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STRENGTHENING THE HOUSING MARKET AND MINIMIZING LOSSES TO TAXPAYERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT

OF THE

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

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING ACTIONS THAT CAN STRENGTHEN THE MORTGAGE MARKET AT NO OR MINIMAL COST TO TAXPAYERS

MARCH 15, 2012

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C O N T E N T S

THURSDAY, MARCH 15, 2012

STRENGTHENING THE HOUSING MARKET AND MINIMIZING LOSSES TO TAXPAYERS

THURSDAY, MARCH 15, 2012

U.S. SENATE,
SUBCOMMITTEE ON HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee convened at 2:33 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Robert Menendez, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN ROBERT MENENDEZ

Chairman MENENDEZ. This hearing will come to order. Thank you all for being here today.

The hearing of the Banking Subcommittee on Housing, Transportation, and Community Development will examine actions that can strengthen the mortgage market at no or minimal cost to taxpayers, including mortgage modifications, such as principal reduction or shared appreciation, reducing distressed property sales, and increasing demand and people's ability to buy homes. This hearing is an important one since the housing market is often what anchors the broader economy and we need to be able to fix the housing market to get the broader economy moving more robustly again and to create jobs.

On a regular basis, I hear from New Jersey homeowners who have trouble with their home loans, whether it is being denied the opportunity to refinance at today's lower interest rates because they are either underwater, or the lost paperwork and years of waiting to get an answer on their request from a mortgage modification from their bank, is a constant challenge.

Like the private sector, the Government should employ more creative tools to reduce defaults and help the housing market recover, such as principal reductions and shared appreciation models, among other methods. In particular, I would note that private banks are finding it more profitable than other methods of mortgage modifications to do principal reductions on about 20 percent of their own portfolio loans, and yet the Government is not even allowing principal reduction on any of its loans, completely removing that tool from the toolbox. So I would like to explore whether or not that makes sense from a simple business judgment perspective about how to best protect taxpayer assets and I look forward to examining these innovative methods, among others, to get the housing market back on track.

With no other Member at this point before the Subcommittee, let me welcome all of our witnesses and I will introduce you. John DiIorio is the Chief Executive Officer for 1st Alliance Lending. Mr. DiIorio spent 15 years of experience in the mortgage industry and has been at the forefront of loss mitigation and refinance efforts. First Alliance is a leading originator of both Hope for Homeowners and short refinance loans, so we appreciate you coming.

Dr. Mark Calabria is the Director of Financial Regulation of the CATO Institute, has worked there since 2009. Before that, he was a senior member of the professional staff of this Subcommittee and we appreciate him coming back. In that position, he worked on issues related to housing, mortgage finance, economics, banking, and insurance for Ranking Member Shelby and he has appeared before the committee many times and we appreciate him coming back to discuss today this issue.

Dr. Laurie Goodman is a Senior Managing Director at Amherst Securities responsible for research and business development. Before joining the firm in 2008, she was head of Fixed Income and Research at UBS. She has also worked at CitiCorp, Goldman Sachs, Merrill Lynch, and the Federal Reserve Bank of New York, and she has appeared before us many times and offered great experience.

So thank you all for coming. With that, Mr. DiIorio, we will start with you and ask you to synthesize your oral testimony to about 5 minutes. All of your statements will be completely included in the record and this way we will have a little time to have a discussion. Mr. DiIorio.

STATEMENT OF JOHN C. DiIORIO, CHIEF EXECUTIVE OFFICER, 1ST ALLIANCE LENDING

Mr. DiIorio. Thank you, Senator. Chairman Menendez, Ranking Member DeMint, and other Members of the Subcommittee, I appreciate the opportunity to testify before you today. I am the CEO of 1st Alliance Lending, a mortgage origination firm that is a leader in originating FHA loans that offer both affordability and principal reduction. We specialize in these loans, which reduce principal for underwater borrowers and provide affordable monthly mortgage payments.

There are a number of programs and loan options that have been created in the last several years to help troubled homeowners, including HAMP loan modifications, HARP, Fannie Mae, and Freddie Mac refinancings, FHA streamlined refinancings, and assistance to unemployed homeowners. While these programs address affordability, generally, they do not provide principal reduction.

