMarco. There would be much, much less lending going on. But I think for the private market to come in and take up that slack, to begin to do that lending, it is going to take a couple of things. It is going to take some certainty, some visibility as to what is going to happen to the mortgage market in the future, so some idea of what is going to happen ultimately to the GSEs because the investments in the infrastructure to do securitization, to do servicing, to do all the parts of the mortgage market are so large that it takes an understanding of what the future is going to be before anybody is going to be able to make those kinds of investments.

Mr. DEMARCO. If I might add, Mr. Chairman, I would strongly endorse that. I think that while—if I may go back to the previous question you asked me about contracting—these are things we can do at the margin to shift some amount of mortgage credit risk off of the balance sheet of Fannie and Freddie and, hence, away from the taxpayer. But fundamentally, Governor Duke is quite right. Market participants, if they are going to make a permanent and lasting investment in bearing mortgage credit risk, they are going to need much more long-term certainty about the role of the Government and what the institutional and legal arrangements are going to be. I very much agree with that.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Director DeMarco, your strategic plan, as I understand it, would shrink Fannie and Freddie's footprints in the marketplace and seek to establish a unified securitization platform. And it is my understanding that the actions would be designed to set the stage for broader housing finance reform.

Mr. DEMARCO. That is correct, Senator.

Senator SHELBY. Are there legal limits on how much the Federal Housing Finance Administration can reform the GSEs without further Congressional action? In other words, Congress has got to step in here, have they not?

Mr. DEMARCO. Yes, Senator Shelby, that is quite correct. We have no authority to alter the charters of Fannie Mae and Freddie Mac, nor do we actually have the authority to abolish those charters.

Senator SHELBY. Could you describe the legal limitations in this regard that Congress placed on the Director of the Federal Housing Finance Administration, which is you, relating to the approval of any business activity, such as principal write-downs, so long as these institutions remain in conservatorship.

Mr. DEMARCO. So the way we interpret this is that Congress has given us a responsibility as conservator to preserve and conserve the assets of the company for the benefit of the company owners——

Senator SHELBY. To protect the taxpayer, right?

Mr. DEMARCO. Protect the taxpayers, yes, Senator, and that is what we are trying to do.

Senator SHELBY. If Congress enacts housing finance reform, which we desperately need, could such an action perhaps help the housing market recover by providing the legal certainty needed to attract private capital, which they are going to need? And if Congress continues to delay the needed reform, could this not continue to undermine the recovery of our housing market? How do you see that?

Mr. DEMARCO. I would concur with that view.

Senator SHELBY. That the sooner we do a comprehensive reform of Freddie and Fannie, the better off the taxpayer is going to be and the better off the housing market is going to be, is that——

Mr. DEMARCO. Yes, Senator.

Senator SHELBY. Thank you. In your running the Federal Housing Finance Administration, describe the risk and what it could ultimately mean to the taxpayers regarding human capital. In other words, how do you keep the human capital, the executives, the knowledgeable people that know these markets that help you preserve these entities and the taxpayers' risk here.

Mr. DEMARCO. Yes, Senator. This is actually, I believe, one of the key risks that FHFA faces as conservator, because what we have here is we have got two large, complex financial institutions, but they are operating with a great deal of uncertainty regarding their future. The Administration has made clear they want——

Senator SHELBY. What does that mean to personnel?

Mr. DEMARCO. It means that these folks do not know if the——

Senator SHELBY. I mean, you are in the market for high-quality personnel, are you not?

Mr. DEMARCO. Yes, Senator, we certainly are, and the people working at these companies today do not know if that company is going to be there 2 years from now, 3 years from now, and so what is it that induces them to stay given that uncertainty? Certainly, as financial markets more generally recover, we are seeing pick-up in the labor market for this kind of talent, and so their opportunity to go work elsewhere continues to get better.

Senator SHELBY. Governor Duke, in your written testimony, you refer to the Fed's white paper on housing, quote, as a "staff paper," end quote. You also state that the paper, and I will quote you again, "does not include recommendations for any specific policy actions." To be clear here in the Committee, it seems that the Fed is not making policy recommendations to Congress in its housing white paper, is that correct?

Ms. DUKE. That is correct.

Senator SHELBY. Did all the members of the Board of Governors, on which you serve as a Governor, approve the white paper, and if not, who did and who did not? Is that an internal matter or is that something you can supply to the Committee?

Ms. DUKE. I want to make sure I am correct, but I think that the members of the Board of Governors saw the white paper but did not vote on the white paper.

Senator SHELBY. OK. The Fed's white paper, among other things, discusses several ways to address the inventory of Real Estate Owned properties, REOs, and lays out options for the REO to rental program. Governor Duke, if the REO rental, Real Estate Owned, policies outlined in the white paper were to be adopted, how much faster will housing markets recover, in your judgment, and how long will it take them to recover in the absence of such policies? In other words, it seems like you have got to do something to move the market.

Ms. DUKE. I wish I could estimate the exact amount of time that it would take or how much difference this would make. We are beginning to see multifamily housing construction pick up in response to these market requests, so——

Senator SHELBY. Excuse me a moment. Now, we do not have many foreclosures, do we, with multifamily housing?

Ms. DUKE. I do not know how many foreclosures there are——

Senator SHELBY. We have had testimony here before this Committee that it was less than one-half of 1 percent. I do not know if that is correct. Mr. DeMarco might want to comment on it.

Mr. DEMARCO. That may be, Senator. Yes. It is certainly not anywhere near the proportion we are having with single family.

Senator SHELBY. But in multifamily housing, as a rule, people have to put more skin in the game, do they not, Mr. DeMarco? They have to pay down——

Mr. DEMARCO. Yes, Senator.

Senator SHELBY. ——with your loans. They have to put some money into the game, is that correct?

Mr. DEMARCO. Yes, Senator.

Ms. DUKE. But Senator, if I could——

Senator SHELBY. Governor Duke.

Ms. DUKE. My point was that an alternative to multifamily housing are portfolios of single-family housing that are offered for rental. But the difficulty there is that there has not historically been large-scale rental of single-family houses. So you do not have an infrastructure that is developed to manage them. You do not have the infrastructure for financing——

Senator SHELBY. Explain what you mean. Give us some examples here.

Ms. DUKE. Let us say you had a 100-unit apartment building or you had 100 single-family units that you were going to rent in a market area.

Senator SHELBY. You have got two different games there.

Ms. DUKE. Two different games. There is financing experience with the multifamily. There is not financing experience with the large number of single-family houses.

Senator SHELBY. So just to put foreclosed properties or inventoried properties out there, single houses, is a lot more difficult than it would be with somebody experienced in multifamily housing——

Ms. DUKE. Right. If somebody wanted to build a 100-unit apartment building, they could build it——

Senator SHELBY. Right——

Ms. DUKE. ——but if somebody wanted to acquire 100 properties, one at a time, it gets very difficult. Now, the unfortunate truth is that there are a number of properties that exist that have been acquired within the GSEs, FHA, on bank books, with servicers, so those properties are already on the books of various entities, and so a mechanism where those properties can be acquired by investors would seem to be an alternative to multifamily housing.

Senator SHELBY. Has the Fed done an inventory on their portfolio, their securities and how many houses there are at risk?

Ms. DUKE. The Fed does not have a——

Senator SHELBY. And if not, why not?

Ms. DUKE. The Fed certainly does not have a large portfolio because we do not foreclose on houses. The securities that we own are agency securities, and so the houses that would be foreclosed on in those loans would be on the books of the GSEs, not on our books.

Senator SHELBY. They would have to handle it.

Ms. DUKE. Right.

Senator SHELBY. OK. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, Governor Duke and Director DeMarco.

Director DeMarco, in response to a question I posed to your IG, he indicated that FHFA, in his words, quote, "has too few examiners to ensure the efficiency and the effectiveness of its GSE oversight programs." You have repeatedly told us that your responsibility is to minimize losses to taxpayers, but if, according to your IG, you cannot ensure the effectiveness of your oversight program, how can you assure us that you are carrying out this duty to minimize taxpayer losses?

Mr. DEMARCO. The IG's report also points out that we have been undertaking a number of steps regarding both restructuring our organization regarding safety and soundness oversight and reallocating resources toward it and his report also commends us for those actions.

I would point out that we recently hired a new head of Enterprise Regulation. It is actually a statutorily stipulated position at the agency. It is an individual that actually spent most of his career at the Federal Reserve System as a Senior Examiner and one of the most senior executives in supervision at the Fed. And we are continuing in the process of not just increasing our staffing levels with regard to supervision, but under this new Deputy Director's leadership, we are restructuring, reorganizing the deployment of those resources to be more effective in our supervisory oversight.

Senator REED. And how long has it taken to hire the individual and to begin to bulk up your resources?

Mr. DEMARCO. It took a fair amount of time to find the right person for this position, Senator, but he is on board now and we have hired—since the IG's report came out, we have hired over a dozen new examiners and that hiring process continues.

Senator REED. The IG also pointed out, in response to my question, that the FHFA, quote, "trend of deference to the Enterprises, including a reliance on the determination of the Enterprises without independently testing and validating them. This largely hands-off approach to the conservatorships exacerbates FHFA's challenges in anticipating problems." Given your deferential approach, it appears from the IG, is it just business as usual back at Fannie and Freddie? And given the fact that until very recently you have not had a significant number of staff at a significantly high level to overtake your responsibilities, that you have not been able fully to guarantee that the taxpayer loss is being minimized?

Mr. DEMARCO. I do not believe that to be the case, Senator. We have over 500 very hard working people at the Federal Housing Finance Agency. I believe the IG and I have a somewhat different perspective on the degree of involvement FHFA shall have in the day-to-day business operations of Fannie Mae and Freddie Mac. Long before I became Acting Director, at the time the conservatorships were established, FHFA made clear that it was delegating day-to-day business operation decision making back to the companies with a set of stipulated goals and things that the Enterprises were supposed to accomplish in conservatorship. We have reconstituted new Boards of Directors in order to assist FHFA in ensuring that these companies operated with proper internal controls and governance processes. That, to me, is part of conserving the value in these entities for lawmakers to ultimately dispose of.

But I believe that in all critical matters where there is a question about the appropriateness of an action or a decision for the conservatorships, I am in close communication and discussions with the companies regarding such matters.

Senator REED. Have you directed Fannie or Freddie or both to independently conduct an evaluation of the pros and cons of principal reduction as a way to, hopefully, in the long run, enhance the value of their franchises?

Mr. DEMARCO. Both companies have been reviewing principal forgiveness alternatives. Both have advised me that they do not believe it is in the best interest of the companies to do so. But as you know, Senator, FHFA has done a great deal of independent review itself of this important matter because I believe that assuring that we are taking appropriate steps to provide assistance to troubled borrowers is very much at the heart of what we are trying to do, but we need to do so in a way in which we are meeting our mandate to protect the taxpayers.

Senator REED. Have you personally reviewed the independent analysis that Fannie and Freddie have done?

Mr. DEMARCO. I have met with and been briefed by both companies on this and I have certainly reviewed all the work that my staff has done on multiple occasions, which I have shared with the Congress.

Senator REED. Do you review the SEC filings that Fannie and Freddie make?

Mr. DEMARCO. Senator, I have drafts of them before they go up, so I have an opportunity to see them, yes. But those filings are the responsibility of the companies.

Senator REED. But you are the conservator. You are representing the Federal Government in everything that they do or fail to do. And again, you simply allow deference to what they decide? You review the drafts and—have you ever made any comments or changes in their SEC filings?

Mr. DEMARCO. We have made some observations to them about their SEC filings. But even in conservatorship, Senator, these companies remain private companies with responsibilities under the securities laws for the filings that are submitted, and the individual executives at those companies that have to sign those filings are subject to all of the legal responsibilities and potential penalties that other private firms are when they do securities filings, Senator.

Senator REED. But——

Mr. DEMARCO. That is part of being in conservatorship.

Senator REED. As conservator, you feel no responsibility similarly?

Mr. DEMARCO. Senator, I do not share the responsibility under the Sarbanes-Oxley Act for the filing of those documents. The executives of the companies do.

Senator REED. Can you assure us that you believe there are no material misstatements or material omissions in those statements?

Mr. DEMARCO. We would certainly be concerned about such things, Senator, and we would have responsibilities both as conservator and as regulator for that and would execute that appropriately both in terms of our oversight of the companies and in terms of our interactions with the Securities and Exchange Commission.

Senator REED. So the answer is you have no concerns.

Mr. DEMARCO. That is correct, Senator. I have not raised any concern with the filings that have been done while they have been in conservatorship.

Senator REED. Thank you.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

Governor Duke, I appreciate your testimony, talking about the fact that the lack of knowledge about what is going to happen, whether GSEs continue to keep the private market off balance and not knowing what to do. Let me ask you, the $25 billion settlement that just occurred where—I think a lot of people think this is coming out of the hides of the servicers, but actually, they can cram down mortgage investors and get credit for that, which is pretty unique and I do not think most Americans understand that is what is really happening, but let me just ask you this. Would that also potentially create some lack of consistency and concern about the private sector being involved in buying mortgages when these types of things can happen and the mortgage investor had nothing whatsoever to do with what happened but was just trying to play a role in financing housing with no underwriting themselves?

Ms. DUKE. I think mortgage investors are certainly going to be interested in all the ways that they can recover the money that they have loaned and ways that they would not recover that money. One thing, though, that the settlement does do is remove an uncertainty, and it is these various uncertainties that are out there about what is going to happen in the mortgage servicing settlement and what is happening with mortgage servicing standards. And so with that information, then various market participants will decide either to invest in mortgages, to invest in servicing and origination platforms, and what they are going to do in that market.

Senator CORKER. But it just continues the lack of knowledge of knowing that settlements can occur that affect them that they had nothing to do with. We just continue down this path of Government getting involved in areas, breaking rationality and creating issues. I appreciate you saying what you just said.

I would ask—and I am going to move on to Mr. DeMarco—I know you wrote a white paper on housing and I know it met with a degree of criticism. But I would appreciate if you guys would write a white paper on financial reform as it is taking place and share with us the pros and negatives that you are seeing there. I would ask for you to commit to that and maybe send something up to us, giving some editorial comments about something that is actually in your central core area. That would be great to hear.

Ms. DUKE. I think as financial reform gets implemented, one of the things we will be following very closely is what are the effects of that financial reform, and as we get that information, yes, we would be happy to share it with you.

Senator CORKER. So you do not have input now?

Ms. DUKE. We have input now, but we are still developing the regulations, and so we are trying—as we develop the regulations, we are absolutely looking at ways that they will impact the market and ways that they will impact the financial system. But I think, further, after all of the regulations are implemented, it is going to be important to then test the assumptions of what you expected to happen and——

Senator CORKER. If you could do those on an interim basis before this is all done over the next 3 years, it would be helpful. But again, I appreciate your testimony about the lack of consistency out there in the private side.

Mr. DeMarco, I just want to tell you, you guys have to go back and just laugh. Here you have tried to lay something out to begin the process of doing something with GSEs, lay out a strategic paper that I think has been met widely as a good step, and here Congress up here has not done a single thing, is totally feckless—feckless—as it relates to these issues. The Administration has done nothing except sending a multiple choice plan up here that, you know, you can choose, each of which is very different than the other.

What is it like to be out there, a person who basically is there to serve the taxpayers, has done a good job at doing that, is trying to move things ahead, and to have people up here criticize you when they themselves do not have the courage, the will, the desire to address these issues?

Mr. DEMARCO. There is a lot of conflict in this job and a lot of balancing, and you are quite right, Senator. There appears to be a lot of criticism.

Senator CORKER. So what do you think it is? I mean, I think most Americans would love to see us deal with the GSEs. I think if you did a poll nationally, people would really love to see us move back to the private sector being more involved. What is it about Congress, do you think, that likes to instead have an entity like this that they can play with and have principal reductions and serve the social purposes that they would like to see that are really outside the norms of the housing industry? What is it about a body like ours, do you think, that causes us to want to do that?

Mr. DEMARCO. Well, there is something about the structure of Congress chartering companies like this, giving it certain benefits unavailable to other market participants, that certainly Congress is then going to want something in return for all those favors. And that goes back well before conservatorship, Senator. For many, many years, Fannie Mae and Freddie Mac operated in a very unique place in our financial system and were viewed very uniquely by Congress and it affected in an adverse way the ability to have appropriate oversight of them, and it certainly has politicized housing and housing finance to a very troubling degree.

Senator CORKER. I know that you have to be diplomatic in your approach, and I appreciate the way you handle yourself and I certainly appreciate you taking the first steps, but I will tell you, if I were in your position and I had any criticism whatsoever from Congress about what you were doing, I would ask them to lay out their plan. And obviously, we have no plan. We like to criticize. I thank you for your leadership. I hope at some point Congress will do its job and reform these entities that I think every American—most every American, except for those who serve in Congress—would like to see reformed. I thank you for your service.

Mr. DEMARCO. Thank you, Senator. When the Congress is ready, we are sure ready to work with them.

Senator CORKER. Thank you.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Well, let us see if we can get some things that Congress and you can agree on. For starters, would you agree that if we have a foreclosure, on average—I know there is a Freddie Mac study, but maybe you have a different study—that says the loss in foreclosure is, on average, about $60,000?

Mr. DEMARCO. That sounds ballpark.

Senator MENENDEZ. OK. So if we can either conserve the—as I look at the law and think about how do we preserve and conserve FHFA to minimize losses on behalf of taxpayers, we can either preserve that loss either by proceeding to foreclosure, which has a $60,000 loss, or we might very well be able to look at principal reduction at the end of the day if it is somewhere at least in that ballpark.

And so it seems to me that what we get, however, in principal reduction is a homeowner who continues to stay in that home instead of become a vacant property, a homeowner who can under that guise be a responsible borrower, a homeowner who is paying taxes on a ratable base and not creating a ripple effect on the community in which multiple foreclosed homes create depressed values for the community in general, and the savings that takes place in not having to take that property and go through our present challenges on the REO to move it so that we can get this housing market to move.

If that is the case, then why is it that you have taken the view that principal reduction is not within the domain of the possibility of what you can do under the law, because it would preserve and conserve just as well, certainly in that universe, as a foreclosure, and it would also meet under the Emergency Economic Stabilization Act the other goal that you have, which is a responsibility to implement a plan that seeks to maximize assistance for homeowners.

Mr. DEMARCO. So, Senator, I have not said that we do not have the legal authority to reduce principal. And in the spirit of your question, which is let us find things we can agree on, there is much that we do agree on here, Senator. We agree that foreclosure——

Senator MENENDEZ. Well, I was listening to Senator Corker and you and I thought there was nothing we agreed on, so that is why I wanted to——

Mr. DEMARCO. Well, I will be happy to clear that up——

Senator MENENDEZ. OK.

Mr. DEMARCO. ——because, Senator, there is much that we agree on, specifically in the context of your question. Foreclosure is the worst possible outcome in almost all instances. It is the most costly. It is the most devastating to the family. It is most devastating to the neighborhood and surrounding community. And we have a responsibility to make all prudent actions to find a remedy to a troubled borrower short of foreclosure because of these costs. So we agree there.

We also agree that if a borrower is committed to their home and perhaps has had a change in circumstances where they have more limited ability to make their mortgage payment, that as one of the approaches to trying to avoid foreclosure, this borrower should be offered an opportunity to have their loan restructured in a way that is affordable to them. And we have taken a great leadership role at FHFA and through Fannie and Freddie to ensure that borrowers get this opportunity.

And I would like to expand on this, because this is very important for everybody to understand. What we did in the Servicing Alignment Initiative is we made clear in terms of aligning Fannie and Freddie's instructions to mortgage servicers that as soon as a borrower goes delinquent, that is the time to get a hold of the borrower, find out what the problem is, and develop quickly an appropriate response to that borrower's condition. If it is just a very limited short-term thing, then it is a pretty simple thing to handle. If it has been a permanent decline in the financial circumstances of the family, then it might require something different, like a loan modification.

But we are doing that, Senator, and we are doing that aggressively. We are outpacing the market, as my testimony shows, with regard to the amount of that activity that we are doing——

Senator MENENDEZ. I do not want to cut you short, but my time is going to expire——

Mr. DEMARCO. You have asked about——

Senator MENENDEZ. Can you get to the point about principal reduction for me——

Mr. DEMARCO. Yes——

Senator MENENDEZ. ——and then I have one other quick question.

Mr. DEMARCO. Yes, I will, Senator. So to understand principal reduction, here is how this works, because there has certainly been a lot of attention focused on us on this issue. Principal reduction alternative in the HAMP modification program is the fourth tool for how to provide assistance to a troubled borrower to make good on their mortgage. HAMP gets—in all of these HAMP modifications, the objective is to get something to—get the borrower to an affordable payment, and it defines affordable payment as 31 percent of their monthly income would go to their mortgage. That is the target when you are doing a loan modification in HAMP, is to get to a 31 percent payment. That can be done by reducing the interest rate. It can be done by extending the term of the loan. It can be done by forbearing on the underwater portion of principal. Or it can be done by principal forgiveness. So these are four tools, using Secretary Donovan's description, in the tool kit for loan modifications.

What FHFA has consistently found in its analysis is that the first three of those tools work better than the fourth one with regard to our fundamental mandate of preserving and conserving, and I think it would be helpful to understand principal forbearance and why that is the case, because it actually——

Senator MENENDEZ. No, I understand what principal forbearance is——

Mr. DEMARCO. But, Senator——

Senator MENENDEZ. You put it at the back end of the loans——

Mr. DEMARCO. Well, but it works very much in accord with the spirit of your proposal, Senator, about shared appreciation, because it takes that underwater—it takes the underwater portion of the principal, sets it aside and says, we are not going to focus on that. We are going to focus on getting you, the borrower, into an affordable payment. You pay that and this underwater portion is going to sit over here to the side, and if you are successful, then we are all going to share in your success.

Senator MENENDEZ. Well, let me ask you this question and then I will yield. We have a disagreement, obviously, in that respect.

Mr. DEMARCO. Mm-hmm.

Senator MENENDEZ. I think there is a fundamental difference that when the marketplace on the private sector is looking at 20 percent of its portfolios and saying it makes sense for us in the marketplace to do so, and they certainly want to preserve their assets as much as possible as you do as a conservator, but I get concerned about this issues on principal reduction, looking at these other issues, because I look at the stories that came out about Freddie making investments that paid off in the event that homeowners are kept in higher-cost loans. And I would assume that they would not make those bets if at the end of the day they were not hopeful that the bet would pay off.

And so it seems to me, is that leading—do you believe that that has influenced Freddie's policies that discourage refinancing for homeowners, because if your bet is that you are going to keep homeowners in the higher rate, then, in fact, why would you make that bet when you can—you would hope to win that bet, and when you can influence that bet at the end of the day by not permitting refinancing, principal reduction, and other elements to take place.

Mr. DEMARCO. Senator, there is no betting going on here. When someone makes a mortgage to a borrower, right, let us say that mortgage is made at 6 percent. If the mortgage rates then subsequently go down to 4 percent, then the holder of that mortgage knows that they have got the risk the borrower is going to exercise their right to refinance that mortgage and, hence, they are going to get their money back faster than they expected and then they are going to have to reinvest it, if they are going to stay in mortgages, they are going to have to reinvest it at lower mortgage rates. If interest rates go from 6 percent to 8 percent, right, then the borrower—the investors holding this 6 percent——

Senator MENENDEZ. Are you telling me Freddie did not make investments——

Mr. DEMARCO. I am saying——

Senator MENENDEZ. ——I called them bets, but they made investments in saying that the consumers would—that it would pay off in the event that homeowners were kept in higher-cost loans. Why would they do that?

Mr. DEMARCO. I am saying, Senator, anybody that is holding a premium mortgage in this mortgage environment has an investment——

Senator MENENDEZ. Your staff is shaking their head behind you. Maybe you can explain what she is shaking her head about.

Mr. DEMARCO. Do I need to consult—all right. So anyone that is holding a 6-percent mortgage in a 4-percent mortgage environment, Senator, is holding an investment by which if the borrower refinances, they are going to get their money back and have to reinvest at a lower rate. This is not a bet against the homeowner.

Senator MENENDEZ. I do not think Freddie would take its money and make investment decisions and say, let me invest to ensure that at the end of the day, I am going to have a positive result in my investment, and the only way I have a positive result in my investment is if the mortgage borrower is kept in a higher rate. I just find that ethically troubling, to say the least.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thanks, Mr. Chairman. I would like to thank our witnesses for joining us today.

I just want to briefly follow up on a comment or line of questioning that Senator Corker raised, which, I guess from my point of view, had to do with the impact on the private market's ability to provide mortgage financing, especially after this settlement has demonstrated the fact that the Government can come along and change the value of a contract that you have pretty much as it sees fit. Frankly, I worry about how much more it is going to cost homeowners to be able to finance their mortgages in light of that. But that is not what I actually wanted to talk to you about, and I would like to direct my questions to Mr. DeMarco.

First, I have a copy here of a cover letter that you sent to Representative Elijah Cummings, and it is dated January 20. And in it, you stated that the FHFA has essentially three principal mandates, the first of which is a statutory responsibility as conservator to preserve and conserve the assets and property of the regulated entities. Is this not a way of saying to protect taxpayers? Is that not——

Mr. DEMARCO. Yes, Senator.

Senator TOOMEY. You go on—now, you mentioned the other two mandates, and then you have a discussion in the next paragraph that—and you state right here, you did not conclude that principal reduction never serves the long-term interests of the taxpayer when compared to forbearance. But you did compare, as I understand it from your letter, the relative cost to taxpayers, and your conclusion, as I read it here, is that by avoiding the principal forgiveness, the net effect is a smaller loss to taxpayers. Is that a fair way to characterize this?

Mr. DEMARCO. Yes, Senator.

Senator TOOMEY. You go on to then quantify what it would cost in this letter if the FHA set out to actually provide the principal forgiveness that would be enough to diminish the value of mortgages to make them equivalent to the value of homes, and you estimate that that would cost almost $100 billion and that that would and this is your language—you say, this would be in addition to the credit losses both Enterprises are currently experiencing. So that is a lot of additional cost to taxpayers, right?

Mr. DEMARCO. Yes, Senator.

Senator TOOMEY. And then, last, you have a discussion about this fact that I do not think has been discussed as much as it ought to be, namely that nearly 80 percent of Enterprise underwater borrowers are current on their mortgage. And, in fact, those who have a loan-to-value ratio above 115 percent are 74 percent current, which seems to me to present a real dilemma of how you would go about doing this.

For instance, if you provided principal forgiveness for everybody who was underwater, you would be asking taxpayers to pick up the tab for people who are actually clearly demonstrating that they are capable of making the payments for the loan that they chose to take. If you did not and you said, no, it is only the people who are not making payments, why, then how fair would that be to the people who are making payments, and would that not create an incentive for people who are currently making payments to stop? Is that not a pretty tough dilemma?

Mr. DEMARCO. I think that says it quite well, Senator. I think that one of the under-reported things here is that while this country has many borrowers with mortgages that are underwater, the vast majority of them are making their payment every month, and they must wonder about some of these discussions we are having.

Senator TOOMEY. And then I will conclude on this, Mr. Chairman. In the next paragraph, you say, "given that any money spent on this endeavor," and by that you are referring to principal reductions, "would ultimately come from taxpayers, and given that our analysis does not indicate a preservation of assets for Fannie and Freddie substantial enough to offset the costs, an expenditure of this nature would at this time, in my judgment"—that is you talking—"require Congressional action."

I just want to say I share that view. I commend you for taking that view and I want to recognize that you have been under a lot of pressure to change that view and I hope you will not change it. I hope you will stick to that view because I think that is the correct view.

Mr. DEMARCO. Thank you, Senator.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you to the panel for your testimony.

One of the things that I found very interesting recently was the article in American Banker, "Why FHFA is Wrong On Principal Forgiveness," and I am sure you have had a chance to read that article as it has been widely discussed. And essentially, the author, Kevin Wack, says that in the third quarter of 2011, I believe it was 18 percent of bank modifications involved principal reduction and he raises the question why it is that for-profit institutions are doing nearly a fifth of their loans with principal reduction and finding that that is the most cost effective way to their profits but you have not found any similar results. And I do want you to give brief responses so that we can actually have a bit of a dialog over several issues.

Mr. DEMARCO. A number of these institutions have purchased these mortgages at a discount. They have bought them at a price at which doing the principal forgiveness was not something where they were taking a loss by doing so.

Senator MERKLEY. Well, fair enough, but no matter what you paid for it, the alternative of the strategies that you use with the individual would still be the same range of options that you have if you had paid a lot more for the loan. So in that context, your logic does not hold, and do you want to further try some other argument?

Mr. DEMARCO. No. I am comfortable with where I have left it.

Senator MERKLEY. OK. You provided the six-page report to the House, and I believe Representative Cummings has said, really, on such a major issue, you ought to provide the full analysis and they have asked you to do so by February 29. Do you intend to make public the full analysis?

Mr. DEMARCO. I provided Representative Cummings and others with the full three different analyses that we had done on this issue and he has come back with some follow-up questions and asked for yet additional information and we are working on that.

Senator MERKLEY. So does that meet his request for the February 29, or——

Mr. DEMARCO. I will not have additional information tomorrow for him.

Senator MERKLEY. One of the notes has been that your analysis did not make one of the most fundamental distinctions, that is, between folks who have mortgage insurance and people who do not have mortgage insurance. Obviously, that has a huge bearing on the net present value impact. Why was such a fundamental distinction not analyzed or not laid out, at least in what you presented to Congress?

Mr. DEMARCO. Because we were able to reach the conclusion about principal forgiveness without going to that point. But if we want to go there, that is quite right. Another issue with principal forgiveness is that I am then putting the taxpayer, jumping them ahead of the mortgage insurance company who is in the first loss position on this mortgage. I would say the same thing holds for any second liens that might exist on this mortgage. So this is reorienting the priority of loss absorption that is part of the structure that is in place today. But we have not had to go to that issue with regard to the analysis that we have done.

Senator MERKLEY. Other observers have noted that in your analysis, you did not look at the shared appreciation model, which actually is forgiveness plus funds that come back to the originator which changes the net present value calculation. So you gain the advantages of people having lower monthly payments, therefore, less likely to strategically default, less likely to financially default, and yet there is a back-end funds that return. Do you intend to— you actually mentioned shared appreciation earlier. Do you intend to do an analysis of that, and if you have not already done it, why not?

Mr. DEMARCO. Shared appreciation mortgages are complex instruments that are not widely articulated in the marketplace. What I was trying to convey to Senator Menendez is that principal forbearance modifications, which we are doing and we are doing a lot of them, are effectively principal forgiveness with a shared appreciation on the mortgage attached to it. It is economically approximately the same thing. So we are, in fact, doing that now, Senator.

Senator MERKLEY. OK. I did not see that in the analysis you presented to Congress. Do you intend to provide that analysis to us?

Mr. DEMARCO. I believe I will try to articulate this more clearly in our next round of discussions regarding principal forgiveness.

Senator MERKLEY. OK. One of the things that was disturbing to folks across the country is when you said in October you had not met any homeowner who has suffered a foreclosure. Have you had a chance to actually talk to homeowners in the real marketplace since October?

Mr. DEMARCO. You know, Senator, I do know families that have suffered foreclosures and I believe that my—people I know personally, things in my personal life really are not relevant to the realm of this because I believe my responsibility goes to analyzing the law, analyzing the options that are available to us, and proceeding.

I will say something I have done since that time, Senator, that you may find meaningful in this regard. In December, I went up to the city of Baltimore and I met with people from the Baltimore City Housing, the Maryland State Housing Finance Agency, and a local community bank there as well as some community activists and had a lengthy discussion about the impact of the housing crisis in Baltimore. We took a tour of several neighborhoods, some of which one might call—for which this housing crisis has been very damaging. And we have talked about what happened. We have talked about demographic issues. We talked about alternatives for trying to generate recovery in those neighborhoods.

I take this seriously, Senator, that we have communities and families across the country that have been greatly harmed by this, and FHFA is trying very hard to be part of bringing some solutions and stability back to this. But I will do so in a disciplined way following the mandate that I believe Congress has given us.

Senator MERKLEY. I believe what you just said is that you are correcting the record from your October statement, or were you misquoted in October?

Mr. DEMARCO. I was not misquoted. That is what I had told the Congresswoman. I thought she meant it in the form of as part of my work effort, had I been going out and meeting with foreclosed homeowners.

Senator MERKLEY. Well, I applaud what you did in Baltimore because I think actually seeing communities on the ground gives one an understanding that analysis and ivory towers do not gain. I think you would be hard pressed to find a street in a working class community like the one I live in that does not have one or two families on it that are foreclosed on. I mean, the impact is very real, very evident, the destruction of families' dreams, the destruction of their finances. I applaud you for going to Baltimore and doing what you can to kind of see the real impact on the ground. Thank you.

Chairman JOHNSON. I would like to thank Governor Duke and Mr. DeMarco as well as Secretary Donovan for being here with us today.

This hearing has provided this Committee important insight toward achieving realistic solutions to many of the problems confronting the housing market. Stabilizing this market remains a top priority of this Committee and I will continue to work to find bipartisan consensus to achieve it.

This hearing is adjourned.

[Whereupon, at 12:34 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

I thank our witnesses for joining us. Today's hearing is part two of our examination of the state of the housing market and steps that can be taken in the near term to remove housing market barriers to economic recovery.

This Committee has undertaken a bipartisan, in-depth look at long-term housing finance reform. I hope to continue this effort with additional hearings and by working with Ranking Member Shelby and Committee Members to seek bipartisan consensus. In today's hearing, we will focus on the immediate problems confronting the housing market and the larger economy, which is a critical first step in finding a long-term solution.

In January, the Federal Reserve released a white paper entitled "The U.S. Housing Market: Current Conditions and Policy Considerations." In this paper, the Fed stated that "continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery."

As I stated during our February 9th hearing on this topic, I share the concern that ongoing challenges in the housing market are acting as a drag on economic recovery. I want to find practical solutions to help overcome them.

Today's hearing provides a good opportunity to discuss the current housing market environment with regulators and the Administration's top housing official. I would like to hear from our witnesses about potential solutions, both legislative and administrative.

In addition to the Federal Reserve's recent white paper, other analysts, regulators, and the Administration have offered up options and proposals to address barriers to housing and economic recovery. Earlier this month, the Administration outlined a new Housing Plan to give more families the opportunity to refinance at today's low rates. Just yesterday, the Federal Housing Finance Agency announced its first pilot sale in an Initiative to address the large volume of Real Estate Owned properties held by the Government-Sponsored Enterprises.

At our February 9th hearing, the witnesses and a number of Committee Members on both sides of the aisle cited helping families refinance at today's low interest rates as a powerful example of an action that would help bolster the housing market and stabilize housing prices. This is particularly true for mortgages held by the GSEs. I would like to see the FHFA take additional steps to facilitate refinancing for families currently stuck in higher-interest mortgages held by Fannie and Freddie. I look forward to hearing more from Acting Director DeMarco on steps that FHFA is planning to take to speed these refinancings.

Without a robust housing market recovery, our economy will continue to drag and millions of Americans will continue to struggle to make ends meet. I look forward to continuing to work with our witnesses and Members of the Committee to find workable solutions to improve the housing market and lead us further down the road to prosperity.

PREPARED STATEMENT OF SHAUN DONOVAN

SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

FEBRUARY 28, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for this opportunity to testify about how the Administration's housing initiatives are helping remove barriers to economic recovery. This hearing comes at an important moment—a moment President Obama described in his State of the Union as "a make or break moment for the middle class and those trying to reach it." In that address, he said that what's at stake is the survival of the basic American promise—the idea that if you work hard, you can do well enough to raise a family, own a home, and put a little away for retirement.

Mr. Chairman, I couldn't agree more. As the President said, the defining issue of our time is how to keep that promise alive—to build a Nation where everyone gets a fair shot, everyone does their fair share, and everyone plays by the same rules. And nowhere is that challenge clearer than in the homes where we live—from when we buy a home—and make the biggest financial decision of our lifetimes—to our ability to refinance that loan, to the way banks treat us as customers should we ever lose a job or experience a medical crisis that puts our homes at risk.

Indeed, as this Committee knows well, too often in the years leading up to the crisis, mortgages were sold to people who couldn't afford or understand them. Banks made huge bets and bonuses with other people's money. The resulting recession cost more than 8 million jobs and our economy and the world plunged into a crisis from which we are still recovering.

Thanks in part to the partnership of this Committee, today we face a very different environment than the one we faced when President Obama took office. Back in January 2009, America's economy was shed 818,000 jobs alone. Housing prices had fallen for thirty straight months. And foreclosures were surging to record levels month after month after month.

Today, because the Obama administration moved to keep interest rates low and restore confidence in Fannie Mae, Freddie Mac, and the Federal Housing Administration, more than 13 million homeowners have refinanced their mortgages since April 2009—putting nearly $22 billion a year in real savings into the hands of American families and into our economy.

Today, because we provided a range of solutions to responsible families fighting to hold on to their homes, more than 5.6 million families have been able to reduce their payments and modify their loans to more sustainable terms and foreclosure notices are down nearly 50 percent since early 2009. Because we provided resources for communities struggling with concentrated foreclosures, today we are on track to help them fund better uses for almost 100,000 vacant and abandoned properties through our Neighborhood Stabilization Program. Most important of all, because of our commitment to economic growth and recover, our economy has added private sector jobs for 23 straight months, totaling 3.7 million jobs.

Mr. Chairman, this represents important progress. But we know there is much more to be done. Three key barriers prevent our housing market—and our economy—from fully recovering.

While the number of homeowners at risk of losing their home is down significantly, there are still too many families that face hardships and are underwater—and their unaffordable monthly payments put them at an increased risk of default, dragging down markets, reducing labor mobility and consumer spending alike.

While targeted support to markets struggling with foreclosures, blight and abandonment has reduced vacancy rates, increased home prices and shrunk the inventory of homes for sale, an overhang of properties at risk of or in foreclosure continues to drag down property values and harm the hardest-hit communities.

While we put an end to the worst abuses that caused this crisis and stabilized the market, it is too difficult to get a mortgage today—largely because of uncertainty over making loans attributable to lack of clarity around mortgage servicing, and continued market volatility.

And so today, I want to talk about the new tools we are providing to overcome these three key barriers—keeping people in their homes, the shadow inventory and access to credit—and the steps we still need to take to move forward.

Relief for Responsible Homeowners, Keeping People in Their Homes

First and foremost, we needed to ramp up our efforts to keep people in their homes and provide relief for homeowners who've done the responsible thing time every month when that mortgage bill arrives in their mailbox.

Mr. Chairman, millions of responsible homeowners who are current on their mortgages and could benefit from today's low interest rates face substantial barriers to refinancing through no fault of their own. Sometimes homeowners with good credit and clean payment histories are rejected because their mortgages are underwater. In the end, these responsible homeowners are stuck paying higher interest rates, costing them thousands of dollars a year.

Indeed, as economist Mark Zandi said, "There is no better way to quickly buoy hard-pressed homeowners than helping them take advantage of the currently record low fixed mortgage rates and significantly reduce their monthly mortgage payments."

That's why, on February 1st, President Obama announced a package of administrative actions and legislative proposals to help responsible homeowners save thousands of dollars through refinancing. Under his proposal, borrowers with loans insured by Fannie Mae or Freddie Mac (GSE-insured loans) would have access to streamlined refinancing through the GSEs. Borrowers with FHA insured loans will be able to take advantage of an enhanced FHA streamline refinance program. And borrowers whose loans are held by private banks or are securitized in private label securities would have access to refinancing through a new, low-cost, streamlined refinance program that would be facilitated by the FHA.

Allow me to explain each of these efforts in detail.

Refinance Assistance for Borrowers With GSE Loans—HARP 2.0

In his jobs speech to Congress last September, President Obama charged HUD and Treasury to work with the Federal Housing Finance Agency to lower barriers to refinancing. Following weeks of intensive discussions with lenders, mortgage insurers, regulators, and investors, FHFA announced changes to help borrowers whose loans were purchased or guaranteed by Fannie Mae or Freddie Mac and who are located in areas suffering from house price declines.

With the Administration's Home Affordable Refinancing Program previously limiting refinancing to borrowers with high loan-to-value ratios (LTVs) of 125 percent and responsible for less than a million refinances, the need to pick up the pace was clear. Announced in October 2011, HARP 2.0 eliminates the LTV ceiling, reduces certain risk-based loan-level guarantee fees (also referred to as loan level pricing adjustments, or LLPAs), extends the program's end date to December 2013, streamlines automated valuation model (AVM) coverage and foregoes appraisal requirement when AVM is available, and provides representations and warranties relief.

Eliminating the LTV cap will allow those GSE borrowers who have been responsible in paying their mortgage, but happen to be deeply underwater, the opportunity to take advantage of unprecedented mortgage interest rates. The extension of the program for 2 years will allow lenders to hire staff and upgrade systems to assure all eligible borrowers will have the opportunity to take advantage of the HARP program. It will minimize the amount of funds borrowers would be required to obtain for a refinance because the GSEs reduce the fees that borrowers have to pay on 30-year fixed rate loans with an LTV over 80 percent from 2 percent to .75 percent of the loan amount. And by ensuring that the GSEs do not require the HARP originator to take responsibility for the quality of the loan that is being refinanced, it will expand the universe of responsible borrowers to whom they offer the refinancing option.

In addition to these changes, the Administration continues to work with FHFA on ways to increase uptake. Specifically, the Administration is evaluating automated valuation models as approval alternatives to manual appraisals, removing operational barriers that preclude or hinder cross-servicer refinances, and seeking to extend HARP 2.0 to those borrowers with LTVs under 80 percent so that more responsible, current homeowners have the opportunity to refinance.

We expect most lenders will have their HARP 2.0 operations fully up and running by the end of March. These changes have met with a very positive response from homeowners. Already, according to an informal survey almost 300,000 families have filed applications for refinancing and stand to save on average $2,500 per year—the equivalent of a pretty good-sized tax cut—speeding our efforts to help responsible families stay in their homes and start to rebuild the wealth they lost in the economic crisis.

We look forward to working with Congress to further reduce the barriers to refinancing under HARP 2.0, including easing costs associated with mortgages that have greater equity than 80 percent, easing underwriting standards, and easing appraisal requirements.

Refinance Assistance for FHA Borrowers—FHA Streamlined Refinance

FHA Streamline Refinances allow borrowers with loans insured by the Federal Housing Administration who are current on their mortgage to refinance into a new FHA-insured loan at today's low interest rates without requiring additional underwriting, allowing these borrowers to reduce their mortgage payments in a low-cost, simple manner. This program benefits current FHA borrowers—particularly those whose loan to value may exceed the current value of their home. This both lower's a borrower's payment and reduces risk to FHA. As part of our efforts to help responsible homeowners who are current on their mortgages and because we see potential for more widespread use of this product, FHA will make changes to the way in which streamline refinance loans are displayed in the Neighborhood Watch Early Warning System (Neighborhood Watch), so that these lenders are not on the hook for loans they did not originate and thus will be more willing to provide the refinancing.

In addition to taking steps to make these refinance loans more widely available, FHA is working on adjusting the premium structure for all Streamline Refinance transactions that are refinancing FHA loans endorsed on or before May 31, 2009, to further incentivize refinance activity. These changes will ensure that borrowers benefit from a net reduction in their overall mortgage payment while still ensuring FHA has the resources to pay any necessary claims.

Broad Based Refinancing for Non-GSE, Non-FHA Borrowers

Lastly, the President has called on Congress to open up opportunities to refinancing for responsible borrowers who are current on their bills and paying their mortgage but whose loans aren't GSE or FHA-insured. Under the proposal, borrowers with standard non-GSE, non-FHA loans will have access to refinancing through a new program run through the FHA. For these responsible borrowers, there will be no more barriers and no more excuses.

Key components of this plan include:

Providing Non-GSE, Non-FHA Borrowers Access to Simple, Low-Cost Refinancing: The program will be simple and straightforward. Any borrower with a loan that is not currently guaranteed by the GSEs or insured by FHA can qualify if they meet the following criteria—each of which is designed to help reduce risk to the taxpayer:

- *They are current on their mortgage:* Borrowers will need to have been current on their loan for the past 6 months and have missed no more than one payment in the 6 months prior.
- *They meet a minimum credit score.* Borrowers must have a current FICO score of 580 to be eligible. Approximately 9 in 10 borrowers have a credit score adequate to meet that requirement.
- *They have a loan that is no larger than the current FHA loan limits in their area:* Currently, FHA limits vary geographically with the median area home price—set at $271,050 in the lowest cost areas and as high as $729,750 in the highest cost areas.
- *The loan they are refinancing is for a single family, owner-occupied principal residence*. This will ensure that the program is focused on responsible homeowners trying to stay in their homes.
- *They are currently employed.* To determine a borrower's eligibility, a lender need only confirm that the borrower is employed.

Borrowers will apply through a streamlined process designed to make it simpler and less expensive for both the borrower and the lender. The President's plan includes additional steps to reduce program costs, including:

- *Establishing loan-to-value limits for these loans.* The Administration will work with Congress to establish risk-mitigation measures which could include requiring lenders interested in refinancing deeply underwater loans (*e.g.,* greater than 140 LTV) to write down the balance of these loans before they qualify. This would reduce the risk associated with the program and relieve the strain of negative equity on the borrower.
- *Creating a separate fund for new streamlined refinancing program.* This will help the FHA better track and manage the risk involved and ensure that it has no effect on the operation of the existing Mutual Mortgage Insurance (MMI) Fund, which is FHA's already established insurance fund.

Cost-Savings to the Borrowers who Participate in This New Program: Given today's record low interest rates, we estimate that on average, borrowers who participate in this program would reduce their monthly payments by between $400 and $500 a month.

Option To Rebuild Equity in Their Homes Through This Program: All underwater borrowers who decide to participate in this refinancing program through the FHA outlined above will have a choice: they can take the benefit of the reduced interest rate in the form of lower monthly payments, or they can apply that savings to rebuilding equity in their homes. The latter course, when combined with a shorter loan term of 20 years, will give the majority of underwater borrowers the chance to get back above water within 5 years, or less.

To encourage borrowers to make the decision to rebuild equity in their homes, we are proposing that the legislation provide for the closing costs of borrowers who chose this option—a value averaging about $3,000. To be eligible, a participant in this option must agree to refinance into a loan with a term of no more than 20 years and with monthly payments roughly equal to those they make under their current loan. For those who agree to these terms, their lender will receive payment for all closing costs directly from the FHA or another entity involved.

A Separate FHA Fund: The broad based refinance program will have a separate fund that is funded through premiums established and direct funding provided under this program with its net cost offset by the financial crisis fee. The program's premium structure will be designed in a way to ensure that homeowners have the incentive for lower monthly payments through the program. By maintaining a separate fund and funding source for this program the broad-based refinance will not be contingent on appropriations action and will have no impact on FHA's MMI Fund which, as the Committee knows, has been strained in recent years.

We look forward to working with Members of this Committee to craft legislation to accomplish these goals and offset the costs associated with establishing a broad-based refinance program.

Further easing refinancing through HARP 2.0, the FHA streamlined refinance, and expanding refinance options for homeowners with non-GSE and non FHA loans finally ties together a critical patchwork of refinance programs. By working together with Congress, we can ensure that every family can have the opportunity to take advantage of today's historically low interest rates. This will save homeowners thousands of dollars a year, and as a result provide much needed payment relief and further strengthen the economy.

HAMP Changes and Extension

In February 2009, the Obama administration introduced the Making Home Affordable Program and the Home Affordable Modification Program (HAMP) to stabilize the housing market and to help struggling homeowners get relief and avoid foreclosure.

As I noted at the beginning of my testimony, since that time more than 5.6 million families have received mortgage modifications with affordable monthly payments—which include more than 1.7 million HAMP trial modification starts. HAMP is managed primarily by Treasury.

There is no question that HAMP has had a positive impact on the private market. Before President Obama took office, as many of you know, many mortgage modifications actually increased costs for borrowers. HAMP has not only helped keep families in their homes—it's also helped set a standard for affordability in the private market, where families today save an average of $333 per month.

And we've made changes to respond to evolving challenges. For instance, when foreclosures began to migrate from the subprime to the prime market because of unemployment, we expanded our focus to offer more help for unemployed homeowners—requiring servicers participating HAMP to give borrowers a minimum of 12 months to catch up on payments while they are looking for work.

In addition, last month, the Administration took a series of steps to expand the eligibility for HAMP and maximize its impact.

Expanded Eligibility: To ensure HAMP reaches a broader pool of distressed homeowners, we opened the program up to those who struggle with secondary debt, such as second liens, medical bills, and credit cards.

In particular, the Administration has created a second tier that would provide modification relief to borrowers not currently eligible. This tier would include:

- Mortgages secured by properties that are currently tenant occupied or properties that are vacant but which the borrower certifies intention to rent.
- Borrowers failing to satisfy the 31 percent debt-to-income (DTI) test, unable to achieve the target monthly mortgage payment ratio without excessive forbearance or who have received a negative net present value (NPV) test due to other factors.

These changes will not only not only help homeowners, but also stabilize neighborhoods struggling with foreclosures by helping hundreds of thousands of owners who rent their properties avoid foreclosure—in turn, keeping more families in their homes.

Principal Reduction: Still, it's not enough to lower the barriers to participation in HAMP—we also need to increase its impact. HAMP has made a real difference for the families who have received a modification—saving an average of more than $500 per month. But to rebuild the equity these families have lost, lowering payments isn't enough.

That's why we are also increasing incentives for cost-effective mortgage modifications that include a write-down of the borrower's principal balance through HAMP.

With these changes to the Principal Reduction Alternative (PRA), whereby investors are eligible for financial compensation incentives whenever the servicer provides a borrower with a permanent modification that reduces mortgage principal, we are tripling the incentives provided to encourage modifications that rebuild equity.

Specifically, with respect to loans which were less than or equal to 6 months past due at all times during the 12-month period prior to the NPV evaluation date, investors will be entitled to receive, effective in May 2012:

- $0.63 per dollar of principal reduction equal to or greater than 105 percent and less than 115 percent mark-to-market LTV (MTM) ratio;
- $0.45 per dollar of principal reduction equal to or greater than 115 percent and less than or equal to 140 percent MTMLTV ratio; and
- $0.30 per dollar of principal reduction in excess of 140 percent MTMLTV ratio

With respect to loans which were more than 6 months past due at any time during the 12-month period prior to the NPV evaluation date, irrespective of MTMLTV (mark-to-market loan-to-value) ratio range, investors will be paid $0.18 per dollar of principal reduction and will not be eligible for incentives in the above extinguishment schedule. These improvements to HAMP augment incentives in a meaningful way for investors to allow for a greater degree of principal reduction of loans underlying the securities they own, thus keeping more people in their homes with mortgages they can afford.

To further increase the amount of principal reduction provided to borrowers, we are also working to expand it to those with loans guaranteed by the GSEs. Borrowers with GSE loans have been unable to benefit from the PRA modification due to FHFA restrictions on the use of principal reduction in modifications. So homeowners couldn't benefit solely because they had a GSE loan. In order to ensure consistency throughout the HAMP program, and to ensure that homeowners can be considered for rebuilding equity modifications, we have notified FHFA that Treasury will pay these incentives to the GSEs if they participate in the program.

Sunset Extension: Lastly, we have extended HAMP's sunset deadline. Originally slated to sunset at the end of 2012, HAMP has been extended to December 31, 2013, which conforms to the recently extended deadline for HARP and provides an expanded window of time for homeowners to gain relief which investors provide while preserving their investments.

Strengthening FHA's Mutual Mortgage Insurance Fund

The books of business in the few years before 2009 have largely driven the high number of claims to the MMI Fund. This was driven by overall economic and unemployment trends as well as by the combined effects of poor underwriting, unscrupulous and noncompliant practices on the part of lenders, and a seller-funded downpayment assistance program that allowed many borrowers to obtain mortgages that they shouldn't have or without a meaningful down payment. As a result, the books of business FHA insured prior to the start of this Administration have severely impacted the health of FHA's MMI Fund. But thanks to our efforts, I can say confidently that FHA is moving in another direction, and that the long term outlook for FHA and the Fund are now much better than they were in 2009. Through systematic tightening of risk controls, increased premiums to stabilize near-term finances and expanded usage of loss mitigation workout assistance to avoid unnecessary claims, the efforts of this Administration have led to the highest quality of loans FHA has seen in its history.

And still, we continue to take steps to further strengthen the Fund. In the FY2013 Budget submission we included 10 bps annual premium increase passed late last year by Congress on all FHA insured loans mandated by law in December, as well as an additional 25 bps annual premium increase on "jumbo" loans making the total increase for these larger loans 35 bps. And, just last yesterday, we announced a series of premium changes that will further increase receipts to FHA by $1 billion in fiscal years 2012 and 2013, beyond the receipts already included in the President's budget submission. In addition, we have also taken significant additional steps to increase accountability for FHA lenders discussed in more detail below.

Yet, despite the unprecedented efforts of the Administration to alter the trajectory of FHA, considerable risks remain. The FHA Mutual Mortgage Insurance (MMI) Fund has two components: the Financing Account, which holds enough money to accommodate expected 30-year losses on FHA's insured portfolio as of the end of the current fiscal year; and the Capital Reserve Account, which is required to hold an additional amount equal to 2 percent of the insurance in force. Since 2009, the Fund's capital reserve ratio has been below that 2 percent level.

Annually, the President's Budget includes estimates regarding the status of the capital reserve at the end of the current fiscal year. This prediction is based on estimates and projections of future economic conditions, including house prices and other economic factors. The 2013 Budget estimate for the FHA Capital Reserve account in fiscal year 2012 did not include the added revenue from the further increased premiums and the proceeds from the recently announced settlements with FHA-approved lenders. With these additional revenues accounted for, the Capital Reserve is estimated to have sufficient balances to cover all future projected losses without triggering a mandatory appropriation under the Federal Credit Reform Act. What's more, the Budget estimates, FHA will add an additional $8 billion to the Capital Reserve Account in 2013, and will return to the congressionally mandated capital reserve ratio of 2 percent by 2015.

As we undertake efforts to strengthen FHA and lay the foundations for the return of private capital, it is important to recognize the critical role that FHA has and continues to play in times of stress on the housing market. One of the critical purposes of the FHA is to stand as a bulwark of liquidity in a time when capital has fled the market, and in such times the FHA will inevitably grow beyond the size that we would be comfortable with, taking on more risk that we would normally be comfortable with. We are in such a time now. So while we will continue to take the steps needed to ensure an FHA that is as strong as we can make it, and we will gradually take the steps needed to pull the FHA back from the market to crowd in more private capital, we must not forget that it is playing an absolutely critical role today, ensuring access to capital in an environment when capital is extremely difficult to come by. As we discuss and consider ways to strengthen FHA and to create an environment for the return of private capital, we must be mindful of its continued critical role inherent in its mission—providing home ownership opportunities to families that do not have access to traditional financing, and to serve as vital source of credit, when the broader market undergoes stress.

Reducing the Overhang and Shadow Inventory

At the same time we provide relief to responsible homeowners and keep families in their homes, we also need to attack the second barrier to our housing recovery: the shadow inventory—the overhang of properties that are at risk of or already in foreclosure.

REO to Rental

With the rental market recovering faster, we need to think creatively about ways we can dispose of this shadow inventory.

With the purchase market continuing to be dragged down by the glut of vacant foreclosed properties and rental rates rising as those who lose their homes to foreclosure seek rental housing, there is an unprecedented imbalance of supply and demand between the purchase and rental markets.

When there are vacant and foreclosed homes in neighborhoods, it undermines home prices and stalls the housing recovery. As part of the Administration's effort to help lay the foundation for a stronger housing recovery, the Department of Treasury and HUD have been working with the FHFA on a strategy to transition REO properties into rental housing. Repurposing foreclosed and vacant homes will reduce the inventory of unsold homes, help stabilize housing prices, support neighborhoods, and provide sustainable rental housing for American families.

With about a quarter-of-a-million foreclosed properties owned by HUD and the GSEs, this August, HUD joined with FHFA and Treasury to issue a "Request for Information" to generate new ideas for absorbing excess inventory and stabilizing prices. In all, about 4,000 submissions were received.

Over the past several months, the interagency task force has been reviewing the submissions and formulating strategies based on the best practices gathered from the RFI. Throughout this process, the task force has continuously met with industry members, community groups and other key stakeholders to make sure they are heard in the strategy development process.

We expect a range of strategies to emerge; however the most commonly discussed centers around selling REO properties to buyers who will convert and market them as rental units.

Recently, the FHFA, in conjunction with Treasury and HUD, announced that investors may prequalify for the first major pilot sale of foreclosed properties repurposed into rental housing. This marks the first of a series of steps that the FHFA and the Administration are taking to develop a smart national program to help manage REO properties, and ease the pressure of these distressed properties on communities and the housing market.

We plan to learn and leverage all we can from this initial pilot as we work towards conducting a series of additional pilots throughout the rest of the year.

Project Rebuild

While expanding REO-to-Rental is a critical tool, in the hardest-hit markets, where prices have dropped most and the most vacant and abandoned buildings are found, more needs to be done to jumpstart construction and reduce vacancy rates.

As I mentioned earlier, the Neighborhood Stabilization Program (NSP) has helped improved sale prices and vacancy rates in areas with concentrated investments. In fact, three-quarters of communities across the country with targeted neighborhood stabilization investments have seen vacancy rates go down—and two-thirds have seen home prices go up compared to surrounding communities. Further, the $7 billion that has been allocated under the three phases of NSP will support an estimated 88,000 jobs by the time the funding is fully spent. These jobs are created in a variety of fields including housing construction, infrastructure construction, maintenance and repair, management, technical consulting services, real estate, State and local Government.

In Hernando County, Florida, our NSP investments have helped families move in to once-foreclosed homes in hard-hit places. Just as importantly, they've helped keep construction workers on the job and given real estate agents the opportunity to show and sell homes once again. Indeed, in the La Puente community, a predominately Hispanic suburb outside Los Angeles, these efforts have helped increase home prices by nearly 15 percent.

However, even in these NSP investment clusters, NSP has been able to reach only 46 percent of the census tracts in the United States that are hardest hit by the foreclosure and unemployment crisis. That is why President Obama has proposed Project Rebuild to further stabilize neighborhoods and communities, an initiative which would create 200,000 jobs in the places that need them most.

Nearly two thirds of the $15 billion Project Rebuild funding will be provided to States and local governments by formula as specified in the American Jobs Act. The remaining third will be allocated by competition—which is open to State and local governments, nonprofits, and for profit entities and consortia of these parties. Project Rebuild proposes important modifications to the NSP model to extend the benefits of the program beyond affordable housing, enabling greater job creation, and a broader positive impact on neighborhoods.

Recognizing that it's not just abandoned homes that can drag down an entire neighborhood, but also vacant commercial properties, Project Rebuild broadens eligible uses to allow commercial projects and other direct job creating activities, capped at 30 percent of funds. Up to 10 percent of formula grants may be used for establishing and operating jobs programs to maintain eligible neighborhood properties. Formula funding will go directly to States and entitlement communities across the country. Competitive funds will be available to States, local governments, for-profit entities, nonprofit entities and consortia of these entities.

Each State will receive a minimum of $20 million of the $10 billion in formula funds. Funds will be targeted to areas with home foreclosures, homes in default or delinquency, and other factors, such as unemployment, commercial foreclosures, and other economic conditions. Project Rebuild also will expand the ability of the private sector to participate with localities—ensuring there is the expertise and capacity to bring these neighborhoods back in a targeted way. I urge the Committee to join with the Administration in working toward the enactment of this proposal.

Reducing Uncertainty, Improving Access to Credit

Of course, underlying many of the issues in our housing market is a lack of certainty—of a clear understanding of the rules of the road lenders need to do business and our housing market needs to recover. And one way to reduce uncertainty is to clear away barriers to recovery—to resolve these matters in a way that holds those responsible accountable, but moves us forward by creating conditions more conducive for lending.

Lender Indemnification

As part of FHA's continued efforts to protect and strengthen the MMI Fund, facilitate access to mortgage credit for qualified borrowers and provide clarity to our lending partners, last month FHA issued final rule governing the process for receiving and maintaining approval to participate in the Lender Insurance (LI) process. These new regulations will provide greater clarity regarding our expectations for our LI lending partners, as well as the actions we will take to prevent losses when those standards are not met.

The regulations reiterate FHA's commitment to ongoing quality assurance reviews of lenders with LI authority. In addition, the rule sets a standard for what constitutes a "serious and material violation" of FHA origination requirements. Serious and material violations, as well as instances of fraud or misrepresentation, will require indemnification by LI mortgagees. In providing a standard for these violations, along with a clear process by which FHA will require indemnifications for loans that do not meet these standards, FHA is providing a level of certainty to our partners with regard to the types of violations which are actionable under HUD policy.

It is significant, however, that FHA currently has the ability to exercise this indemnification authority with respect to only one of our two classes of FHA approved lenders. FHA Direct Endorsement (DE) Lenders are currently not subject to the same regulations with regard to indemnification. In order to protect the MMI Fund and ensure the term viability of the FHA, the Administration continues to pursue legislation to allow FHA to pursue indemnifications from these DE lenders.

In addition, we believe it is important for the Federal Housing Finance Agency to work with Fannie Mae and Freddie Mac to make clear the rules of the road for GSE lenders with straightforward and well defined representations and warranties that will further reduce uncertainty around repurchase risk. Equipping banks with a better understanding of what mortgages they can be held responsible for can yield positive externalities with respect to REO inventory overhang and the damaging impact of foreclosures on house prices.

Homeowner Bill of Rights

Consumers need certainty and clarity most of all. The Homeowners Bill of Rights recently announced by President Obama would guarantee consumers access to a simple mortgage disclosure form, so borrowers understand the loans they are taking out; full disclosure of fees and penalties; guidelines to prevent conflicts of interest that end up hurting homeowners; support to keep responsible families in their homes and out of foreclosure; and, protection for families against inappropriate foreclosure, including right of appeal.

Tackling All Three Barriers: Mortgage Servicing Settlement

All three of the barriers I have described—keeping people in their homes, the shadow inventory, and uncertainty—are addressed by the historic mortgage servicing settlement the Obama administration and a bipartisan coalition of attorneys general from 49 States reached providing at least $25 billion on behalf of American homeowners.

The product of 16 months of intensive negotiations between the five banks and an unprecedented coalition of State attorneys general and Federal agencies, including the Departments of Justice, Treasury, and HUD, that spanned partisan lines, the settlement helps families keep their homes and reduces the shadow inventory by providing relief to homeowners, in part by forcing banks to reduce the principal balance on many loans, refinancing loans for "underwater" borrowers. In addition the settlement will pay billions of dollars to States to stabilize communities and cover the costs associated with the foreclosure crisis and consumers who have been foreclosed upon.

And it reduces uncertainty by providing clear servicing standards going forward for these five institutions which currently service over 70 percent of all mortgages—standards that can set the stage for servicing standards going forward.

Background

In the summer of 2010, HUD initiated a large-scale review of the FHA's largest servicers, devoting thousands of hours to reviewing servicing files for thousands of FHA-insured loans. While we began with a focus on failure to engage in loss mitigation, the scope of this review encompassed a long list of mortgage servicing issues, such as lost paperwork, long delays and missed deadlines. As HUD's Office of the Inspector General found, the country's five largest loan servicers routinely signed foreclosure related documents without really knowing whether the facts they contained were even correct.

In effect, many of the very same financial institutions responsible for selling loans to people who couldn't afford them and then packaging those mortgages to make profits, effectively fueling the housing crisis, were actually making it worse—harming families, neighborhoods and our economy.

Following revelations of widespread use of "robo-signed" affidavits in foreclosure proceedings across the country, the Federal–State working group launched an investigation into the problem and confronted the 5 largest servicers, representing more than 80 percent of the loans serviced, about these problems. These banks soon acknowledged that individuals had been signing thousands of foreclosure affidavits without reviewing the validity or accuracy of the sworn statements. Several national banks then agreed to stop their foreclosure filings and sales until corrective action could be taken.

Other servicer-related problems were identified as well, including deceptive practices in the offering of loan modifications (for example, telling consumers that a loan modification was imminent while simultaneously foreclosing). These performance failures resulted in more than just poor customer service. Unnecessary foreclosures occurred due to failure to process homeowners' requests for modified payment plans. And where foreclosures should have been concluded, shoddy documentation led to protracted delays. This misconduct not only harmed homeowners—but communities, our housing market and economy.

Relief for Homeowners

The settlement imposes monetary sanctions on the banks while providing immediate and continuing relief to homeowners. The single largest Federal–State civil settlement ever agreed to—and the largest financial recovery from the banks during this crisis—the accord will enable hundreds of thousands of distressed homeowners to stay in their homes through enhanced loan modifications. It will also fund payments to victims of unfair foreclosure practices and provide support for housing counseling and State-level foreclosure prevention programs.

One of the most important features of the settlement is the $17 billion in consumer relief options that will offer homeowners a variety of home retention and home disposition alternatives. Because the banks will receive credit for employing these options at specified credit rates (*e.g.*, a deficiency waiver carries a 10 percent credit, so for every dollar supplied by the bank, it would only count 10 cents), this $17 billion has the potential to provide as much as $32 billion in relief.

Much of this relief will come in the form of principal reduction for distressed homeowners. Enabling these families to restructure their debt and start building equity again not only improves their prospects—but also those of their neighbors who have watched property values plummet by $5,000–10,000 simply because there are foreclosures on their block.

In addition, it provides:

- $3 billion for refinances for current homeowners who, because their home values are underwater, would not be able to refinance their mortgages into lower interest rate loans.
- Approximately $2.6 billion to States which can choose to apply funds to repay public funds lost as a result of servicer misconduct, fund housing counselors, legal aid, and other similar purposes determined by State attorneys generals.
- A $1.5 billion Borrower Payment Fund for borrowers who were foreclosed upon on or after January 1, 2008. Banks must notify those borrowers of their right to file a claim. Payout is anticipated to be approximately $2,000 per person, depending upon levels of claim and whether they meet some relatively basic criteria. Borrowers receiving claims will not have to waive any legal rights or claims against the banks, and can seek additional relief.

With specific regard to the Borrower Payment Fund, as I noted earlier, when HUD initiated a large-scale review of the FHA's largest servicers in the summer of 2010, we found that families who should not have gotten into trouble—and who should have been able to get some help early on that was both good for them and good for the lender—didn't get that help—help that in many cases banks were legally obligated to provide.

These $2,000 payments will be made to families who suffered from these kinds of errors—where borrowers were charged fees that they shouldn't have been or had dropped calls or lost paperwork when they sought help with their mortgages.

For families who suffered much deeper harm—who may have been improperly foreclosed on and lost their homes and could therefore be owed hundreds of thousands of dollars in damages—the settlement preserves their ability to get justice in two key ways:

First, if a borrower can document that they were improperly foreclosed on, they can receive every cent of the compensation they are entitled to through a process established by Federal banking regulators. The agreement also preserves the right of homeowners to take their servicer to court. Indeed, if banks or other financial institutions broke the law or treated the families they served unfairly, they should pay the price—and with this settlement they will.

I would note that these funds are paid entirely by the banks. The taxpayer doesn't pay a dime.

And homeowners aren't the only ones who will see the benefits of this settlement. So, too, will the taxpayer who has paid a steep price for financial institutions' failure to follow the law when it came to families who had FHA-insured loans. In addition to the steps I mentioned earlier that FHA is taking to protect its MMI fund, approximately $900 million from this settlement will help shore up the FHA's finances, preserving this critical resource for the future and protecting taxpayers' investment.

Residential Mortgage Backed Security Group

While this historic settlement will offer significant help to those who suffered the most harm and provide a path toward stability for our housing market and our broader economy, it isn't designed to address all the issues of the housing crisis. While it resolves certain violations of civil law based on the banks' mortgage loan servicing activities, the United States and the State attorneys general preserved the right to pursue claims in a number of important areas, including criminal authorities, securities claims, and loan origination claims.

Indeed, in some ways, just as important as what this settlement accomplishes is what it does not do. It will not prevent State attorneys general or regulators from pursuing criminal cases or conducting investigations that get to the bottom of the crisis. Last month, Attorney General Holder and I joined New York Attorney General Schneiderman and several other State attorneys general in announcing a working group comprised of representatives from DOJ, HUD, SEC, and the State AGs focused on investigating the conduct of financial servicers that broke the law and contributed to the crash of the housing market, including securities- and origination-related cases.

New Customer Service Standards

That's why this agreement forces the banks that service nearly 2 out of every 3 mortgages to take action to address the problems uncovered during our investigations.

In particular, these standards prohibit robo-signing, improper documentation and lost paperwork; clarify what servicers have to do on foreclosures and modifications, including requiring strict oversight of foreclosure processing, including of third-party vendors; make foreclosures a last resort by requiring servicers to evaluate homeowners for other loan mitigation options first; restrict banks from foreclosing while the homeowner is being considered for a loan modification; and establish procedures and timelines for reviewing loan modification applications, and give homeowners the right to appeal denials. Having to satisfy these requirements, banks are also more certain of the costs associated with them.

These standards will set the stage for clear, national servicing rules for all servicers which the new Consumer Financial Protection Bureau, under the leadership of Director Richard Cordray, and along with an interagency team comprised of independent regulators as well as Treasury and HUD, are working to craft These national standards are an aggressive and critical first step in a broader Administration effort to provide a single, straightforward set of commonsense rules that are in keeping with Homeowner Bill of Rights that families can count on when they're buying a home and paying their mortgage. The standards in this settlement will serve as benchmark for the development of these uniform rules, giving people the confidence that lenders and servicers are following a long list of rights should they ever lose a job or have a medical emergency that puts their home at risk.

Lastly, the settlement's release of limited origination claims with both Bank of America and Citibank which, coupled with the Lender Insurance indemnification rule discussed earlier, provides clarity for lenders on when the FHA will take action, reducing concerns over lawsuits and additional reputational risk. In the same way, clarifying representations and warranties at the GSE level will help to achieve a well-defined and well understood buyback policy that fosters a degree of uniformity and certainty across the Government-backed space.

An Economy Built to Last

And so, Mr. Chairman, as you can see, we have made very important, significant progress in recent months to get our housing market back on track—helping tens of thousands of additional families refinance, putting in place the most significant principal reduction effort in history and establishing critical consumer protections that hold powerful institutions accountable for their actions, help our housing market recover and give every homeowner the dignity, respect and fair treatment they deserve.

But for all this progress, we can't declare victory and go home. We still need Congress to act to ensure that every responsible family in America, regardless of who services their loan, has the opportunity to refinance.

We still need to continue our work together to create a robust private system of housing finance and protect the FHA fund for the future.

And we still need a balanced national housing policy that ensures Americans have access to credit for those in a position for sustainable home ownership, assistance for those who feel the strain of high housing costs, rental options near good schools and good jobs, and above all—choices in housing that make sense for them and for their families.

That is the goal of all this work—and it is fundamental to creating an economy built to last. And I look forward to working with Congress to make it possible. Thank you.

PREPARED STATEMENT OF ELIZABETH A. DUKE

GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 28, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to talk about the current situation in housing markets.

The Federal Reserve has a keen interest in the state of housing and has been actively engaged in analyzing issues in the housing and mortgage markets. Issues related to the housing market and housing finance are important factors in the Federal Reserve's various roles in formulating monetary policy, regulating banks, and protecting consumers of financial services. In particular, the failure of the housing market to respond to lower interest rates as vigorously as it has in the past indicates that factors other than financial conditions may be restraining improvement in mortgage credit and housing market conditions and thus impeding the economic recovery. Federal Reserve staff have been actively working to understand the reasons behind the impairment in housing and mortgage markets and the tradeoffs involved in designing policies that would remove obstacles to normal market functioning.

On January 4, 2012, the Federal Reserve released a staff paper titled "The U.S. Housing Market: Current Conditions and Policy Considerations", which is attached at the end of my written statement. The paper provides information on current conditions in the housing market and analytic background on some housing market issues. Although the paper does not include recommendations for any specific policy actions, it does lay out a framework for discussion by outlining some options and tradeoffs for policy makers to consider. My testimony today will be drawn from this paper.

Six years after aggregate house prices first began to decline, and more than 2 years after the start of the economic recovery, the housing market remains a significant drag on the U.S. economy. In a typical economic cycle, as the economy turns down households postpone purchases of durable goods such as housing. Once the cycle bottoms out, improving economic prospects and diminishing uncertainty usually help unleash this pent-up demand. This upward demand pressure is often augmented by lower interest rates, to which housing demand is typically quite responsive.

The current economic recovery has not followed this script, in part because the problems in the housing market are a cause of the downturn as well as a consequence of it. The extraordinary fall in national house prices has resulted in $7 trillion in lost home equity, more than half the amount that prevailed in early 2006. This substantial blow to household wealth has significantly weakened household spending and consumer confidence. Another result of the fall in house prices is that around 12 million households are now underwater on their mortgages—that is, they owe more on their mortgages than their homes are worth. Without equity in their homes, many households who have experienced hardships, such as unemployment or unexpected illness, have been unable to resolve mortgage payment problems through refinancing their mortgages or selling their homes. The resulting mortgage delinquencies have ended in all too many cases in foreclosure, dislocation, and personal adversity. Neighborhoods and communities have also suffered profoundly from the onslaught of foreclosures, as the neglect and deterioration that may accompany vacant properties makes neighborhoods less desirable places to live and may put further downward pressure on house prices.

An ongoing imbalance between supply and demand exacerbates these problems in the housing market. For the past few years, the actual and potential supply of single-family homes for purchase has greatly exceeded the effective demand, in part because of the large number of homes that have come back onto the market after moving through the foreclosure process. The elevated pace of foreclosures, unfortunately, is likely to be sustained for quite a while and therefore will continue to put downward pressure on home prices.

At the same time, a host of factors have been weighing on housing demand. Many households have been reluctant or unable to purchase homes because of concerns about their income, employment prospects, and the future path of home prices. Tight mortgage credit conditions have also prevented many households from purchasing homes. Although some retrenchment in lending standards was necessary and appropriate given the lax standards that prevailed before the crisis, current lending practices appear to be limiting or preventing lending even to creditworthy households.

In the paper, we discussed the benefits and costs of a variety of policy options that have been proposed to respond to these difficult housing issues, including increasing credit availability for households seeking to purchase a home or to refinance an existing mortgage; exploring the scope for further mortgage modifications, including encouraging short sales and deeds-in-lieu of foreclosure in cases where foreclosure cannot be avoided; and expanding the options available for holders of foreclosed properties to dispose of their inventory responsibly. Any policy proposals, though, will require wrestling with difficult choices and tradeoffs, as initiatives to benefit the housing market will likely involve shifting some of the burden of adjustment from some parties to others.

I greatly appreciate the leadership that the Senate Banking Committee has shown on the profound challenges facing the housing market. For its part, the Federal Reserve will continue to use its policy tools to support the economic recovery and carry out its dual mandate to foster maximum employment in the context of price stability. In its supervisory capacity, the Federal Reserve will continue to encourage lenders to find ways to maintain prudent lending standards while serving creditworthy borrowers.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

January 4, 2012

The U.S. Housing Market: Current Conditions and Policy Considerations

The ongoing problems in the U.S. housing market continue to impede the economic recovery. House prices have fallen an average of about 33 percent from their 2006 peak, resulting in about $7 trillion in household wealth losses and an associated ratcheting down of aggregate consumption. At the same time, an unprecedented number of households have lost, or are on the verge of losing, their homes. The extraordinary problems plaguing the housing market reflect in part the effect of weak demand due to high unemployment and heightened uncertainty. But the problems also reflect three key forces originating from within the housing market itself: a persistent excess supply of vacant homes on the market, many of which stem from foreclosures; a marked and potentially long-term downshift in the supply of mortgage credit; and the costs that an often unwieldy and inefficient foreclosure process imposes on homeowners, lenders, and communities.

Looking forward, continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery. Of course, some of the weakness is related to poor labor market conditions, which will take time to be resolved. At the same time, there is scope for policymakers to take action along three dimensions that could ease some of the pressures afflicting the housing market. In particular, policies could be considered that would help moderate the inflow of properties into the large inventory of unsold homes, remove some of the obstacles preventing creditworthy borrowers from accessing mortgage credit, and limit the number of homeowners who find themselves pushed into an inefficient and overburdened foreclosure pipeline. Some steps already being taken or proposed in these areas will be discussed below.

Taking these issues in turn, the large inventory of foreclosed or surrendered properties is contributing to excess supply in the for-sale market, placing downward pressure on house prices and exacerbating the loss in aggregate housing wealth. At the same time, rental markets are strengthening in some areas of the country, reflecting in part a decline in the homeownership rate. Reducing some of the barriers to converting foreclosed properties to rental units will help redeploy the existing stock of houses in a more efficient way. Such conversions might also increase lenders' eventual recoveries on foreclosed and surrendered properties.

Obstacles limiting access to mortgage credit even among creditworthy borrowers contribute to weakness in housing demand, and barriers to refinancing blunt the transmission of monetary policy to the household sector. Further attention to easing some of these obstacles could contribute to the gradual recovery in housing markets and thus help speed the overall economic recovery.

Finally, foreclosures inflict economic damage beyond the personal suffering and dislocation that accompany them.[1] In particular, foreclosures can be a costly and inefficient way to resolve the inability of households to meet their mortgage payment obligations because they can result in "deadweight losses," or costs that do not benefit anyone, including the neglect and deterioration of properties that often sit vacant for months (or even years) and the associated negative effects on neighborhoods.[2] These deadweight losses compound the losses that households and creditors already bear and can result in further downward pressure on house prices. Some of these foreclosures can be avoided if lenders pursue appropriate loan modifications aggressively and if servicers are provided greater incentives to pursue alternatives to foreclosure. And in cases where modifications cannot create a credible and sustainable resolution to a delinquent mortgage, more-expedient exits from homeownership, such as deeds-in-lieu of foreclosure or short sales, can help reduce transaction costs and minimize negative effects on communities.

Intertwined in these issues is the unresolved role of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, in both the near term and long term.[3] The GSEs hold or guarantee significant shares of delinquent mortgages and foreclosed properties. Because of their outsized market presence, the GSEs' actions affect not only their own portfolios, but also the housing market overall. However, since September 2008, the GSEs have operated in conservatorship under the direction of the Federal Housing Finance Agency (FHFA), with specific mandates to minimize losses for taxpayers and to support a stable and liquid mortgage market. In many of the policy areas discussed in this paper--such as loan modifications, mortgage refinancing, and the disposition of foreclosed properties--there is bound to be some tension between minimizing the GSEs' near-term losses and risk exposure and taking actions that might promote a faster recovery in the housing market. Nonetheless, some actions that cause greater losses to be sustained by the GSEs in the near term might be in the interest of taxpayers to pursue if those actions result in a quicker and more vigorous economic recovery.

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[1] This paper does not address the important issues surrounding whether lenders and servicers have appropriately carried out their roles in foreclosures. In April 2011, the Federal Reserve, along with the other federal banking agencies, announced formal enforcement actions requiring many large banking organizations to address a pattern of misconduct and negligence related to deficient practices in residential mortgage loan servicing and foreclosure processing. These deficiencies represented significant and pervasive compliance failures and unsafe and unsound practices at these institutions. For further information, see Board of Governors of the Federal Reserve System (2011), "Federal Reserve Issues Enforcement Actions Related to Deficient Practices in Residential Mortgage Loan Servicing and Foreclosure Processing," press release, April 13, www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm, and Board of Governors of the Federal Reserve System (2011), "Federal Reserve Board Announces a Formal Enforcement Action against the Goldman Sachs Group, Inc., and Goldman Sachs Bank USA," press release, September 1, www.federalreserve.gov/newsevents/press/enforcement/20110901b.htm.

[2] See, for example, John Y. Campbell, Stefano S. Giglio, and Parag P. Pathak (2011), "Forced Sales and House Prices," *American Economic Review*, vol. 101 (August), pp. 2108–31, www.aeaweb.org/atypon.php?return_to=/doi/pdfplus/10.1257/aer.101.5.2108; and Dan Immergluck and Geoff G. Smith (2006), "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate*, vol. 17 (1), pp. 57–80 (Washington: Fannie Mae Foundation), http://content.knowledgeplex.org/kp2/cache/documents/1860/186040.pdf.

[3] This paper does not discuss alternatives for longer-term restructuring of the housing finance market, including the future form or role of the GSEs.

In this report, we provide a framework for thinking about directions policymakers might take to help the housing market. Our goal is not to provide a detailed blueprint, but rather to outline issues and tradeoffs that policymakers might consider. We caution, however, that although policy action in these areas could facilitate the recovery of the housing market, economic losses will remain, and these losses must ultimately be allocated among homeowners, lenders, guarantors, investors, and taxpayers.

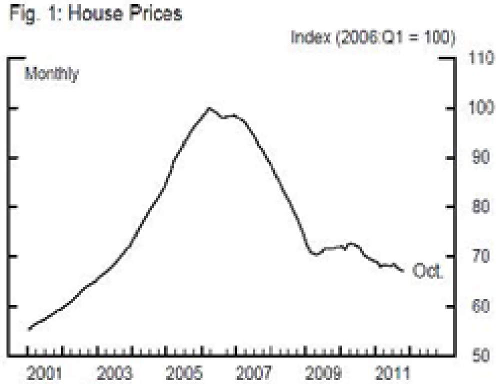
We begin with some background regarding housing market conditions. We then discuss proposals aimed at foreclosed properties that are owned by financial institutions such as the GSEs or banks. After that, we examine proposals aimed at homeowners at risk of default or foreclosure. Finally, we discuss ideas for improving mortgage servicing practices.

Housing Market Conditions

House Prices and Implications for Household Wealth

House prices for the nation as a whole (figure 1) declined sharply from 2007 to 2009 and remain about 33 percent below their early 2006 peak, according to data from CoreLogic. For the United States as a whole, declines on this scale are unprecedented since the Great Depression. In the aggregate, more than $7 trillion in home equity (the difference between aggregate home values and mortgage debt owed by homeowners)--more than half of the aggregate home equity that existed in early 2006--has been lost. Further, the ratio of home equity to disposable personal income has declined to 55 percent (figure 2), far below levels seen since this data series began in 1950.[4]

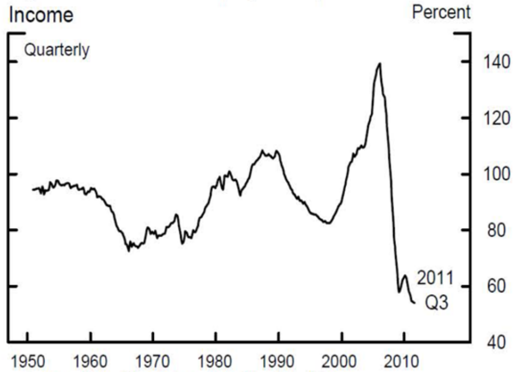
Fig. 1: House Prices



Source: CoreLogic.

[4] Data are from the Federal Reserve Board's Flow of Funds Accounts.

Fig. 2: Ratio of Home Equity to Disposable Personal Income



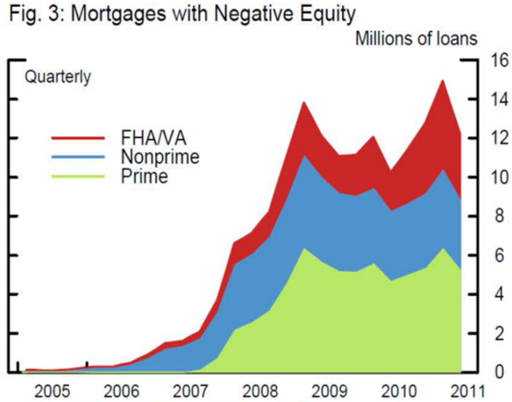
Source: Flow of Funds Accounts of the United States.

This substantial blow to household wealth has significantly weakened household spending and consumer confidence. Middle-income households, as a group, have been particularly hard hit because home equity is a larger share of their wealth in the aggregate than it is for low-income households (who are less likely to be homeowners) or upper-income households (who own other forms of wealth such as financial assets and businesses). According to data from the Federal Reserve's Survey of Consumer Finances, the decline in average home equity for middle-income homeowners from 2007 through 2009 was about 66 percent of the average income in 2007 for these homeowners. In contrast, the decline in average home equity for the highest-income homeowners was only about 36 percent of average income for these homeowners.[5]

For many homeowners, the steep drop in house prices was more than enough to push their mortgages underwater--that is, to reduce the values of their homes below their mortgage balances (a situation also referred to as negative equity). This situation is widespread among borrowers who purchased homes in the years leading up to the house price peak, as well as those who extracted equity through cash-out refinancing. Currently, about 12 million homeowners are underwater on their mortgages (figure 3)--more than one out of five homes with a mortgage.[6] In states experiencing the largest overall house price declines--such as Nevada, Arizona, and Florida--roughly half of all mortgage borrowers are underwater on their loans.

[5] Middle-income households are defined as those in the 40th through 60th percentiles of the household income distribution. High-income households are defined as those with income exceeding the 90th percentile of the household income distribution. In 2007, the 40th percentile was around \$40,000; the 60th percentile was around \$65,000; and the 90th percentile was around \$150,000.
[6] This calculation does not account fully for second liens. The share of underwater borrowers would likely be a bit higher if we had complete coverage of these liens. These estimates are derived from CoreLogic and LPS Applied Analytics data.

Fig. 3: Mortgages with Negative Equity



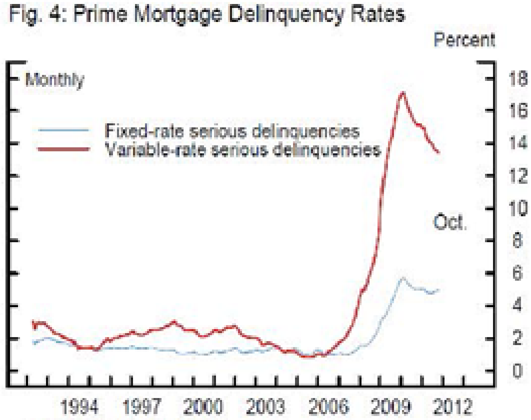
Note: Negative equity number likely understated because of incomplete data on junior liens. Nonprime category includes alt-A and subprime loans.

Negative equity is a problem because it constrains a homeowner's ability to remedy financial difficulties. When house prices were rising, borrowers facing payment difficulties could avoid default by selling their homes or refinancing into new mortgages. However, when house prices started falling and net equity started turning negative, many borrowers lost the ability to refinance their mortgages or sell their homes. Nonprime mortgages were most sensitive to house price declines, as many of these mortgages required little or no down payment and hence provided a limited buffer against falling house prices. But as house price declines deepened, even many prime borrowers who had made sizable down payments fell underwater, limiting their ability to absorb financial shocks such as job loss or reduced income.[7]

The resulting surge of delinquencies (figure 4) has overwhelmed the housing finance system. Mortgage servicers were unprepared for the large number of delinquent borrowers and failed to invest the resources necessary to handle them properly, resulting in severely flawed and, in some cases, negligent servicing practices. Exacerbating the problem, some of the incentives built into servicing contracts encouraged foreclosures rather than loan modifications.

[7] For more discussion, see Christopher Mayer, Karen Pence, and Shane M. Sherlund (2009), "The Rise in Mortgage Defaults," *Journal of Economic Perspectives*, vol. 23 (Winter), pp. 27–50, www.aeaweb.org/atypon.php?return_to=/doi/pdfplus/10.1257/jep.23.1.27.

Fig. 4: Prime Mortgage Delinquency Rates



Source: LPS Applied Analytics.

Mortgage Credit Conditions

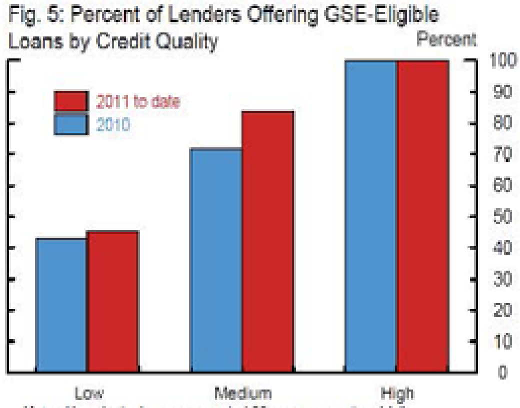
As a result of these developments, mortgage credit conditions have tightened dramatically from their pre-recession levels. Mortgage lending standards were lax, at best, in the years before the house price peak, and some tightening relative to pre-crisis practices was necessary and appropriate. Nonetheless, the extraordinarily tight standards that currently prevail reflect, in part, obstacles that limit or prevent lending to creditworthy borrowers. Tight standards can take many forms, including stricter underwriting, higher fees and interest rates, more-stringent documentation requirements, larger required down payments, stricter appraisal standards, and fewer available mortgage products.[8] Bank responses to the quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices indicate persistent net tightening in lending standards for mortgages to purchase homes from 2007 through 2009, and surveys since then have yet to show any unwinding of that move, even for prime mortgages eligible for GSE or Federal Housing Administration (FHA) guarantees, for which lenders do not bear the credit risk.[9]

Other data show, for instance, that less than half of lenders are currently offering mortgages to borrowers with a FICO score of 620 and a down payment of 10 percent (figure 5)--even though these loans are within the GSE purchase parameters.[10] This hesitancy on the part of lenders is due in part to concerns about the high cost of servicing in the event of loan delinquency and fear that the GSEs could force the lender to repurchase the loan if the borrower defaults in the

[8] With regard to appraisals, the Appraisal Foundation's Appraisal Practices Board has recently issued for public comment a draft of guidance that would address the special challenges of performing residential appraisals in declining-value markets, including the method by which appraisers assemble data on market conditions and the extent to which distressed transactions should affect the comparable-sales valuation of a property.
[9] Results from the Senior Loan Officer Opinion Survey on Bank Lending Practices are available at www.federalreserve.gov/boarddocs/snloansurvey.
[10] Federal Reserve staff calculation based on data from LoanSifter.

future.[11] Concerns about the high cost of servicing reflect recent experience, in which servicers were badly underprepared to deal with the volume of troubled loans, along with ongoing uncertainty about the cost of compliance with mortgage servicing-related regulatory requirements going forward; prospective capital treatment of mortgage servicing rights under Basel III may also be affecting the perceived costs and benefits of servicing operations. Lenders' reaction to the possibility of forced repurchases highlights the tradeoff between the GSEs pursuing a policy of reducing their near-term losses and risk exposure versus adopting policies to support the broader housing market. Aggressively putting back delinquent loans to lenders helps the GSEs maximize their profits on old business and thus limits their draws on the U.S. Treasury, but at the same time, it discourages lenders from originating new mortgages. Meanwhile, for loans that are ineligible for GSE purchase, only high-credit-score borrowers generally have access to financing, and lenders often keep these loans in portfolio, leading them to be selective about the volume of such loans they originate.

Fig. 5: Percent of Lenders Offering GSE-Eligible Loans by Credit Quality



Note: Hypothetical owner-occupied 30-year conventional fully documented mortgage. Low: FICO 620, LTV 90; Medium: FICO 680, LTV 90; High: FICO 720, LTV 80.
Source: LoanSifter.

Reduced mortgage lending is also notable among potential first-time homebuyers, who are typically an important source of incremental housing demand. These households often have relatively new credit profiles and lower-than-average credit scores, as they tend to be younger and have fewer economic resources to make a large down payment. Consumer credit record data show that the share of 29- to 34-year-olds getting a first-time mortgage was significantly lower

[11] When the GSEs purchase mortgages from originators, the contracts specify that the originators make "representations and warranties" with respect to information related to the borrower, property, and so on. In the case of delinquency, if the GSEs believe these representations and warranties were violated (for example, information was false or inadequately verified), they can "put back" the loan to the originator, who is obligated to repurchase the mortgage at par value.

in the past 2 years than it was 10 years earlier.[12] The same data show that the drop-off was more pronounced among individuals with less-than-excellent credit scores, even in parts of the country where unemployment rates are better than the national average.[13] These data suggest a large decline in mortgage borrowing by potential first-time homebuyers due to not only weaker housing demand, but also the effect of tighter credit conditions on all but the highest-credit-quality borrowers.

At the same time, a host of factors have been weighing on housing demand. High unemployment and weak income growth have made it difficult for many households to purchase homes despite the large declines in house prices and mortgage rates. Uncertainty about the future prospects for the economy and labor market has also likely made some households reluctant to buy homes. The combination of weak demand to purchase homes and the restricted supply of mortgages has put considerable downward pressure on house prices in many areas.

Addressing Foreclosed Properties: REO to Rental

Background

At the same time that housing demand has weakened, the number of homes for sale is elevated relative to historical norms, due in large part to the swollen inventory of homes held by banks, guarantors, and servicers after completion of foreclosure proceedings. These properties are often called real estate owned, or REO, properties. While the total stock of REO properties is difficult to measure precisely, perhaps one-fourth of the 2 million vacant homes for sale in the second quarter of 2011 were REO properties. The combination of weak demand and elevated supply has put substantial downward pressure on house prices, and the continued flow of new REO properties--perhaps as high as 1 million properties per year in 2012 and 2013--will continue to weigh on house prices for some time.[14] To the extent that REO holders discount properties in order to sell them quickly, the near-term pressure on home prices might be even greater.

In contrast to the market for owner-occupied houses, the market for rental housing across the nation has recently strengthened somewhat. Rents have turned up in the past year (figure 6), and the national vacancy rate on multifamily rental properties has dropped noticeably from its peak in late 2009. These developments have been fairly widespread across metropolitan areas. The relative strength of the rental market reflects increased demand as families who are unable or unwilling to purchase homes are renting properties instead. Rental demand has also been

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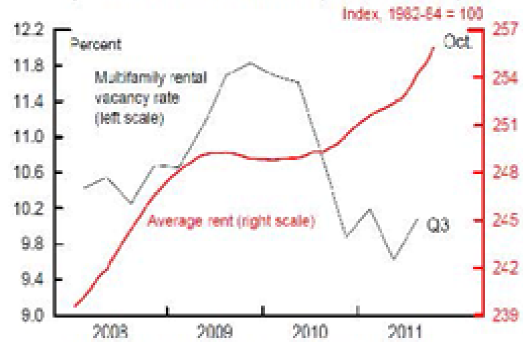
[12] In particular, 17 percent of individuals in this age group acquired a mortgage for the first time between mid-1999 and mid-2001, while only 9 percent did so between mid-2009 and mid-2011. These figures were calculated using data from the FRBNY/Equifax Consumer Credit Panel.

[13] For example, among individuals with credit scores between 620 and 740 and who lived in counties with unemployment rates less than 9 percent in 2010, the share obtaining first-time mortgages was 23 percent from 1999 through 2001 and only 14 percent from 2009 through 2011. In contrast, individuals with credit scores above 740 in the same counties experienced a decline of just 2 percentage points (26 percent to 24 percent). These figures were calculated using data from the FRBNY/Equifax Consumer Credit Panel.

[14] The timing of future REO flows is difficult to forecast because the foreclosure process has slowed considerably in many states since the October 2010 revelations of significant deficiencies in foreclosure processes at many servicers. Foreclosures in states with judicial foreclosure processes have been particularly affected.

supported by families who have lost their homes to foreclosure--the majority of whom move to rental housing, most commonly to single-family rentals.[15]

Fig. 6: Rent Index and Multifamily Rental Vacancy Rate



Note: Rental vacancy rate is seasonally adjusted by Board staff.
Source: For average rent, Bureau of Labor Statistics; for vacancy rate, Census Bureau.

The price signals in the owner-occupied and rental housing markets--that is, the decline in house prices and the rise in rents--suggest that it might be appropriate in some cases to redeploy foreclosed homes as rental properties. In addition, the forces behind the decline in the homeownership rate, such as tight credit conditions, are unlikely to unwind significantly in the immediate future, indicating a longer-term need for an expanded stock of rental housing.

Although small investors are currently buying and converting foreclosed properties to rental units on a limited scale, larger-scale conversions have not occurred for at least three interrelated reasons. First, it can be difficult for an investor to assemble enough geographically proximate properties to achieve efficiencies of scale with regard to the fixed costs of a rental program.[16] Second, attracting investors to bulk sales opportunities--whether for rental or resale--has typically required REO holders to offer significantly larger price concessions relative to direct sales to owner occupants through conventional realtor-listing channels, in part because it can be difficult for investors to obtain financing for such sales. Third, the supervisory policy of GSE and banking organization regulators has generally encouraged sales of REO property as early as practicable. We discuss each of these issues in more detail later.[17]

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[15] See Raven Molloy and Hui Shan (2011), "The Post-Foreclosure Experience of U.S. Households," Finance and Economics Discussion Series 2011-32 (Washington: Board of Governors of the Federal Reserve System, May), www.federalreserve.gov/pubs/feds/2011/201132.

[16] Consider the most cost-effective form of rental housing: a large apartment building in which the costs of operating the building are spread over many units. By pooling nearby properties, a rental program can come closer to approximating the efficiencies of a large apartment building.

[17] As discussed later in this paper, under banking laws and regulations, banking organizations generally may not engage in property management as an ongoing business, although they are generally allowed to manage REO properties during the permitted REO holding periods. In contrast, those who make decisions regarding disposition

Characteristics of REO Properties

Fannie Mae, Freddie Mac, and the FHA together hold about half of the outstanding REO inventory and so might be able to aggregate enough properties to facilitate a cost-effective rental program in many rental markets. As of early November 2011, about 60 metropolitan areas each had at least 250 REO properties currently for sale by the GSEs and FHA--a scale that could be large enough to realize efficiency gains.[18] Atlanta has the largest number of REO properties for sale by these institutions with about 5,000 units. The next-largest inventories are in the metropolitan areas of Chicago; Detroit; Phoenix; Riverside, California; and Los Angeles, each of which have between 2,000 and 3,000 units.

Other financial institutions also hold or control substantial inventories of REO properties. More than one-fourth of REO properties are held by non-agency securitized pools, which are controlled by mortgage servicers under the terms of pooling and servicing agreements. Because these properties are more likely to have been financed by subprime and alt-A loans, they are concentrated in somewhat different metropolitan areas than the inventory held by the GSEs and FHA. About 50 metropolitan areas appear to have at least 250 REO properties held by securitized pools, with the largest inventories in Miami; Los Angeles; Riverside, California; Chicago; and Las Vegas.[19] The remaining REO inventory--a bit less than one-fourth--is held by commercial banks and thrifts. Roughly 50 metropolitan areas each have at least 250 properties held by these institutions, and the geographic distribution of these properties is similar to that of the inventory held by the GSEs.[20]

Not all of these REO properties are good candidates for rental properties, even in geographic markets with sufficient scale. As discussed in more detail later, some properties are badly damaged, in low-demand locations, or otherwise low value. Nonetheless, according to Federal Reserve staff calculations, many REO properties appear to be viable rental properties in terms of both physical adequacy and potential attractiveness to tenants. For example, most REO properties are in neighborhoods with median house values and incomes that are roughly similar to the medians for the metropolitan area overall.[21] Similarly, the vast majority of REO properties are in neighborhoods with an average commute time that is similar to the average for the entire metropolitan area, suggesting that the properties are not located unusually far from employment centers.[22]

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of REO properties in securitized pools may be, or may feel, restrained from renting properties by provisions in the pooling and servicing agreements.

[18] Federal Reserve staff calculations from data on the Department of Housing and Urban Development's Real-Estate Owned Properties Portal, available at www.huduser.org/reo/reo.html. Recently, only around half of the properties in the REO inventories of the GSEs have been offered for sale at any given point. The other properties are leased to existing tenants under the provisions of the Protecting Tenants at Foreclosure Act, are located in states with a redemption period after foreclosure, or are under renovation or otherwise unavailable for sale.

[19] Federal Reserve staff calculation based on data from CoreLogic.

[20] Federal Reserve staff calculation based on data provided by McDash Analytics, LLC, a wholly owned subsidiary of Lender Processing Services, Inc.

[21] About three-fourths of REO properties are in neighborhoods where the median house values and incomes are greater than 80 percent of the medians for the metropolitan area.

[22] Data on median house values, income, and commute times are from the 2000 Census.

Many REO properties also appear to be viable rental properties in terms of improving loss recoveries to the REO property holder. One method of gauging the profitability of renting a particular property is to calculate its capitalization rate, or cap rate--the expected annual cash flows from renting the property relative to the price at which the REO property holder could expect to sell it in the owner-occupied market.[23] Preliminary estimates suggest that about two-fifths of Fannie Mae's REO inventory would have a cap rate above 8 percent--sufficiently high to indicate renting the property might deliver a better loss recovery than selling the property.[24] Estimated cap rates on the FHA's REO inventory are a bit higher--about half of the current inventory has a cap rate above 8 percent--because FHA properties tend to have somewhat lower values relative to area rents. These cap rate calculations are illustrative examples subject to a number of assumptions, and do not control for the fact that holding on to properties and renting them may entail more risk than selling into the owner-occupied market. In particular, the REO holder receives cash in the event of a sale, but earns a potentially higher but more uncertain return from renting a property.

Finally, the number of properties currently in the foreclosure process is more than four times larger than the number of properties in REO inventory. The geographic distribution of these "pipeline" properties is similar to that of REO properties, although states that are experiencing significant foreclosure delays tend to have larger backlogs.[25] If recent trends continue, the share of REO inventory held by the GSEs and FHA should increase.

REO to Rental Program Design

The data cited earlier suggest that a government-facilitated REO-to-rental program has the potential to help the housing market and improve loss recoveries on REO portfolios. The FHFA released a request for information on August 10, 2011, to collect information from market participants on possible ways to accomplish this objective and received more than 4,000 responses. An interagency group in which the Federal Reserve is participating is considering issues related to the design of a program that would facilitate REO-to-rental conversions. As no such program currently exists, predicting its success or efficacy is difficult. Ongoing experimentation and analysis will be a crucial component of developing such a program.

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[23] For further discussion of cap rates in the real estate context more generally, see Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2009), "Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts," Supervision and Regulation Letter, SR 09-07 (October 30), p. 31, www.federalreserve.gov/boarddocs/srletters/2009/sr0907a1.pdf.

[24] The return from renting is the annual gross rental income less leasing costs, maintenance expenses, property taxes, management fees, and foregone rent when the property is vacant. This estimate assumes leasing costs are equal to one month's rent, management fees are 8 percent of monthly rent, maintenance expenses are 2 percent of the property's market value, and the property is vacant for one month per year. Data on rents are from Zillow and the 2010 American Community Survey, and data on property taxes are from the 2007–09 American Community Survey. The cap rate estimates are based on Fannie Mae's and the FHA's REO portfolios as of midsummer 2011.

[25] Of course, it is possible that properties will transition from foreclosure to REO at a faster rate in some locations than others, for instance due to state foreclosure laws, so the flow of incoming REO could be distributed somewhat differently than the current stock.

A government-facilitated REO-to-rental program could take many forms. The REO holder could rent the properties directly, sell the properties to a third-party investor who would rent the properties, or enter into a joint venture with such an investor. In making this decision, policymakers should consider what program design will provide for the best loss recoveries and the best outcomes for communities.

To date, REO holders have avoided selling properties in bulk to third-party investors because the recoveries that REO holders receive on such sales are generally lower than the corresponding recoveries on sales to owner occupants. Investors considering such bulk-sale transactions tend to demand a higher risk premium than owner occupants and thus will purchase only at lower prices. Investors in such transactions also might have more difficulty obtaining debt financing than owner occupants. Although mortgage products are available for individual one- to four-family houses and for multifamily properties (albeit currently at tight terms), no mortgage products currently exist for a portfolio of single-family homes.[26] In addition, REO holders must absorb the costs of assembling inventory for bulk sale--that is, holding properties off the market until enough properties have been assembled to cover the fixed costs of a rental program. Until the inventory is assembled, the REO holder receives no revenue from the property but incurs direct financing costs; carrying costs such as taxes, utilities, and maintenance expenses; and the continued depreciation of the property.

An REO-to-rental program that relies on sales to third-party investors will be more viable if this cost-pricing differential can be narrowed. REO holders will likely get better pricing on these sales if the program is designed to be attractive to a wide variety of investors. Selling to third-party investors via competitive auction processes may also improve the loss recoveries.

Providing investors with debt financing will likely also affect the prices they offer on bulk pools of REO properties. As noted, such financing is largely unavailable now, thus limiting the number of potential investors. In the current tight mortgage lending environment, private lenders may not have the capacity to fund a large-scale rental program, and it may be appropriate for REO holders to fill the gap. However, whether such funding should be subsidized is an important question. Subsidized financing provided by the REO holder may increase the sales price of properties, but at the cost of reducing the REO holder's future income stream. If so, the costs of such financing need to be accounted for in the rental program.

In addition, a program that minimizes the amount of time that a vacant property lingers in REO inventory before being rented would reduce disposition costs to the REO holder. These costs might be reduced by including properties that are already rented, such as properties rented under the provisions of the Protecting Tenants at Foreclosure Act.[27] Another possibility is to auction to

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[26] It is unclear whether these mortgages have not existed because of a historical lack of demand (that is, under earlier housing market conditions, investors did not find operating large-scale rental programs of single-family homes attractive) or because lenders perceived such loans as not worth the risk.

[27] The Protecting Tenants at Foreclosure Act of 2009 protects tenants from immediate eviction by persons or entities that become owners of residential property though the foreclosure process. Title VII of the Helping Families Save Their Homes Act of 2009. Public Law 111-22, effective May 20, 2009 (www.gpo.gov/fdsys/pkg/PLAW-111publ22/pdf/PLAW-111publ22.pdf).

investors the rights to acquire, in a given neighborhood, a future stream of properties that meet certain standards instead of auctioning the rights to current REO holdings. A third possibility is to encourage deed-for-lease programs, which circumvent the REO process entirely by combining a deed-in-lieu of foreclosure--whereby the borrower returns the property to the lender--with a rent-back arrangement in which the borrower remains in the home and pays market rent to the lender.

If, after addressing these obstacles, selling to third-party investors still provides lower loss recoveries than selling to owner occupants, policymakers might want to consider the merits of allowing or facilitating the rental of properties by REO holders themselves. Alternatively, policymakers may judge that the broader positive effects on the economy from redirecting properties to the rental market justify a moderate decline in loss recoveries. Finally, even if the cost differential is large at this point, the calculation may change if the foreclosure process accelerates in some states and REO holders experience significant increases in their inventories.

An REO-to-rental program should also consider the effects that poorly managed or maintained properties have on communities and, in particular, ensure that communities are not damaged by rental practices. For example, investors might be allowed to bid on properties only after demonstrating some experience with property management and commitment to rehabilitation of properties. Experienced nonprofit organizations with established ties to the community could also play a natural role as rental managers. In the case of for-profit companies or joint ventures, investors might be given an incentive to provide appropriate property management by deferring some of their compensation. Investors might receive some proportion of their payment only after several years of renting properties in a manner consistent with "good landlord" practices and compliance with pertinent landlord-tenant and fair-housing requirements.

A final consideration is the length of time REO properties are rented before they are placed on the for-sale market. Given the depressed state of the housing market, properties may remain rental properties for an extended period. Rent-to-own provisions, which would give existing tenants the option to purchase their properties during their tenancies, might facilitate the transition of some renters back to the owner-occupied market. Such provisions may also reduce costs by encouraging renters to maintain their properties to a greater extent.

The Role of Banks

The GSEs, of course, do not hold all of the residential REO exposure. As of September 2011, U.S. commercial banks had $10 billion in residential REO properties on their balance sheets, while savings and loans had an additional $1.4 billion.[28] Generally, banking organizations are not permitted to engage in real estate ownership or property management, and supervisory policy typically encourages banking organizations to dispose of REO property as early as practicable. However, current law clearly contemplates some scope for REO ownership to last beyond the fastest-possible disposition. In particular, federal laws dealing with bank holding companies and

[28] In aggregate, the serviced-for-others REO portfolios managed by banking organizations are significantly larger than their owned portfolios. These statistics are for the owned portfolios in depository institutions, as disclosed in bank and thrift regulatory reports.

national banks and state laws dealing with state-chartered banks typically allow banking institutions to hold REO properties for a time (such as up to five years), and often include a possibility of extending the permissible holding period, if approved by the appropriate regulator. During this holding period, banking organizations are permitted to rent the REO properties on their balance sheets, as well as manage the properties directly or through a third-party vendor, and take steps necessary to keep up the properties' condition and value. Regulators generally expect that such rentals would be done with the goal of improving the ultimate recovery to the banking organizations. Regulators also expect that banking organizations engaged in rental of REO properties demonstrate ongoing good faith efforts to sell the properties within the statutory and regulatory time periods and as appropriate under prevailing market conditions.

In light of the current unusually difficult circumstances in many housing markets across the nation, the Federal Reserve is contemplating issuing guidance to banking organizations and examiners to clarify supervisory expectations regarding rental of residential REO properties by such organizations while such circumstances continue (and within relevant federal and statutory and regulatory limits). If finalized and adopted, such guidance would explain how rental of a residential REO property within applicable holding-period time limits could meet the supervisory expectation for ongoing good faith efforts to sell that property. Relatedly, if a successful model is developed for the GSEs to transition REO properties to the rental market, banks may wish to participate in such a program or adopt some of its features.

Land Banks: An Option for Low-Value Properties

Some REO properties are low value and less likely to be viable for an REO-to-rental program. About 5 percent of properties in the REO inventory of the GSEs and FHA are appraised at less than $20,000. In some markets, the share is significantly higher; for example, in Detroit and Cleveland, more than half of the REO inventory of these institutions is appraised below this value. In these markets, low-value properties are less suitable for disposition through sales in the owner-occupied market or through rental market strategies, and alternative disposition strategies may be needed.

Currently, a small number of these properties are disposed of through land banks, which are typically public or nonprofit entities created to manage properties that are not dealt with adequately through the private market. Land banks are government entities that have the ability to purchase and sell real estate, clear titles, and accept donated properties. Properties may be rehabilitated as rental or owner-occupied housing, or demolished, as market conditions dictate.

While the number of land banks has increased significantly over the past few years, capacity nationwide remains quite limited, in terms of both institutional infrastructure and funding. Only a handful of states have passed legislation to establish land banks, and, as a result, many areas lack land banks altogether. Only about half of the GSE and FHA inventory of low-value REO properties (properties with a value of $20,000 or less) is in metropolitan areas with an existing land bank. In addition, the land banks that have been created have only limited resources--the largest land bank can handle about 100 properties per month, but most handle just a few each month. This capacity pales in comparison with the number of low-value REO properties in current inventory. One potential strategy would be to consider increasing funding (at the federal, state, or local level) and technical assistance to land banks in existence, encourage the creation of more land banks on the local or regional level, or create a national land bank program, in order to scale up capacity to match current low-value inventories. Such initiatives would need appropriate controls to promote value to the communities affected and maximize efficiency whenever possible.

Credit Access and Pricing

As noted earlier, mortgage credit conditions have tightened dramatically from their pre-recession levels. Lax mortgage lending standards in the years before the house price peak contributed to problems in the housing market, so some tightening relative to pre-crisis practices was necessary and appropriate. The important question is whether the degree of tightness evident today accurately reflects sustainable lending and appropriate consumer protection.

Financial regulators have been in consultation with the GSEs and originators about the sources of the apparent tightness in lending standards. Continued efforts are needed to find an appropriate balance between prudent lending and appropriate consumer protection, on the one hand, and not unduly restricting mortgage credit, on the other hand. In particular, policymakers should recognize that steps that promote healthier housing and mortgage markets are good for safety and soundness as well.

Addressing Homeowners at Risk of Default or Foreclosure

Obstacles to Refinancing

Many homeowners have been unable to take advantage of historically low mortgage rates because of low or negative home equity, slightly blemished credit, or tighter credit standards. Perhaps only about half of homeowners who could profitably refinance have the equity and creditworthiness needed to qualify for traditional refinancing.

In response to some of these obstacles, the FHFA introduced the Home Affordable Refinance Program (HARP) in 2009. HARP allows qualifying borrowers who are current on their payments, and whose mortgages are owned or guaranteed by Fannie Mae or Freddie Mac, to refinance even if they have insufficient equity to qualify for a traditional refinance.[29] Participation in the program to date has been relatively modest, with only about 925,000 mortgages refinanced through HARP.[30]

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[29] A traditional GSE refinance requires a loan-to-value (LTV) ratio of 80 percent or less unless the mortgage is enhanced with mortgage insurance provided by a third party. Initially, HARP allowed refinances of qualifying loans with LTVs up to 125 percent. To have qualified, loans must have been originated before May 31, 2009, and have been current with certain restrictions on late payments over the preceding year.

[30] Data from the FHFA's quarterly Foreclosure Prevention & Refinance Report. See Federal Housing Finance Agency (2011), "Foreclosure Prevention & Refinance Report: Third Quarter 2011," report (Washington: FHFA, October), www.fhfa.gov/webfiles/22827/3Q2011ForePrevFullReport12611.pdf.

The low participation rate has been attributed, in part, to lender worries about GSE putback risks. When a lender refinances a loan originated by a competitor, the new lender in effect takes on some of the original lender's putback risk. Because lenders are reluctant to take on this added risk, they tend to refinance only their own loans and do not aggressively market the program to borrowers.

GSE fees known as loan-level pricing adjustments (LLPAs) are another possible reason for low rates of refinancing. Under normal circumstances, LLPAs are used to provide higher compensation to the GSEs for the risk that they undertake when new loans are extended to borrowers with high loan-to-value (LTV) ratios or low credit scores. In a HARP refinancing, however, the GSEs already carry the credit risk on the original mortgage, and refinancing to a lower rate could even lower the credit risk of some such loans; thus, it is difficult to justify imposing a higher LLPA when refinancing in this circumstance.

To reduce these and other obstacles to refinancing, the FHFA announced changes to HARP in October 2011.[31] LLPAs for HARP loans were eliminated for borrowers shortening the term of their loans to 20 years or less and reduced for longer-term loans, certain representation and warranty requirements were waived, loans with LTVs greater than 125 percent were made eligible for the program, the appraisal process was largely automated, servicers were given greater flexibility to notify borrowers of their eligibility for refinancing through HARP, and private mortgage insurers agreed to facilitate the transfer of mortgage insurance. Some estimates suggest that another million or so homeowners could refinance their mortgages with these changes in effect.

Nonetheless, more might be done--for example, reducing even further or perhaps eliminating remaining LLPAs for HARP refinances (again, on the rationale that the GSEs already carry the credit risk on such loans); more comprehensively reducing putback risk; or further streamlining the refinancing process for borrowers with LTVs below 80 percent, a potentially large group of borrowers who face some (though not all) of the same obstacles confronting high-LTV borrowers. Fannie Mae has reduced putback risk for all loans (including those below 80 percent LTV as well as those above 80 percent LTV), while Freddie Mac has reduced putback risk for loans above 80 percent LTV but not those below 80 percent LTV. Harmonizing traditional refinancing programs for borrowers with LTVs less than 80 percent, so that these programs become operationally consistent with HARP, could facilitate more refinancing among this group of borrowers.

An important group of borrowers who are not able to take advantage of the HARP program is homeowners with high LTVs but whose mortgages are not guaranteed by the GSEs. For the most part, these borrowers are not able to refinance through any public or private program. One possible policy option might be to expand HARP--or introduce a new program--to allow the GSEs to refinance non-GSE, non-FHA loans that would be otherwise HARP eligible. Unlike HARP refinances, however, these refinances would introduce new credit risk to the GSEs

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[31] Federal Housing Financing Agency (2011), "Fannie Mae and Freddie Mac Announce HARP Changes to Reach More Borrowers," press release, October 24, www.fhfa.gov/webfiles/22721/HARP_release_102411_Final.pdf.

because the GSEs do not currently guarantee the loans, even if the loans were offered only to borrowers who are current on their payments and would meet underwriting standards (for example, debt-to-income ratio and credit score), if not for their high loan-to-value ratios. Perhaps 1 million to 2-1/2 million borrowers meet the standards to refinance through HARP except for the fact that their mortgages are not GSE-guaranteed.[32]

To be sure, this change would introduce a host of risk-management issues, and the GSEs would likely require new underwriting and fees for insuring these loans. Moreover, legislative changes to GSE governing statutes would likely be needed because the GSEs are prohibited from purchasing or guaranteeing mortgages with LTV ratios exceeding 80 percent unless the mortgages have credit enhancement such as mortgage insurance. This policy, because it requires a potentially large expansion of the GSE balance sheet, would also have to be balanced against the other policy goals of winding down the GSEs over time and returning private capital to the mortgage market.

The structure of the HARP program highlights the tension between minimizing the GSEs' exposure to potential losses and stabilizing the housing market. Although the GSEs would take on added credit risk from expanding HARP to non-GSE loans, the broader benefits from an expanded program might offset some of these costs. In particular, some homeowners who are unable to refinance because of negative equity, slightly blemished credit, or tighter underwriting standards could reduce their monthly payments significantly, potentially reducing pressures on the housing market. A stronger housing market would in turn likely imply an earlier stabilization of house prices and reduced rates of mortgage delinquency, helping both borrowers and lenders. Neighborhoods would benefit from reduced rates of foreclosure and fewer vacant homes, while localities would experience gains, or less pronounced reductions, in property tax receipts. The reduction in aggregate mortgage payments could also provide some boost to consumer spending, although the net effect would likely be relatively small, in part because the gains to homeowners may be partially offset by corresponding reductions in the incomes of investors in mortgage-backed securities.

However, many GSE and non-GSE mortgages are not eligible for traditional or HARP refinancing because they are already delinquent or have been sufficiently delinquent in the past. These mortgages might be best addressed through loan modification programs--the topic of the next section.

Loan Modifications and the HAMP Program

Loan modifications help homeowners stay in their homes, avoiding the personal and economic costs associated with foreclosures. Modifying an existing mortgage--by extending the term, reducing the interest rate, or reducing principal--can be a mechanism for distributing some of a homeowner's loss (for example, from falling house prices or reduced income) to lenders, guarantors, investors, and, in some cases, taxpayers. Nonetheless, because foreclosures are so

[32] Federal Reserve staff calculation based on data from CoreLogic and from McDash Analytics, LLC, a wholly owned subsidiary of Lender Processing Services, Inc.

costly, some loan modifications can benefit all parties concerned, even if the borrower is making reduced payments.

About 880,000 permanent modifications have been made through the voluntary Home Affordable Modification Program (HAMP), which is part of the Making Home Affordable (MHA) program. HAMP pays incentives to lenders, servicers, and borrowers to facilitate modifications. Among its key program terms, HAMP reduces monthly payments for qualifying borrowers to 31 percent of income. For borrowers who have received HAMP modifications, the help is often substantial. For example, the median monthly payment after a permanent HAMP modification is about $831, compared with about $1,423 before the modification.[33] Millions of additional mortgages have been modified by lenders, guarantors, and the FHA.

As is the case with all loan modifications, some mortgages that have been modified under HAMP have ended up defaulting after modification. For example, among HAMP modifications made permanent in the first quarter of 2010, 16 percent of mortgages were more than 90 days late a year after modification, and 22 percent were 90 days late after 18 months.[34] These re-default rates are lower than those for non-HAMP modifications, according to Office of the Comptroller of the Currency (OCC) statistics.[35] Such defaults after modification highlight the difficulty that some homeowners have had in sustaining even substantially reduced mortgage payments over time. In some cases, this difficulty likely owes to the burden from other expenses, such as medical or elder care, or other debt, such as a second mortgage or consumer debt, which may make a 31-percent-of-income first mortgage payment unaffordable.

On the other hand, the 31 percent payment-to-income target has also precluded the participation of borrowers who might benefit from a modification even though their first-lien payment is already less than 31 percent of income. One potential method of expanding the reach of HAMP that may be worth exploring would involve allowing payments to be reduced below 31 percent of income in certain cases. This exploration might consider incorporating all of a borrower's mortgage payments on a property in the debt-to-income calculation, instead of just the first lien. Alternatively, taking the entirety of a borrower's balance sheet into account or making

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[33] Data from the October 2011 Making Home Affordable program servicer performance report. See U.S. Department of the Treasury (2011), *October 2011 Making Home Affordable Report and Servicer Assessments for Third Quarter 2011*, report (Washington: U.S. Department of the Treasury, December), available at www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Pages/default.aspx.

[34] More recent modifications may have different default experiences due to different economic conditions during the life of the loan.

[35] For example, according to the OCC Mortgage Metrics Report for the third quarter of 2011 (table 32), some 17 percent of HAMP permanent modifications finalized in the second quarter of 2010 at a select group of national banks and thrifts had fallen 60 days delinquent within 12 months of the modification. In contrast, for this same group of financial institutions, some 31 percent of non-HAMP modifications made permanent in the second quarter of 2010 had become 60 or more days delinquent within the same interval. The lower rate of delinquency for HAMP permanent modifications has likely been influenced by differences in documentation standards, magnitudes of payment reduction, and requirements for a trial period. For the OCC report, see U.S. Department of the Treasury, Office of the Comptroller of the Currency (2011), *OCC Mortgage Metrics Report, Third Quarter 2011* (Washington: Department of the Treasury, December), www.occ.treas.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2011/mortgage-metrics-q3-2011.pdf.

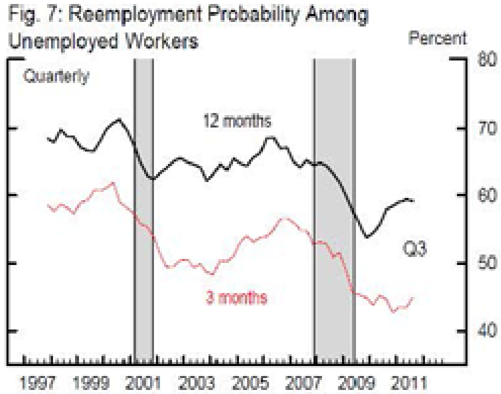
allowances for other unavoidable borrower expenses might be considered. Expanding the magnitude of potential payment reduction in this way would, though, raise difficult issues of fairness and implementation.

Another issue is the fact that many borrowers have gone delinquent or have defaulted because of income loss resulting from unemployment or other presumably temporary factors, which impairs their ability to meet previously affordable payment obligations. The basic HAMP modifications focus on longer-term payment reduction to a level that can be supported by the borrower's income at the time of modification. This approach is often ill-suited for those who have lost their jobs because the income of unemployed borrowers is generally quite low.

Instead of a longer-term modification, a payment deferral may be more helpful to temporarily unemployed borrowers whose income, it is hoped, will rise in the near future. MHA has introduced an unemployment forbearance program under which servicers grant 12 months' forbearance. Resources from the Hardest Hit Fund, which was created by the Department of the Treasury (Treasury) under the Troubled Asset Relief Program, have been used to provide assistance to unemployed homeowners through a variety of programs run by state housing finance agencies.

Programs of this type may prove helpful in preventing costly foreclosures among homeowners suffering temporary income reductions. Nonetheless, a significant challenge involves targeting these initiatives to the borrowers most likely to be reemployed. In the current economy, fewer than 60 percent of unemployed workers find reemployment within a year of losing their jobs (figure 7). Moreover, even after reemployment, a borrower's income from the new job may be lower than in the previous job, and his or her savings may be depleted, reducing the borrower's ability to keep up with mortgage payments. Further work in this area is warranted to better understand the tradeoffs in devising such programs.

Fig. 7: Reemployment Probability Among Unemployed Workers



Note: Probability of being employed 3 and 12 months after losing job. Four-quarter moving average of not seasonally adjusted data. Shaded areas indicate NBER-dated recessions.

Broadly speaking, HAMP emphasizes modifications in which the net present value to the lender of the modification exceeds the net present value of pursuing a foreclosure. It should be recognized that other types of loan modifications may be socially beneficial, even if not in the best interest of the lender, because of the costs that foreclosures place on communities, the housing market, and the broader economy. However, although policymakers might very well decide that the social costs--while obviously difficult to gauge--are great enough to justify additional loan modifications, lenders are unlikely to be willing to make such modifications on their own. Moving further in this direction is thus likely to involve additional taxpayer funding, the overriding of private contract rights, or both, which raises difficult public policy issues and tradeoffs.

Loan Modifications with Principal Reduction

Reducing monthly payments to a sustainable level for distressed borrowers who are significantly underwater on their mortgages may require principal reductions--that is, reductions in their mortgage balances--in addition to interest rate concessions and term extensions. Consequently, HAMP allows principal reduction to be used as part of its standard protocol when interest rate reduction and term extension are not sufficient to reduce a borrower's debt-to-income ratio to 31 percent. In addition, the HAMP program introduced the Principal Reduction Alternative (PRA), which allows the servicer to use principal reduction as the first step in modifying the loan. In both cases, HAMP uses principal reduction primarily as a means to improve the affordability of a borrower's mortgage, though with the concomitant benefit of reducing negative equity.[36] The Hardest Hit Fund has also funded principal reduction programs at the state level.

Negative equity is a problem, above and beyond affordability issues, because it constrains the ability of borrowers to refinance their mortgages or sell their homes if they do not have the means or willingness to bring potentially substantial personal funds to the transaction. An inability to refinance, as discussed previously, blocks underwater borrowers from being able to take advantage of the large decline in interest rates over the past years. An inability to sell could force underwater borrowers into default if their mortgage payments become unsustainable, and may hinder movement to pursue opportunities in other cities.

Principal reduction has been proposed and debated as one possible policy response to negative equity, including for borrowers current on their mortgage payments. Principal reduction has the potential to decrease the probability of default (and thus the deadweight costs of foreclosure) and to improve migration between labor markets. Principal reduction may reduce the incidence of default both by improving a household's financial position, and thus increasing its resilience to economic shocks, and by reducing the incentive to engage in "strategic" default (that is, to default solely based on the household's underwater position rather than on the affordability of the payments).

[36] Reflecting the preference for capitalization and interest rate reduction that is built into the HAMP "waterfall," 98 percent of HAMP modifications reduced the interest rate and 31 percent reduced principal. Since its inception in October 2010, the PRA program has modified 32,000 loans.

These potential benefits, however, are hard to quantify. Based on the evidence to date, the effect of negative equity on migration between labor markets appears to be fairly small.[37] The effect of reducing negative equity on default is hard to estimate because borrowers with high LTV ratios tend to have other characteristics correlated with default.[38] For example, high-LTV homeowners often made small initial down payments--perhaps due to a lack of financial resources--and tend to live in areas with greater declines in house prices, where unemployment and other economic conditions also tend to be relatively worse. Hence, principal reduction is likely to lower delinquency rates by less than the simple correlation between LTV and default rates would suggest. Further research or policy experiments in this area would be useful.

At the same time, the costs of large-scale principal reduction would be quite substantial. Currently, 12 million mortgages are underwater, with aggregate negative equity of $700 billion. Of these mortgages, about 8.6 million, representing roughly $425 billion in negative equity, are current on their payments.[39] These costs might be reduced if it was possible to target borrowers who are likely to default without a principal reduction. However, identifying such borrowers among the many who are current on their payments is difficult. Moreover, targeting principal reduction efforts on those most likely to default raises fairness issues to the extent that it discriminates against those who were more conservative in their borrowing for home purchases or those who rent instead of own. Depending on the requirements for relief, such a program may also give some borrowers who otherwise would not have defaulted an incentive to do so.

An alternative to large-scale principal reduction for addressing the barriers that negative equity poses for mortgage refinancing and home sales could involve aggressively facilitating refinancing for underwater borrowers who are current on their loans, expanding loan modifications for borrowers who are struggling with their payments, and providing a streamlined exit from homeownership for borrowers who want to sell their homes, such as an expanded deed-in-lieu-of-foreclosure program (described later). This approach focuses on reducing payments rather than reducing principal per se, and could be more effective at keeping committed borrowers in their homes if affordability is the prime consideration driving default.

Alternatives to Foreclosure

Despite the potential for loan modifications and targeted forbearance programs to prevent unnecessary foreclosures, many borrowers will not be able to keep their homes. In these cases, the most efficient solution may be to find an alternative to foreclosure such as a short sale or a deed-in-lieu-of-foreclosure (DIL). In a short sale, the home is sold to a third-party buyer offering less than the amount owed by the homeowner. In a DIL, there is no sale, but the

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[37] See Raven Molloy, Christopher Smith, and Abigail Wozniak (2011), "Internal Migration in the United States," *Journal of Economic Perspectives*, vol. 25 (Summer), pp. 173–96, www.aeaweb.org/articles.php?doi=10.1257/jep.25.3.173.
[38] See Neil Bhutta, Jane Dokko, and Hui Shan (2010), "The Depth of Negative Equity and Mortgage Default Decisions," Finance and Economics Discussion Series 2010-35 (Washington: Board of Governors of the Federal Reserve System, June), www.federalreserve.gov/pubs/feds/2010/201035/201035pap.pdf.
[39] About 660,000 mortgages are 30 days past due, 310,000 are 60 days past due, 1 million are 90 days or more past due, and 1.4 million are in foreclosure.

property is transferred directly to the lender or guarantor, rather than going through the formal foreclosure process. Both options are within the bounds of mortgage contracts and avoid some of the economic damage potentially caused by the foreclosure process. Short sales can be attractive because the property is transferred to a (presumably sustainable) new owner, keeping the property out of REO and reducing potential negative effects on communities from vacant properties. DILs can also be helpful because they can sometimes be easier to execute than a short sale and because they can fit into an REO-to-rental program to prevent a discounted sale that would otherwise occur. Both options may be particularly attractive to borrowers if lenders partially or fully waive borrower liability for deficiency balances. The MHA's Home Affordable Foreclosure Alternatives program provides incentive payments to facilitate both short sales and DILs.

Both short sales and DILs, however, face barriers in current markets. Short sales require a willing buyer, a price that is acceptable to all parties, and a timeline that allows the transaction to close before foreclosure (which is likely proceeding on a parallel path). DILs may not be actively pursued because of informational or logistical obstacles. Further, short sales and DILs often present additional obstacles to lenders, such as the disposition of second liens, the cost and uncertainty of loss recovery via mortgage insurance or deficiency judgments, and (in the case of DILs) accumulating additional REO properties. For their part, borrowers may not know about DILs or short sales as an alternative to foreclosure and, in some cases, may see little reason to engage in a short sale or DIL rather than stay in their homes throughout the often drawn-out foreclosure process. Given the scope of the economic losses associated with foreclosure, figuring out ways to surmount these obstacles is crucial.

Mortgage Servicing: Improving Accountability and Aligning Incentives

Mortgage servicers interact directly with borrowers and play an important role in the resolution of delinquent loans. They are the gatekeepers to loan modifications and other foreclosure alternatives and thus play a central role in how transactions are resolved, how losses are ultimately allocated, and whether deadweight losses are incurred.

Thus far in the foreclosure crisis, the mortgage servicing industry has demonstrated that it had not prepared for large numbers of delinquent loans. They lacked the systems and staffing needed to modify loans, engaged in unsound practices, and significantly failed to comply with regulations. One reason is that servicers had developed systems designed to efficiently process large numbers of routine payments from performing loans. Servicers did not build systems, however, that would prove sufficient to handle large numbers of delinquent borrowers, work that requires servicers to conduct labor-intensive, non-routine activities. As these systems became more strained, servicers exhibited severe backlogs and internal control failures, and, in some cases, violated consumers' rights. A 2010 interagency investigation of the foreclosure processes at servicers, collectively accounting for more than two-thirds of the nation's servicing activity, uncovered critical weaknesses at all institutions examined, resulting in unsafe and unsound practices and violations of federal and state laws.[40] Treasury has conducted compliance reviews since the inception of HAMP, and, beginning in June 2011, it released servicer compliance reports on major HAMP servicers. These reports have shown significant failures to comply with the requirements of the MHA program.[41] In several cases, Treasury has withheld MHA incentive payments until better compliance is demonstrated.

These practices have persisted for many reasons, but we focus here on four factors that, if addressed, might contribute to a more functional servicing system in the future. First, data are not readily available for investors, regulators, homeowners, or others to assess a servicer's performance. Second, even despite this limitation, if investors or regulators were able to determine that a servicer is performing poorly, transferring loans to another servicer is difficult. Third, the traditional servicing compensation structure can result in servicers having an incentive to prioritize foreclosures over loan modifications.[42] Fourth, the existing systems for registering liens are not as centralized or as efficient as they could be.

The lack of consistent metrics for assessing the quality of practices across servicers is a significant problem. Helpful metrics might include measures of borrowers' ability to contact representatives through call centers, results from third-party satisfaction surveys, or measures of investors' abilities to get data on loss-mitigation activities. Treasury has taken steps toward addressing this lack of consistent metrics in its monthly MHA reports, which include data on error rates, complaint response quality, and conversion rates (from trial to permanent modifications). These data could help inform the development of appropriate metrics for the industry.

The information provided by the metrics could be even more helpful if combined with lower costs when transferring servicing rights to a competing servicer. In a well-functioning servicing market, lower quality servicers would quickly lose business to competitors who are better able to reduce losses to investors, deliver a high quality of interaction with homeowners, and comply with regulations. However, because servicing systems are not interoperable or designed to easily import or export new records, transferring servicing responsibilities from one servicer to another is expensive, time consuming, and prone to error.

A third potential area for improvement in mortgage servicing is in the structure of compensation. Servicers usually earn income through three sources: "float" income earned on cash held temporarily before being remitted to others, such as borrowers' payments toward taxes and hazard insurance; ancillary fees such as late charges; and an annual servicing fee that is built into

[40] See Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2011), *Interagency Review of Foreclosure Policies and Practices*, report (Washington: Board of Governors of the Federal Reserve System, April), www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.
[41] The latest quarterly servicer assessment reports (through October) can be found in the Treasury's *October 2011 Making Home Affordable Report* (see note 33).
[42] See Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf (2008), "The Incentives of Mortgage Servicers: Myths and Realities," Finance and Economics Discussion Series 2008-46 (Washington: Board of Governors of the Federal Reserve System, November), www.federalreserve.gov/pubs/feds/2008/200846/revision/index.html.

homeowners' monthly payments. For prime fixed-rate mortgages, the servicing fee is usually 25 basis points a year; for subprime or adjustable-rate mortgages, the fee is somewhat higher. From an accounting and risk-management perspective, the expected present value of this future income stream is treated as an asset by the servicer and accounted for accordingly.

The value of the servicing fee is important because it is expected to cover a variety of costs that are irregular and widely varying. On a performing loan, costs to servicers are small--especially for large servicers with highly automated systems. For these loans, 25 basis points and other revenue exceed the cost incurred. But for nonperforming loans, the costs associated with collections, advancing principal and interest to investors, loss mitigation, foreclosure, and the maintenance and disposition of REO properties might be substantial and unpredictable and might easily exceed the servicing fee.

The standard servicing compensation model assumes that the revenue streams are more than enough in low-default environments, allowing servicers to cross-subsidize for high-default scenarios. But most servicers do not appear to have invested in enough infrastructure, or reserved sufficient capital, for high-stress conditions. Thus, they were ill equipped to deal with the magnitude of the ongoing foreclosure wave. Also, the fee structure of the servicing industry helped create perverse incentives for servicers to, for example, reduce the costs associated with working out repayments and moving quickly to foreclosure, even when a loan modification might have been in the best interest of the homeowner and investor.

Possible changes to the compensation model might include aligning servicing fees more closely with expenses, such as smaller annual servicing fees for performing loans but higher compensation for servicing delinquent loans, with fees tied directly to expenses incurred and with incentives for loan performance.[43] A small part of the current servicing business, including niche institutions known as "special servicers," already operates under such a payment regime. In addition, servicers' contractual requirement to continue advancing payments of principal and interest to investors, even when a loan is delinquent, strengthens servicers' incentives to move quickly to foreclosure. One possibility might be to advance mortgage principal and interest only 60 days beyond the first missed payment. This change would affect payment streams to investors modestly, and the market could adjust pricing accordingly, but it could also help align the interests of servicers, borrowers, and investors in reaching final resolution of delinquent mortgages.

A final potential area for improvement in mortgage servicing would involve creating an online registry of liens. Among other problems, the current system for lien registration in many jurisdictions is antiquated, largely manual, and not reliably available in cross-jurisdictional form. Jurisdictions do not record liens in a consistent manner, and moreover, not all lien holders are required to register their liens. This lack of organization has made it difficult for regulators and policymakers to assess and address the issues raised by junior lien holders when a senior mortgage is being considered for modification. Requiring all holders of loans backed by

[43] The FHFA has proposed and sought comment on alternative servicer compensation structures. See Federal Housing Finance Agency (2011), "Alternative Mortgage Servicing Compensation Discussion Paper," white paper (Washington: FHFA, September), www.fhfa.gov/webfiles/22663/ServicingCompDiscussionPaperFinal092711.pdf.

residential real estate to register with a national lien registry would mitigate this information gap and would allow regulators, policymakers, and market participants to construct a more comprehensive picture of housing debt.

The national lien registry could also record the name of the servicer. Currently, parties with a legitimate interest in contacting the servicer have little to go on from the land records because, among other reasons, many liens have been recorded only in the name of the trustee or of Mortgage Electronic Registration Systems (MERS).[44] Registering the servicer, and updating the information when servicing is transferred, could help local governments and nonprofits, for example, who might be working to resolve the status of vacant or abandoned properties. Implementing a modernized registry could build on systems that have been put in place locally in some jurisdictions and could be designed to retain a role for state and local governments as the default collectors of information, as long as the information is collected in an efficient and consistent manner.[45]

Conclusion

The challenges faced by the U.S. housing market today reflect, in part, major changes taking place in housing finance; a persistent excess supply of homes on the market; and losses arising from an often costly and inefficient foreclosure process (and from problems in the current servicing model more generally). The significant tightening in household access to mortgage credit likely reflects not only a correction of the unsound underwriting practices that emerged over the past decade, but also a more substantial shift in lenders' and the GSEs' willingness to bear risk. Indeed, if the currently prevailing standards had been in place during the past few decades, a larger portion of the nation's housing stock probably would have been designed and built for rental, rather than owner occupancy. Thus, the challenge for policymakers is to find ways to help reconcile the existing size and mix of the housing stock and the current environment for housing finance. Fundamentally, such measures involve adapting the existing housing stock to the prevailing tight mortgage lending conditions--for example, devising policies that could help facilitate the conversion of foreclosed properties to rental properties--or supporting a housing finance regime that is less restrictive than today's, while steering clear of the lax standards that emerged during the last decade. Absent any policies to help bridge this gap, the adjustment process will take longer and incur more deadweight losses, pushing house prices lower and thereby prolonging the downward pressure on the wealth of current homeowners and the resultant drag on the economy at large.

In addition, reducing the deadweight losses from foreclosures, which compound the losses that households and creditors already bear and result in further downward pressure on house prices, would provide further support to the housing market as well as provide assistance to struggling homeowners. Policymakers might consider minimizing unnecessary foreclosures through the

[44] MERS provides services related to tracking and registering residential mortgage ownership and servicing, acts as mortgagee of record on behalf of lenders and servicers, and initiates foreclosure actions. The April 2011 enforcement action included an action against MERS (see note 1).

[45] Although most of the information that would be registered is already in the public record, safeguards would be needed to protect privacy.

use of a broad menu of types of loan modifications, thereby allowing a better tailoring of modifications to the needs of individual borrowers; and servicers should have appropriate incentives to pursue alternatives to foreclosure. Policymakers also may want to consider supporting policies that facilitate deeds-in-lieu of foreclosure or short sales in order to reduce the costs associated with foreclosures and minimize the negative effects on communities.

Restoring the health of the housing market is a necessary part of a broader strategy for economic recovery. As this paper suggests, however, there is unfortunately no single solution for the problems the housing market faces. Instead, progress will come only through persistent and careful efforts to address a range of difficult and interdependent issues.

PREPARED STATEMENT OF EDWARD J. DEMARCO

ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

FEBRUARY 28, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I am pleased to be invited here today to discuss the actions the Federal Housing Finance Agency (FHFA) has taken or will take in our role as Conservator for Fannie Mae and Freddie Mac (the Enterprises) to aid recovery of the U.S. housing market.

In my testimony, I will respond to the Committee's request for a description of FHFA's work as Conservator of the Enterprises to address barriers to housing recovery, including our leadership role in preventing foreclosures through loss mitigation, facilitating refinancing at today's low interest rates, and initiating a real estate owned (REO) program to address the supply of foreclosed homes.

Current Activities

Let me start by describing some of the key activities that FHFA and the Enterprises have undertaken to address problems in the mortgage market. In contrast to how they are sometimes portrayed, the Enterprises are playing a leading role in providing assistance to homeowners and seeking to avoid foreclosures. As I have stated before, these activities are based on FHFA's statutory responsibilities as Conservator, and the Enterprises' historic statutory missions.

Enterprise Loss Mitigation Activities

The Enterprises have been leading the effort on foreclosure prevention since they entered conservatorship. On a nationwide basis, Fannie Mae and Freddie Mac own or guarantee 60 percent of the mortgages outstanding, but they account for a much lower proportion, 29 percent of seriously delinquent loans. These are loans that have been delinquent for 3 or more months or are in the process of foreclosure. However, the housing crisis is concentrated in a handful of States. Ten States account for approximately half of loans serviced and 60 percent of the country's seriously delinquent loans. Similar to the nationwide proportions, the Enterprises hold approximately 59 percent of the loans in those States but account for 29 percent of seriously delinquent loans in those States. As such, while the Enterprises are taking a leadership role in solving the crisis, similar actions from the holders of the other 70 percent of seriously delinquent loans are crucial to a successful outcome.

Even though the Enterprises have a smaller share of seriously delinquent loans than other market participants, they account for about half of all Home Affordable Modification Program (HAMP) permanent modifications. Similarly, data from the Office of the Comptroller of the Currency (OCC) show that in the 2 years ending in the third quarter of 2011, modifications on Fannie Mae and Freddie Mac loans accounted for 40 percent of all loan modifications. Between HAMP modifications and their own proprietary loan modifications, Fannie Mae and Freddie Mac have completed over one million loan modifications since the fourth quarter of 2008. These modifications typically lowered borrowers' payments by substantial amounts and have yielded positive results.

The performance of Enterprise modified loans has improved relative to Enterprise loan modifications from before HAMP was fully implemented, and it is better relative to contemporaneous modifications on Federal Housing Administration (FHA) or Veterans' Administration (VA) loans and loans held by private investors. For Enterprise loans modified throughout 2010, fewer than 20 percent of the loans had missed two or more payments after 9 months. Comparable redefault rates are down from the 40 percent range for their loans modified in 2008 and most of 2009.

Some observers have cited declines in the number of loan modifications completed by Fannie Mae and Freddie Mac over the past year or so as evidence of a lack of support for foreclosure prevention. In fact, this trend is applicable to all investors in mortgages as illustrated by the OCC's report. The quarterly number of loan modifications peaked in the second and third quarters of 2010 for all investors in mortgages (*i.e.,* the GSEs, FHA, VA, portfolio investors, and private investors). A contributing factor to this trend may be that the initial backlog of eligible borrowers in 2009 has been addressed to some extent.

The continued leadership and improvements in the Enterprises' foreclosure prevention efforts is based on continued program evaluations and efforts to make these programs work better. In particular, the Servicing Alignment Initiative (SAI) established new borrower communication requirements for servicers to ensure that borrower outreach occurs at the earliest stage of delinquency, when foreclosure prevention measures are most effective. Furthermore, under SAI, Fannie Mae and Freddie Mac made clear that servicers are expected to evaluate borrowers for the full range of loss mitigation options simultaneously. This allows the borrower and servicer to pursue and lock in an alternative to foreclosure as quickly as possible. Servicers are obligated to collect information from borrowers and assess their eligibility for a modification well before a loan is referred for foreclosure and such referrals may only occur after an independent review of the case to ensure that the borrower was, in fact, considered for an alternative to foreclosure.

To encourage loan modifications, the Enterprises offer substantial incentive payments to servicers to motivate them to meet the aggressive timelines for offering loan modifications, be they HAMP or Enterprise standard modifications. The payments should cover the servicers' costs for engaging in more borrower outreach, such as "door-knocking" and other face-to-face techniques.

The SAI improvements represent a highly targeted approach, the goal of which is to refocus the servicers' resources and attention on moving all borrowers into alternatives to foreclosure, quickly, efficiently, and aggressively. The SAI aligned the requirements of the Enterprises to remove inconsistencies that could cause servicers confusion and delay.

Furthermore, under the SAI the Fannie Mae standard modification program was adopted by Freddie Mac, again, to ensure that borrowers had easy access to a simple and straightforward modification option. I am pleased to see that the Treasury Department has acknowledged the benefit of this program, creating a Tier 2 program under the HAMP that is modeled on the Enterprise program. As the data show, more borrowers have benefited from the Enterprise modification programs than from HAMP, so I think that this program change will help more households access a modification.

The Home Affordable Refinance Program

Fannie Mae and Freddie Mac are at the forefront of refinance activity for current borrowers. Since April 1, 2009, the Enterprises have completed more than 10 million refinances, accounting for 63 percent of refinance originations over that period. With respect to underwater borrowers, Fannie Mae and Freddie Mac account for less than half of underwater borrowers compared to their 60 percent share of total mortgages serviced. However, Fannie Mae and Freddie Mac are the only institutions that currently operate a large-scale refinancing program for underwater borrowers. Since the inception of the Home Affordable Refinance Program (HARP), the Enterprises have completed over one million HARP refinances. Furthermore, since the inception of HARP, Fannie Mae and Freddie Mac have completed 1.9 million streamlined refinances that expedited the refinance process for borrowers.

HARP was designed in 2009 to allow borrowers with loans backed by Fannie Mae and Freddie Mac, whose loan-to-value (LTV) ratios had increased as a result of declining home values, a refinancing option that did not require new or additional mortgage insurance coverage. In October 2011, FHFA announced a set of changes to HARP meant to enhance access to the program.

The program allows lenders to qualify borrowers using a very streamlined underwriting process, relying on the borrower's payment history as an indication of capacity and willingness to repay the new loan. While this streamlined underwriting approach is available for most borrowers with loans backed by Fannie Mae and Freddie Mac, those with the highest LTV ratios stand to benefit most because they have fewer or no other refinance options available to them. HARP is intended to serve these borrowers, whose LTV ratios are greater than 80 percent.

FHFA and the Enterprises have been closely tracking program participation and performance since the program's inception in 2009. The eligible population for the program is fairly limited, but the data, reported monthly in the FHFA Foreclosure Prevention and Refinance Report, suggested that some borrowers were not being reached or were not taking advantage of the program.

To better understand why eligible borrowers were not accessing the program, FHFA and the Enterprises established a task force to work with the industry to assess and streamline program operations. The research showed that increasing access to the program would not be driven by addressing any single or obviously restrictive program feature. Rather, a variety of operational constraints and risk mitigation measures put in place by program participants, to control for and limit a transfer of risk from one party to another required revision. By working through the broad set of issues with a cross-section of market participants, FHFA and the Enterprises were able to create an environment where all parties were willing to accept some degree of risk and to streamline program requirements and operations in a way that was mutually beneficial.

In the end, the set of policy changes announced by FHFA were fairly simple—(a) extend the program sunset date to December 31, 2013, to provide lenders with more time to execute against the more liberal program terms; (b) provide lenders with additional relief from representations and warranties, to provide comfort that the Enterprises would not pursue repurchases for defects in original loan files; (c) transmit property value data to lenders to use when originating the new loans, limiting the need for appraisals; (d) reduce the loan-level pricing adjustments for all borrowers and eliminate them altogether for borrowers who choose mortgage terms of 20 years or less, a product option that reduces risk to the Enterprises and helps a borrower build equity faster; and (e) remove the loan-to-value cap, previously set at 125 percent. The program modifications took effect on December 1, 2011, for those lenders who were able to update and implement quickly; for most in the industry, including the Enterprises, implementation will continue through the next few months.

In exchange for these program changes, lenders and mortgage insurance companies agreed to remove their own restrictions and overlays, to offer the program in a manner that is consistent with the parameters set out by the Enterprises. This agreement across the industry was unprecedented and the participation and support of the industry is to be commended. Already many of the largest lenders are seeing tremendous borrower interest and we expect to see an increase in HARP volume in the upcoming reports.

Some have suggested that the program changes made to HARP ought to be carried over to the rest of the book of business at Fannie Mae and Freddie Mac. In fact, both companies do have streamlined refinance programs available today. The data suggests that borrowers are not having any excessive difficulty accessing these and other refinance programs as over 10 million households have refinanced with Enterprise-backed loans over the last 3 years.

Real Estate Owned Initiative

The Enterprises are also in the process of evaluating alternative methods for selling Real Estate Owned (REO) in ways that produce value for taxpayers and contribute to improved housing market stability. Yesterday we announced the first transaction in our REO Initiative pilot program. This transaction includes approximately 2,500 properties, divided into 8 subpools by geographic area. Information on the number of properties in each location is available on FHFA's Web site, but let me say here that the targeted Metropolitan Statistical Areas are likely no surprise to you because they represent hard-hit parts of the country: Las Vegas, Nevada; Phoenix, Arizona; various communities in Florida; Chicago, Illinois; Riverside and Los Angeles, California; and Atlanta, Georgia.

With this next step, prequalified investors will be able to submit applications to demonstrate their financial capacity, relevant market experience, and specific plans for purchasing pools of foreclosed properties with the requirement to rent the purchased properties for a specified number of years.

Future transactions will also be targeted to these types of markets, where the supply of homes for sale is greater than the demand from homebuyers and where demand for rental housing is strong. The pilot is not intended to be a national bulk sale program, where the entire existing inventory is pooled for sale to investors; we are engaged in a targeted effort that is focused on markets with a large number of foreclosed properties and where local market conditions suggest a possible benefit from this approach.

The number of properties available for sale by Fannie Mae and Freddie Mac represents only a fraction of the total supply that is depressing home values in certain affected markets. The existing retail sales strategy at both companies works well for moving properties into the hands of new owner-occupants at close to market values. However, through FHFA's REO Initiative, we are testing to see if FHFA can help address the broader set of market conditions with pilot programs that could serve as models to be replicated by other market players and in differing market situations.

In addition to this pilot work, which is focused on moving properties in bulk, both companies are looking for ways to enhance their existing retail sales strategies, reexamining the programs available for homebuyers and for small investors. The Enterprises' retail execution has been very successful to date. Our primary goal will continue to be selling properties first to homebuyers who will use them as their primary residences or nonprofits that include homes in mission-oriented activities. We also want to enhance the opportunity for smaller-scale investors to bid on properties, and obtain financing, should initial efforts to market the properties to owner-occupants fail.

Strategic Plan

At FHFA we are faced with a fundamental task of directing the operations of two companies that account for roughly three-quarters of current mortgage originations and have approximately $5 trillion in outstanding obligations and credit guarantees.

FHFA's task is complicated by the uncertain future of the Enterprises and increasing dissatisfaction with various aspects of their business operations. Conflicting opinions abound about what our responsibilities should be. Some think FHFA should be doing more to help housing recover, others think that FHFA should be winding down the Enterprises' operations more quickly, others think that FHFA should be making all the business decisions at the Enterprises, and others think that the Enterprises are part of the Federal Government.

To address these issues, what FHFA has done since conservatorship is to be clear about how we view our legal responsibilities as Conservator, and what actions we are going to take to fulfill those responsibilities.

Two years ago, FHFA sent a letter to Congress that set forth the agency's understanding of its conservatorship obligations and what actions we intended to take to fulfill those obligations. In that letter, we focused on four main areas, including: Enterprise focus on loan modifications and mitigating credit losses; reduction in the Enterprises' retained portfolios; no new product deployments by the Enterprises; and meeting the Enterprises' affordable housing goals.

It is time to update and extend that plan in view of where the Enterprises and the country's housing system are today. In particular, with the conservatorships operating for over 3 years and no near-term resolution in sight, it is time to assess the goals and directions of conservatorship.

The strategic plan FHFA released last week, which is attached to this testimony, outlines the steps FHFA has taken and will be taking to address these challenges. The plan sets forth three strategic goals for the next phase of conservatorship:

1. *Build.* Build a new infrastructure for the secondary mortgage market.
2. *Contract.* Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.
3. *Maintain.* Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

The first goal—building a new infrastructure—recognizes that the country would be without a secondary market for non- Government-insured mortgages without the Enterprises. No private sector infrastructure exists today that is capable of securitizing the $100 billion per month in new mortgages being originated. This goal establishes the steps FHFA and the Enterprises will take to create that necessary infrastructure and upon which Congress and market participants may use to develop the mortgage market of the future.

The "Build" component includes the following activities, some that FHFA has already been working on over the last year:

- New securitization platform
- Standardized pooling and servicing agreements, including transparent servicing requirements
- Servicing compensation structure that promotes competition
- Enhanced loan-level data for investors
- An efficient system for document custody and record keeping

The second goal—contracting Enterprise operations—describes steps that FHFA plans to take to gradually shift mortgage credit risk from the Enterprises to private investors and eliminate the direct funding of mortgages by the Enterprises. This goal is consistent with the fundamental goals of the conservatorship, of the Enterprises operating in a sound and solvent condition, and of limiting future risk exposure in the face of uncertainty.

The "Contract" component includes the following activities:

Single-Family Credit Guarantees

- Increase guarantee fee pricing
- Develop loss-sharing arrangements
- Expand ways of using mortgage insurance

Multifamily Credit Guarantees

- Market analysis of the viability of the Enterprises' multifamily operations

Capital Markets

- Portfolio already on a steady path of reduction

The third goal—maintaining foreclosure prevention efforts and credit availability—recognizes that the work begun 3 years ago is not finished. Programs and strategies to ensure ongoing mortgage credit availability, assist troubled homeowners, and minimize taxpayer losses while restoring stability to housing markets continue to require energy, focus, and resources.

The “Maintain” component includes the following activities:

- Implementation of recent HARP changes
- Continued implementation of SAI and loss mitigation activities
- Further implementation of REO disposition initiative
- Renewed focus on short sales, deeds-in-lieu, and deeds-for-lease foreclosure prevention options
- Alignment and greater transparency on Enterprise representation and warranty policies

Achieving these strategic goals will fulfill the statutory responsibilities Congress assigned FHFA as Conservator and also prepare the foundation for a new, stronger housing finance system in the future. Although that future may not include Fannie Mae and Freddie Mac, at least as they are known today, this important work in conservatorship can be a lasting, positive legacy for the country and its housing system.

Properly implemented, this strategic plan should benefit:

- Homeowners, by ensuring continued emphasis on foreclosure prevention and credit availability;
- Taxpayers, by furthering efforts to limit losses from past activities while simplifying risk management and reducing future risk exposure;
- Market participants, by creating a path by which the Enterprises’ role in the mortgage market is gradually reduced while maintaining market stability and liquidity; and
- Lawmakers, by building a foundation on which they may develop new legal frameworks and institutional arrangements for a sound and resilient secondary mortgage market of the future.

The public interest is best served by ensuring that Fannie Mae and Freddie Mac have the best available corporate leaders and business professionals to carry out the work necessary to meet the critical goals set forth here. The managers and staff at each company also have critical roles to play since the numerous activities and changes necessary to accomplish the strategic goals will require substantial effort by many people at Fannie Mae and Freddie Mac.

Conclusion

The strategic plan provides an outline for the next chapter of conservatorship, one that focuses in earnest on building a secondary mortgage market infrastructure that will live beyond the Enterprises. The steps envisioned in the strategic plan are consistent with various approaches to housing finance reform.

The final chapter, though, remains the province of lawmakers. Fannie Mae and Freddie Mac were chartered by Congress and by law, only Congress can abolish or modify those charters and set forth a vision for a new secondary market structure. This plan envisions actions by the Enterprises that will help establish a new secondary mortgage market, while leaving open all options for Congress and the Administration regarding the resolution of the conservatorships and the degree of Government involvement in supporting the secondary mortgage market in the future.

I would be happy to answer any questions you may have about my testimony or FHFA’s new strategic plan.

A Strategic Plan for Enterprise Conservatorships:

The Next Chapter in a Story that Needs an Ending

February 21, 2012

Summary

Since establishing conservatorships for Fannie Mae and Freddie Mac (the Enterprises) in 2008, the Federal Housing Finance Agency (FHFA) and the Enterprises have focused on three key goals:

- mitigating Enterprise losses, which ultimately accrue to taxpayers;
- ensuring families have access to mortgages to buy a home or refinance an existing mortgage; and
- offering borrowers in trouble on their mortgage an opportunity to modify their loan or otherwise avoid foreclosure.

Two years ago, FHFA sent Congress a letter setting forth the agency's understanding of its conservatorship obligations and how it planned to fulfill those obligations. It is time to update and extend that plan in view of the status of the Enterprises and the country's housing system today. In particular, with the conservatorships operating for more than three years and no near-term resolution in sight, it is time to assess the goals and directions of the conservatorships.

This assessment has been made in light of FHFA's statutory mandate to "take such action as may be necessary to put [Fannie Mae and Freddie Mac] in a sound and solvent condition." FHFA also needs to make sure strategic decisions about the Enterprises' future are in accord with the statutory purpose of the conservator for "reorganizing, rehabilitating, or winding up the affairs of a regulated entity."

This strategic plan outlines the steps FHFA has taken and will be taking to address these challenges. The plan sets forth three strategic goals for the next phase of conservatorship:

1. **Build.** Build a new infrastructure for the secondary mortgage market.

2. **Contract.** Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.

3. **Maintain.** Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

The strategic plan explores each of these goals and identifies particular actions FHFA is contemplating, or already taking, to accomplish them.

The first goal – building a new infrastructure – recognizes that the country would be without a secondary market for non-government-insured mortgages without the Enterprises. No private sector infrastructure exists today that is capable of securitizing the $100 billion per month in new mortgages being originated. Simply shutting down the Enterprises would drive up interest rates and limit mortgage availability. This goal establishes the steps FHFA and the Enterprises will take to create that necessary infrastructure, including a securitization platform and national

standards for mortgage securitization that Congress and market participants may use to develop the mortgage market of the future.

The second goal – contracting Enterprise operations – describes steps that FHFA plans to take to gradually shift mortgage credit risk from the Enterprises to private investors and eliminate the direct funding of mortgages by the Enterprises. This goal is consistent with the fundamental goals of the conservatorship, of the Enterprises operating in a sound and solvent condition, and of limiting future risk exposure in the face of uncertainty.

The third goal – maintaining foreclosure prevention efforts and credit availability – recognizes that the work begun three years ago is not finished. Programs and strategies to ensure ongoing mortgage credit availability, assist troubled homeowners, and minimize taxpayer losses while restoring stability to housing markets continue to require energy, focus, and resources.

Achieving these strategic goals will fulfill the legal requirements Congress assigned FHFA as conservator and also prepare the foundation for a new, stronger housing finance system in the future. Although that future may not include Fannie Mae and Freddie Mac, at least as they are known today, this important work in conservatorship can be a lasting, positive legacy for the country and its housing system.

Properly implemented, this strategic plan should benefit:

- Homeowners, by ensuring continued emphasis on foreclosure prevention and credit availability;
- Taxpayers, by furthering efforts to limit losses from past activities while simplifying risk management and reducing future risk exposure;
- Market participants, by creating a path by which the Enterprises' role in the mortgage market is gradually reduced while maintaining market stability and liquidity; and
- Lawmakers, by building a foundation on which they may develop new legal frameworks and institutional arrangements for a sound and resilient secondary mortgage market of the future.

The public interest is best served by ensuring that Fannie Mae and Freddie Mac have the best available corporate leaders to carry out the work necessary to meet the critical goals set forth here. The managers and staff at each company also have critical roles to play since the numerous activities and changes necessary to accomplish the strategic goals will require substantial effort by many people at Fannie Mae and Freddie Mac.

The early chapters of the conservatorship story focused on market functioning and loss mitigation. More recent chapters have covered renewed efforts to enhance refinancing opportunities and real estate owned (REO) disposition. The strategic goals and performance objectives set forth here provide an outline for the next chapter of the story, one that focuses in earnest on building a secondary mortgage market infrastructure that will live beyond the

Enterprises. This next chapter will also see a gradual reduction in the Enterprises' dominant position in holding mortgage credit risk as private capital is encouraged back into that role.

The final chapter, though, remains the province of lawmakers. Fannie Mae and Freddie Mac were chartered by Congress and by law, only Congress can abolish or modify those charters and set forth a vision for a new secondary market structure.

One critical point: The steps envisioned in this strategic plan are consistent with each of the housing finance reform frameworks set forth in the white paper produced last year by the U.S. Department of the Treasury and the U.S. Department of Housing and Urban Development as well as with the leading congressional proposals introduced to-date. This plan envisions actions by the Enterprises that will help establish a new secondary mortgage market, while leaving open all options for Congress and the Administration regarding the resolution of the conservatorships and the degree of government involvement in supporting the secondary mortgage market in the future.

A Strategic Plan for Enterprise Conservatorships:

The Next Chapter in a Story that Needs an Ending

Introduction

The Housing and Economic Recovery Act of 2008 (HERA), which created the Federal Housing Finance Agency (FHFA), granted the Director of FHFA discretionary authority to appoint FHFA conservator or receiver of the Enterprises "for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity."[1]

On September 6, 2008, well over three years ago, FHFA exercised that authority, placing the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (together, the Enterprises) into conservatorships. FHFA has since overseen the largest, most complex conservatorships in history.

Two years ago, FHFA sent Congress a letter setting forth the agency's understanding of its conservatorship obligations and how it planned to fulfill those obligations. It is time to update and extend that plan in view of the status of the Enterprises and the country's housing system today.

The two companies have received more than $180 billion in taxpayer support. The benefit to the country from maintaining their operations has been to ensure the secondary mortgage market continues to function. During this time, the Enterprises have completed more than 2 million foreclosure prevention actions, including more than 1 million loan modifications and they have refinanced more than 10 million mortgages. Together they are guaranteeing roughly $100 billion per month in new mortgage production, representing about 3 of every 4 mortgages being originated. But the Enterprises' ongoing operations are entirely dependent on taxpayer support provided through the Senior Preferred Stock Purchase Agreements with the U.S. Department of the Treasury.

The future of the Enterprises and the housing finance system continues to be the subject of many questions and much debate. A new structure for housing finance requires congressional action,

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[1] Housing and Economic Recovery Act of 2008, Section 1367 (a)(2), amending the Federal Housing Enterprises Financial Safety and Soundness Act, 12 USC 4617(a)(2).

but no clear legislative consensus has emerged from the Administration or Congress. In the meantime, like other large, complex financial institutions, the Enterprises require strategic direction though they face an uncertain future. Market participants are also seeking answers about the future.

This strategic plan provides lawmakers and the public with an outline for how FHFA as conservator intends to guide the Enterprises over the next few years. FHFA has developed this plan because of the following:

- The Enterprises' boards of directors and management teams can more readily fulfill the goals of conservatorship with a clear and transparent course of action.
- As investors in the Enterprises today, taxpayers deserve a plan on how their continued support will be used.
- Proposals for rebuilding the secondary mortgage market vary in their reliance on government credit guarantees but most assume some sort of securitization infrastructure to take the place of the Enterprises or assume the Enterprises' securitization infrastructures are used in some way in the future.
- Lawmakers have asked FHFA for ideas on a stable transition from a secondary market dominated by the Enterprises to one that could operate without them.
- FHFA committed to provide a strategic plan for the next stage of the conservatorships in response to a request from the Chairman of the House Financial Services Subcommittee on Oversight and Investigations in December 2011.

As with any strategic plan, this document is not a step-by-step guide. Rather, it sets forth certain broad objectives that are consistent with FHFA's legal mandate and the policy direction that has emerged from the Administration and Congress. Importantly, this plan is consistent with each of the housing finance reform frameworks set forth in the white paper produced last year by Treasury and the U.S. Department of Housing and Urban Development (HUD) and with the leading congressional proposals introduced to-date. This plan envisions actions by the Enterprises that will help establish a new secondary mortgage market, while leaving open all options for Congress and the Administration regarding the resolution of the conservatorships and the degree of government involvement in supporting the secondary mortgage market in the future.

FHFA remains committed to its obligation to ensure a stable and liquid secondary mortgage market while preserving and conserving Enterprise assets to minimize taxpayer losses. FHFA looks forward to continuing to work with Congress and the Administration on a resolution of the conservatorships and a comprehensive review of the country's housing finance system.

Background: The Early Chapters of the Conservatorship Story

The Law

As conservator and regulator, FHFA has three legal obligations that direct the agency's activities and decisions involving the Enterprises.

First, HERA specified two conservator powers, stating that the agency may "take such action as may be

(i) necessary to put the regulated entity in a sound and solvent condition; and

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."[2]

FHFA has reported on numerous occasions that, with taxpayers providing the capital supporting Enterprise operations, this "preserve and conserve" mandate directs FHFA to minimize losses on behalf of taxpayers.

Second, although each Enterprises is in conservatorship, without statutory changes their mission of supporting a stable and liquid mortgage market remains the same as before the conservatorships. FHFA has a statutory responsibility to ensure each Enterprise "operates in a safe and sound manner"[3] and that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets."[4]

Third, under the Emergency Economic Stabilization Act of 2008 (EESA), FHFA has a statutory responsibility to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of … available programs to minimize foreclosures."[5]

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[2] 12 USC 4617(b)(2)(D)

[3] 12 USC 4513(a)(1)(B)(i)

[4] 12 USC 4513(a)(1)(B)(ii)

[5] 12 USC 5220(b)(1)

Conservatorship Goals

In 2008, the immediate objectives of conservatorship were to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets. Because the private mortgage securitization market had already retreated and there were no other effective secondary market mechanisms in place, the Enterprises' continued operations were necessary for most Americans to obtain a mortgage or refinance an existing mortgage.

Since 2008, several government efforts have kept the country's housing finance system functioning, including:

- the Treasury Department's financial backstop of Enterprise debt and mortgage-backed securities (MBS);
- Treasury's and the Federal Reserve's MBS purchases;
- FHFA's and the Enterprises' actions to ensure the continued functioning of the secondary mortgage market; and
- the Federal Housing Administration's (FHA) rapidly growing market presence.

As a result, credit has remained available, albeit with more restrictive underwriting terms, and more than 10 million Americans have refinanced Fannie Mae and Freddie Mac mortgages.

During these years, these same government agencies together with the Enterprises and other market participants undertook a series of efforts to help families avoid foreclosure through loan modification programs and foreclosure alternatives. For FHFA and the Enterprises, these efforts directly relate to the "preserve and conserve" mandate because such activities are designed to reduce credit losses on mortgages originated primarily in the years before conservatorship. In addition, these efforts are consistent with FHFA's other mandates, including the EESA mandate to maximize assistance for homeowners. Since conservatorship began, the Enterprises have completed more than two million foreclosure prevention actions, including more than one million loan modifications.

Today, loss mitigation efforts focus on helping households as early as possible when they become delinquent on their mortgages, and employing innovative strategies for returning foreclosed properties back to the market. The continued high level of mortgage delinquencies shows that more is left to do, but several programs now exist to address these challenges. FHFA and the Enterprises will remain vigilant in ensuring that appropriate assistance and support is offered to all homeowners in distress through loan modifications and other foreclosure avoidance tools.

Three years into conservatorship, it is time to update and extend the goals of conservatorship in light of FHFA's statutory mandate and the market environment that has evolved since 2008. As noted, the operations of the Enterprises in conservatorship are unlike anything the country has experienced. The conservatorship structure was designed to allow a temporary period for an institution to stabilize and return to the market or to lead to an orderly disposition of a firm.

Unlike the banking industry, there are not thousands of potential firms ready to step into the business of mortgage securitization. Indeed, outside of the securitization available through the Government National Mortgage Association (Ginnie Mae) for loans primarily backed by FHA, there is little else in place today to assume the secondary market functions served by the Enterprises.

What Needs to Be Done Now

Policymakers need to address the future structure of housing finance, which would allow for a smooth transition from today's market. Without action by Congress, FHFA must continue to look to the existing statutory provisions that guide the conservatorships. In particular, FHFA must consider what it means to "take such action as may be necessary to put [Fannie Mae and Freddie Mac] in a sound and solvent condition" when it is clear that the draws the companies have taken from the Treasury are so large they cannot be repaid under any foreseeable scenarios.

Without further statutory direction, FHFA views the mandate to restore the Enterprises to a sound and solvent condition as best accomplished not only through aggressive loss mitigation efforts, but also by reducing the risk exposure of the companies, through appropriate underwriting and pricing of mortgages. Such actions are consistent with what would be expected of a private company operating without government support. At the same time, the unanticipated length of the conservatorships poses additional risks for taxpayers and markets not contemplated by HERA. FHFA views those risks as best managed by contracting the Enterprises' footprint in the marketplace.

To achieve these outcomes, FHFA will need to make strategic decisions regarding the Enterprises' level of participation in the market while developing ways for the taxpayers to ultimately derive value, consistent with FHFA's "preserve and conserve" mandate.

Reviewing the Existing Landscape: Considerations for Moving Forward

In view of FHFA's statutory mandates and in light of the current environment, it is necessary to define new goals for the Enterprises operating in conservatorship. Key issues and circumstances FHFA faces include the following:

- The Enterprises' losses are of such magnitude that the companies cannot repay taxpayers in any foreseeable scenario.

- The operational infrastructures at each company are working but require substantial investment to support future business. The question is whether to improve the current infrastructure or to consider this an opportunity to build something new.

- In the absence of other comparable market infrastructure, minimizing future taxpayer losses and ensuring market liquidity and stability requires preserving the Enterprises as working companies. But some of the things this approach requires, such as retaining some semblance of private sector pay comparability, have generated concerns because the companies receive substantial taxpayer assistance.

- Although the housing finance system cannot be called healthy, it is stable and functioning, albeit with substantial ongoing government support.

- Congress and the Administration have not reached consensus on how to resolve the conservatorships and define a path for housing finance. Legislative proposals have begun to emerge, but enactment soon appears unlikely.

Absence of consensus on a resolution of the conservatorships does not imply a lack of consensus on general direction. Both the Administration and Congress have expressed discomfort with the level of government involvement in the mortgage market and a desire for greater private sector participation and risk-taking. A central issue remains: whether a government guarantee is essential to a functioning mortgage market. On other market issues, some consensus has emerged on what is needed to fix the problems we have witnessed over the past several years. At a minimum there is a desire for greater standardization and more equitable and transparent treatment of borrowers and investors in mortgage origination, mortgage servicing, and securities disclosure.

Over the past two years, FHFA has initiated several long-term improvements to the housing finance system that address shortcomings in the current system, meet the goal of reducing taxpayer exposures, and provide flexibility for lawmakers as they move toward legislative action on housing finance. These improvements include the following:

- The Uniform Mortgage Data Program will improve the consistency, quality, and uniformity of data collected at the beginning of the lending process. Developing standard terms, definitions, and industry standard data reporting protocols will decrease costs for originators and appraisers and reduce repurchase risk. It will allow new entrants to use industry standards rather than having to develop their own proprietary data systems to compete with other systems already in the market. Common data definitions, electronic data capture, and standardized data protocols will improve efficiency, lower costs and enhance risk monitoring. Standardizing data will be a key building block of housing finance reform.

- The Joint Servicing Compensation Initiative is considering alternatives for future mortgage servicing compensation for single-family mortgage loans. The goals of any changes to the current Enterprise model of compensation will be improving service for borrowers, reducing financial risk to servicers, and providing flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the "To Be Announced" mortgage securities market. More broadly, the goals of the initiative are to consider changes to the servicing compensation structure that would improve competition in the market for mortgage servicing and which could be replicated across any form of housing finance reform.

- The Servicing Alignment Initiative has produced a single, consistent set of protocols for servicing Enterprise mortgages from the moment they first become delinquent. This initiative responds to concerns about how delinquent mortgages have been serviced and it simplifies the rules for mortgage servicers by giving them just one set of procedures to follow whether a mortgage is owned by Fannie Mae or Freddie Mac. The first phase of this initiative has already been implemented. Developed in consultation with the federal banking agencies and state attorneys general, the new requirements could serve as the basis for establishing broad national mortgage servicing standards.

- The Loan-Level Disclosures Initiative will produce loan-level investor disclosures on Enterprise MBS, both at the time of origination and throughout a security's life. Improving MBS disclosures will help establish consistency and quality of data. With better information, private investors can efficiently measure and price mortgage credit risk, which will likely be a hallmark of any form of housing finance reform.

Writing the Next Chapter: Setting the Strategic Goals

Looking ahead, three broad goals will define the focus of the conservatorships for the next few years:

1. **Build.** Build a new infrastructure for the secondary mortgage market.

2. **Contract.** Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.

3. **Maintain.** Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

Achieving these strategic goals will fulfill the legal requirements Congress assigned FHFA as conservator and also prepare the foundation for a new, stronger housing finance system in the future. Although that future may not include Fannie Mae and Freddie Mac, at least as they are known today, this important work in conservatorship can be a lasting, positive legacy for the country and its housing system.

Properly implemented, this strategic plan should benefit:

- Homeowners, by ensuring continued emphasis on foreclosure prevention and credit availability;

- Taxpayers, by furthering efforts to limit losses from past activities while simplifying risk management and reducing future risk exposure;
- Market participants, by creating a path by which the Enterprises' role in the mortgage market is gradually reduced while maintaining market stability and liquidity; and
- Lawmakers, by building a foundation on which they may develop new legal frameworks and institutional arrangements for a sound and resilient secondary mortgage market of the future.

Strategic Goal 1: **Building a New Infrastructure**

The absence of any meaningful secondary mortgage market mechanisms beyond the Enterprises and Ginnie Mae is a dilemma for policymakers expecting to replace the Enterprises. This fact was a key motivation for the conservatorships and for the Treasury support agreements in the first place. Without an alternative market infrastructure that investors could rely on, new mortgages would have been largely unavailable if the Enterprises suddenly had been shut down.

The elements for rebuilding the market system are known and work on them can begin without knowing whether there will be a government guarantee apart from FHA in the mortgage market of the future. In fact, the four initiatives FHFA and the Enterprises have already begun would be essential to any new infrastructure.

A secondary mortgage market infrastructure without Fannie Mae and Freddie Mac would likely include the following elements:

- A framework to connect capital markets investors to homeowners – specifically, a securitization platform that bundles mortgages into any of an array of securities structures and provides all the operational support to process and track the payments from borrowers through to the investors.

- A standardized pooling and servicing agreement that replaces the Enterprises' current Servicer Participation Agreement and corrects the many shortcomings found in the pooling and servicing agreements used in the private-label MBS market before the housing bubble burst.

- Transparent servicing requirements that set forth requirements for mortgage servicers' responsibilities to borrowers and investors across a spectrum of issues including delinquent loan servicing, solicitation for refinance or loan modifications, and servicing transfers.

- A servicing compensation structure that promotes competition for, rather than concentration of, mortgage servicing. Such a structure would take full account of mortgage servicers' costs and requirements, and consider the appropriate interaction between origination and servicing revenue.

- Detailed, timely, and reliable loan-level data for mortgage investors at the time a security is issued and throughout the life of the security. Such transparency is a prerequisite for private capital to bear a meaningful portion of mortgage credit risk.

- A sound, efficient system for document custody and electronic registration of mortgages, notes, titles, and liens that respects local property laws but also enhances the liquidity of mortgages so that borrowers may benefit from a liquid secondary market for buying and selling mortgages. Such a system should be especially attuned to privacy and security issues while providing full transparency where required by law or in the interest of borrowers.

- An open architecture for all these elements, to facilitate entry to and exit from the marketplace and an ability to adapt to emerging technologies and legal requirements over time.

Securitization Platform

Beyond the initiatives FHFA and the Enterprises have begun, a cornerstone to building for the future is a new securitization platform. While competing securitization platforms may emerge in the future, back-office operations arguably lend themselves to a public utility construct, at least in the early stages of building a new secondary mortgage market infrastructure. The economies of scale are substantial as are the potential market benefits of standardization to a single securitization platform. Neither Enterprise has a securitization infrastructure capable of becoming a market utility today. Taking on that role would require substantial investment of both human capital and information technology resources.

Both Enterprises would have to draw from the American taxpayer to make such a long-term infrastructure investment, so it makes more sense to do this only once. FHFA will determine how Fannie Mae and Freddie Mac can work together to build a single securitization platform that would replace their current separate proprietary systems.

In the intermediate term, a single platform would allow for a single mortgage-backed security. Accomplishing this objective will take time. FHFA and the Enterprises will provide market participants with ample time to adjust to the new structure in order to minimize disruptions and uncertainty. Ensuring, indeed enhancing, liquidity for mortgage-backed securities will be a central objective.

For the platform to have long-term value, it should have an open architecture that will permit multiple future issuers of mortgage-backed securities to access the platform and it should be flexible enough to permit a wide array of securities and mortgage structures. Since this platform could become a type of public utility (in effect) that would outlast the Enterprises as we know them today, input from all market stakeholders will be sought.

The intended outcome of such an important infrastructure investment is to provide a sound securitization platform on which to rebuild the country's secondary mortgage market. The platform itself will be one way American taxpayers realize a return on their substantial investment in the Enterprises while also making it possible to retire the Enterprises' proprietary systems and programs from the marketplace. The platform will be designed to issue securities supported with or without a government guarantee.

Pooling and Servicing Agreements

Beyond building the operational infrastructure to issue mortgage-backed securities, building for the future also requires developing and implementing standards for underwriting, disclosures, servicing and other considerations. Creating a robust and standardized pooling and servicing agreement is key. The strategic goal is to learn from the Enterprises' existing practices and the shortcomings identified in the private-label mortgage-backed securities market and to solicit broad public input to build a better standard for the future. Input from investors and a careful review of applicable Securities and Exchange Commission rules and best practices will be essential.

As with the securitization platform, the goal is not to rebuild Fannie Mae and Freddie Mac but rather to leverage the experience and human capital expertise at these firms to build a new infrastructure for the future. The goal is not a proprietary system but rather an open system that promotes competition and transparency while forming a basis for a stable, liquid, and efficient secondary mortgage market.

Developing these standards will not only correct past problems, it will make the existing system better. We know how past shortcomings have harmed borrowers and investors. Since the point of a secondary mortgage market is to operate an infrastructure that most efficiently brings investor capital to individual families seeking to finance a home, standards must be more transparent and accessible for both of these "end-users."

Strategic Goal 2: **Contracting Enterprise Operations**

Since entering conservatorship in September 2008, Fannie Mae and Freddie Mac have bought or guaranteed roughly three of every four mortgages originated in the country. Mortgages guaranteed by FHA make up most of the rest. Reducing the Enterprises' position in the marketplace and doing so in a safe and sound manner, in the absence of other comparable private-sector players operating in this market, is the second strategic goal.

The Enterprises operate three lines of business: a single-family mortgage credit guarantee business, a multifamily mortgage credit guarantee business, and a capital markets business that finances single-family and multifamily mortgages by issuing debt securities in the capital markets.

Single-Family Credit Guarantees

The first strategic goal sets forth a plan for moving away from each company's proprietary securitization platform but it does not address the mortgage credit insurance business. It is that business for which the securitization platform provides the architecture for delivering the Enterprise guarantee to investors. Establishing a path for shifting mortgage credit risk from the Enterprises (and, thereby, taxpayers) to private investors is central to the second goal.

Gradually shifting mortgage credit risk from Fannie Mae and Freddie Mac to private investors could be accomplished in several ways. The following are under consideration or already being implemented:

- Increase guarantee fee pricing. Continued gradual increases in the Enterprises' guarantee fee (or, g-fee) pricing may move their pricing structure closer to the level one might expect to see if mortgage credit risk was borne solely by private capital. In September 2011, FHFA announced its intention to continue a path of gradual price increases based on risk and the cost of capital. In December 2011, in the Temporary Payroll Tax Cut Continuation Act of 2011, Congress directed FHFA to increase guarantee fees by at least an average of 10 basis points and further directed that FHFA consider the cost of private capital and the risk of loss in setting guarantee fees. Congress also encouraged FHFA to require guarantee fee changes that reduce cross-subsidization of relatively risky loans and eliminate differences in fees across lenders that are not clearly based on cost or risk.

- Establish loss-sharing arrangements. Most Enterprise mortgage securitization yields securities fully guaranteed by the Enterprises. Alternative securities structures could result in private investors bearing some or all of the credit risk. FHFA is considering various approaches, including senior-subordinated security structures.

- Expand reliance on mortgage insurance. As required by law, most mortgages purchased or guaranteed by the Enterprises with less than 20 percent borrower equity in the property have private mortgage insurance in the first-credit-loss position. While some mortgage insurers are facing financial challenges as a result of housing market conditions, others may have the capital capacity to insure a portion of the mortgage credit risk currently retained by the Enterprises. This could be accomplished through deeper mortgage insurance coverage on individual loans or through pool-level insurance policies.

Multifamily Credit Guarantees

Unlike the single-family credit guarantee business, each Enterprise's multifamily business has weathered the housing crisis and generated positive cash flow. In contrast to their common approach to their single-family businesses, Fannie Mae and Freddie Mac do not take the same approach to their multifamily businesses. For a significant portion of its business, Fannie Mae shares multifamily credit risk with loan originators through its delegated underwriting program. For a significant and increasing portion of its business, Freddie Mac shares multifamily credit risk with investors by issuing classes of securities backed by multifamily mortgages where the investor bears the credit risk. Both approaches are broadly accepted in the marketplace.

Rising rental rates and declining vacancy and delinquency rates reflect, in part, the shift of some households from home ownership to renting as well as other demographic trends. The demand for Enterprise employees with expertise in this specialized market is also strong; both companies have lost key personnel to other market participants.

Multifamily lending has played an important role in how the Enterprises have fulfilled past affordable housing mandates, but the activity itself is more akin to other commercial real estate lending than to the Enterprises' single-family businesses. In conservatorship, the Enterprises have seen their market share grow in the multifamily sector but they do not dominate that market as they do in single-family.

Given these conditions, generating potential value for taxpayers and contracting the Enterprises' multifamily market footprint should be approached differently from single-family, and it may be accomplished using a much different and more direct method. To evaluate how to accomplish the second strategic goal in the multifamily business, each Enterprise will undertake a market analysis of the viability of its multifamily operations without government guarantees. This will require market reviews of their respective business models and the likely viability of those models operating on a stand-alone basis after attracting private capital and adjusting pricing, if needed, to attract and retain that capital.

Capital Markets

Before conservatorship, many Enterprise observers and analysts thought capital market activities to be each company's source of greatest profits, controversy and risk. With the numerous subsidies inherent in the government-sponsored enterprise (GSE) charters granted by Congress, the Enterprises have long been able to borrow money in the capital markets by issuing debt securities at interest rates approaching those of Treasury securities. They did this not by virtue of their financial strength and strong capital base, but because of a broad perception in the marketplace that the government would not let the companies default on their obligations. With this borrowing advantage, which was unavailable to other investors, the Enterprises issued debt to buy mortgages, including their own MBS, in competition with private investors.

The Enterprises fund their retained portfolios through their capital markets operations, which need to continually monitor and hedge the interest rate risk inherent in mortgages, including the risk that changing interest rates could lead to either sudden mortgage prepayments or a slowdown in mortgage prepayments. Interest rate risk overwhelmed the savings and loan industry in the 1980s and made Fannie Mae technically insolvent in the early 1980s. Although capital markets operations were not the leading contributor to the losses that led the Enterprises into conservatorship and the accompanying taxpayer support, it remains a complex business activity requiring specialized and expert risk managers.

Today, this business line is already on a gradual wind-down path. The Treasury support agreements require the Enterprises to shrink their retained mortgage portfolios at a rate of 10 percent per year. Most mortgages the Enterprises add to their retained portfolios today are delinquent mortgages removed from their mortgage-backed securities. Each Enterprise also has certain legacy assets from before conservatorship, including private-label MBS, for which there is little or no liquidity in the marketplace. Thus, over time the Enterprises' retained portfolios are becoming smaller, but also less liquid.

Maximizing returns for taxpayers on the $1.4 trillion in mortgage assets currently owned and financed by the Enterprises is a key element of FHFA's mandate as conservator. The gradual wind-down of the retained portfolios since 2009 has led FHFA to consider strategic sales of assets that maximize value for the conservatorships. But depressed market prices for many of these assets, particularly when tied to market illiquidity rather than a permanent decline in asset value, argues for holding some of them for a longer period to minimize taxpayer loss.

In view of the need to retain capital market expertise to operate this business, accomplishing the second strategic goal for this line of business has two basic options: retain each company's in-house capital markets expertise to continue to manage these portfolios to maximize value while managing risk or retain a third-party investment firm(s) to manage each company's portfolio. The first is less disruptive but retains human capital risk, especially in view of proposed legislation on Enterprise compensation. The second option would hasten the shrinkage in Enterprise headcount but is likely to be the more costly, and it poses new control and oversight challenges for FHFA.

Strategic Goal 3: **Maintaining Foreclosure Prevention Efforts and Credit Availability**

Amidst the building up and winding down activities defined by the first two strategic goals, there remains a critical third goal: ensuring ongoing stability and liquidity in the marketplace for new mortgages and mortgage refinancing, and continuing the critical tasks of foreclosure prevention and loss mitigation. This third goal has been central to the conservatorships since they began and it continues to be essential today.

Together, the Enterprises purchase or guarantee roughly $100 billion in home purchase and refinanced mortgages each month. Market confidence in the Enterprises' ongoing ability to provide this stable, liquid flow of mortgage-backed securities to investors is essential to stabilizing house prices and ensuring stability in the value of nearly $3.9 trillion in outstanding Enterprise mortgage-backed securities.

Other ongoing Enterprise activities that must be continued and enhanced include:

- Successful implementation of the Home Affordable Refinance Program (HARP), including the significant program changes announced in October 2011.

- Continued implementation of the Servicing Alignment Initiative, including its rigorous approach to loss mitigation through loan modifications and other means by reaching out to borrowers at the first signs of distress.

- Renewed focus on short sales, deeds-in-lieu, and deeds-for-lease options that enable households and the Enterprises to avoid foreclosure. The frictions and barriers to more successful use of these tools should be identified and removed using the same renewed focus brought to HARP last year. Enhanced use of these foreclosure avoidance tools may have important benefits for borrowers, neighborhoods, and taxpayers. Given the large backlog of pending foreclosures, renewed focus on these alternatives is a near-term priority.

- Further development and implementation of the real estate owned (REO) disposition initiative announced by FHFA last year. Adding creative strategies for placing foreclosed homes back into the marketplace, including efforts to convert properties into rental units, remains a promising path to reduce losses and to stabilize house prices and neighborhoods hit hard by the housing crisis.

Beyond these sensible strategies to assist homeowners and reduce taxpayer losses, achieving the third strategic goal will require FHFA and the Enterprises to work harder to resolve certain long-standing concerns in the marketplace that may be suppressing a more robust recovery and limiting credit availability. Each of these will be particularly challenging to resolve as they are essential to conservatorship efforts to minimize losses and to put the Enterprises in a more sound and solvent condition to manage the new business being taken on with taxpayer support.

First, representations and warranties are a long-standing means for enhancing liquidity in the mortgage origination process while protecting the Enterprises from loans not underwritten to prescribed standards. Representations and warranties are a loan originator's assurance to an Enterprise that a mortgage sold to the Enterprise has been underwritten as specified by contract, and, if that is found not to be the case, the originator undertakes responsibility for buying the loan back at par. Enforcing these claims ensures the Enterprises are compensated for losses that are the legal responsibility of another party. Still, such enforcement is costly and some have argued it has delayed market recovery because it led to new mortgage originations being underwritten to stricter standards than the Enterprises require.

FHFA and the Enterprises will respond to this market concern by aligning and making policies for representations and warranties more transparent (consistent with the first strategic goal). As noted earlier, a long-term goal associated with the Uniform Mortgage Data Program is to reduce representation and warranty risk through up-front monitoring of loan quality. In conjunction with this initiative and, in the interim, defining more clearly under what conditions representations and warranties will be employed to put back mortgages is an objective under the third strategic goal. Completing the resolution of outstanding "put back" requests is a related objective.

Second, FHFA has filed 18 separate lawsuits in connection with alleged securities law violations in private-label mortgage-backed securities purchased by the Enterprises. Speedy resolution of these claims would also help restore some vibrancy to the mortgage market and put claims related to past deficiencies to rest.

Accomplishing the Strategic Goals: Human Capital and Business Realities

No business endeavor can be successful without careful consideration of human capital. The numerous activities and changes necessary to accomplish the three strategic goals described here cannot be accomplished solely by legislation or declaration. They require substantial effort by many people at both Fannie Mae and Freddie Mac.

The boards and executives responsible for the business decisions that resulted in the Enterprises entering conservatorship and subsequent taxpayer support are long gone. Nearly every current top executive at each company either joined the company *after* the conservatorships were established or were promoted from within to replace departed executives. It is also worth noting that shareholders of each Enterprise effectively have already lost their entire investment.

The public interest is best served by ensuring that Fannie Mae and Freddie Mac have the best available corporate leaders to carry out the work necessary to meet the critical goals set forth here. FHFA and the Enterprises' boards of directors currently are engaged in a search for a new chief executive officer (CEO) for each company. We are seeking accomplished corporate leaders willing to undertake the unique challenge of running a large, complex financial institution while fulfilling the public goals described here in an uncertain legislative environment. FHFA and the boards are seeking highly qualified executives willing to take on these daunting challenges as a form of public service, despite the ongoing criticism of the companies and their executives. The success of these new CEOs will depend directly on the stability and experience of the executive teams and staff already in place at each company. Disrupting what has taken more than three years to achieve will only add to taxpayer losses and threaten the fragile housing recovery.

FHFA and the Enterprise boards of directors have taken seriously the concerns raised by members of Congress and the public regarding executive compensation. For 2012, work on a new compensation structure that eliminates bonuses is nearly complete. The new structure will be all salary, some paid currently, but a larger portion will be deferred. The deferred salary will be at-risk, meaning it may be reduced (but not increased) from the target amount, and reductions would be based on shortcomings in achieving individual performance goals and corporate conservatorship goals tied to this strategic plan.

Mid-level managers and rank and file staff have been held to a pay freeze the past two years. Yet retention of these staff is at least as important as retaining senior management. The day-to-day running of the businesses and the countless decisions that result in gains or losses are made in these ranks. Even with the great uncertainty as to the future of their companies, many Enterprise staff have remained committed to the important work taking place there.

When the conservatorships were created, FHFA made clear to Enterprise employees, Congress, and the public that retaining corporate managers and staff was essential to the work of the conservatorships. Conservatorship did not turn once-private companies into government agencies, nor their workers into government employees. As with everything else with these conservatorships, there has been a challenging yet critical balancing required.

In addition to the senior managers and staff, the Enterprises' boards of directors have played, and continue to play, an important role in assisting Enterprise management and FHFA. Board members themselves are engaged in a form of public service while retaining fiduciary responsibility as board members, and they too face unique challenges as boards of companies in government conservatorship.

From FHFA's standpoint, part of what is being preserved and conserved at the Enterprises is the processes and procedures, including business decision-making and requirements, of private financial institutions. These are critical to safe and sound operations, and can be disrupted by a failure at the senior management or operational staff levels. Each board's oversight of its Enterprise helps to preserve and reinforce among managers and staff these important private-sector disciplines. Each board's review and consideration of risk management practices, key business decisions, human capital management, and other key functions greatly assists FHFA in its regulatory and conservatorship responsibilities by providing the discipline and rigor expected of corporate boards. In these ways, the boards help FHFA enhance the corporate value at each Enterprise for ultimate disposition by Congress.

Conservatorship: Writing the Final Chapter

The early chapters of the conservatorship story focused on market functioning and loss mitigation. More recent chapters have covered renewed efforts to enhance refinancing opportunities and REO disposition. The strategic goals and performance objectives set forth here provide an outline for the next chapter of conservatorship, one that focuses in earnest on building a secondary mortgage market infrastructure that will live beyond the Enterprises themselves. This next chapter will also see a gradual reduction in the Enterprises' dominant position in holding mortgage credit risk as private capital is encouraged back into that role.

The final chapter, though, remains the province of lawmakers. Fannie Mae and Freddie Mac were chartered by Congress and by law, only Congress can abolish or modify those charters. The strategic plan set forth here will move the housing finance system forward and enhance the foundation on which Congress can make decisions about the role of government in the future of the country's housing finance system. Congress then can decide on the disposition of the Enterprises and their business operations.

This plan does not anticipate Fannie Mae and Freddie Mac continuing as they existed before conservatorship. And though the Enterprises may well cease to exist at some point in the future, at least as they are known today, the country's $10 trillion single-family mortgage market will not go away. Therefore, an orderly transition to a new structure is needed.

Ensuring the ongoing liquidity and stability of the market, and establishing new conduits that connect local mortgage originators with the capacity of global capital market investors, will require new institutions and legal frameworks. The executives and employees of Fannie Mae and Freddie Mac are well situated to begin the process of building for that future and they can be expected to remain key contributors to housing finance in whatever new companies and institutional arrangements arise to replace Fannie Mae and Freddie Mac. Getting the most value for taxpayers and bringing stability and liquidity to housing finance during this long transition remain the overriding objectives of FHFA as conservator.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SHAUN DONOVAN

Q.1. Secretary Donovan, in your testimony before the Committee, you stated that the non-GSE loans that would be eligible for refinancing through the Federal Housing Administration as part of the President's recently announced housing plan are "already low-risk loans." The President's plan, however, appears to include loans that do not fall into this category. For example, it specifies that the refinancing program would be open to borrowers with a low FICO score of 580 as well as borrowers with "deeply underwater loans."

How do you define "low-risk loans?"

A.1. Although the plan calls for loans with FICOs as low as 580, the plan explicitly states that the loan must be current at the time of the refinancing. Furthermore, the borrower must have exhibited a strong track record of on-time payments, with no late payments in the 6 months prior to the refinancing and no more than one 30 day late in the 6 months prior to that. The borrower may have suffered one or more hardships in the past which may be the reason the credit score is low, however, the borrower has reestablished the ability to pay and has proven responsibility with the strong 12-month payment history.

Q.2. Specifically, what are the expected default rates for borrowers eligible for this program? What is the expected participation rate, and how many foreclosures do you expect this program would prevent? What is the projected subsidy for this program, and how would it be offset?

A.2. We expect that that with homeowners experiencing lower interest rates, the likelihood of default would be decreased. However, at this time we do not have official estimates of default rates, participation rates, or other performance parameters.

It is estimated, based on the current program guidelines that roughly three million borrowers would be eligible to participate. We cannot estimate exactly how many homeowners will participate in this program, as the decision to refinance is contingent on many personal factors, such as expected time in a residence, employment, *etc.*

This is not an explicitly targeted foreclosure prevention program like HAMP, but we do expect that home ownership sustainability will improve when homeowners can refinance to lower rates. This in turn improves neighborhood stability and reduces the likelihood of default in the long run.

We are working with members of the Senate to develop program parameters and identifying sources of funding to serve as a backstop to the premiums that would be collected through the program to absorb unexpected large losses.