We argue, and our experiences substantiate, that principal reduction is critical in concert with affordability efforts in providing long-term solutions to American homeowners. Moreover, we are finding that sophisticated financial entities with their own money at risk in these assets are using principal reduction in a targeted manner to maximize the recovery value of these mortgages. There is a growing consensus that supports these conclusions and I appreciate the opportunity to share our experiences on this subject.

According to CoreLogic, at the end of 2011, 11.1 million homes are underwater. That simply means the amount of the current mortgage exceeds the value of the property. It seems hard to understand how we can address our underlying housing problems and restore health to the housing market without addressing this issue.

Homeowners who are underwater are house-locked, unable to sell their home should they need to move for employment. Homeowners who are significantly underwater, particularly in areas where housing prices are less likely to recover, face the prospect of a very long period in which they will have no equity in their home. HAMP and other proprietary loan modifications address affordability problems, but even HAMP assistance phases out over time and ultimately borrowers receiving payment modifications will continue to be faced with the challenge of negative equity.

An often overlooked fact is that principal reduction, done correctly and in a targeted manner, is sometimes the best economic option for the holder of the mortgage and often significantly enhances the value of the asset. In fact, we increasingly see holders of underwater mortgages utilizing principal reduction as part of their asset maximization efforts. These are sophisticated counterparties acting in their own financial best interest. Of course, where they utilize this option, it is also good for the homeowner and, by extension, for housing markets by reducing risk of default and foreclosure.

First Alliance Lending works with a number of major banks, investment banks, and sophisticated financial counterparties who hold or purchase pools of single-family loans, including loans to currently distressed and underwater borrowers. First Alliance analyzes these pools to identify borrowers who qualify for our programs and for whom it makes sense financially to utilize this option.

We have utilized FHA refinance principal reduction programs, which provide opportunities for these types of distressed homeowners to refinance their existing loan, but only the existing first mortgage holder forgives a portion of principal in order to meet FHA's loan-to-value requirements.

For homeowners that qualify, we do far more than the cursory calculations that are done for loan modifications. We do full underwrites. We analyze the borrower's total debt burden-to-income to make sure the homeowner is financially sound and capable of meeting their financial obligations. These steps are important in reducing redefault and foreclosure risk because modifications which focus only on payment affordability of the first mortgage loan do not take into account the financial stress of other debt that the homeowner may have.

Again, let me emphasize, these investors and mortgage holders that we work with agree to principal reductions voluntarily. Moreover, they make the decision to do so in their own financial best interest.

First Alliance has been underwriting FHA loss mitigation loans long enough that we now have a track record with seasoned loans. From the perspective of the FHA, I am very pleased to let you know the redefault rates on these loans are very low, far lower than ever expected. As of March 1, our default rate—cumulative default rate—was just below 8.6 percent. This performance, we contend, shows the powerful impact of principal reduction.

There is significant question about moral hazard when it comes to principal reduction. I hope we take some time to address those questions today because I think it is an important part of the discussion, and I want it to be known, we do not experience a lot of moral hazard in our process. We are not seeing borrowers who are looking for a free ride or a handout. These are people that have genuine hardship. Refinance with principal reduction offers them a long-term solution.

Thank you. I look forward to your questions.

Chairman MENENDEZ. Thank you very much.

Dr. Calabria.

STATEMENT OF MARK CALABRIA, DIRECTOR OF FINANCIAL REGULATION STUDIES, CATO INSTITUTE

Mr. CALABRIA. Chairman Menendez, Senator Corker, other Members of the Committee, thank you for the invitation to appear at today's hearing.

Before delving into maybe the less cheery aspects of my testimony, let me first say that I believe that there is a very strong likelihood that 2012 is going to be the year that the national housing market hits bottom. I expect there to be continued depreciation, but I expect it to be small, on the order of around 3 percent. I also say I think a number of metropolitan markets might actually see positive appreciation later in this year. So the positive is, I do think we are getting very close to a bottom.

A turn around in the housing market, even if it is modest, would have a substantial impact on both the mortgage market and the overall economy. As importantly, the recent improvements in the labor market will ultimately filter through to the housing market. In fact, I would say I do not think there is any bigger driver behind the housing market today than the labor market. Stabilization or modest improvement in house prices will also change the incentive for borrowers to default. It is not simply the level of prices, but also the direction of prices that impacts a borrower's decision to default. Further appreciation, even from a position of negative equity, will reduce the rate of defaults.

As we know, our housing and mortgage markets are in distress. Rather than repeat that here, let me focus on what I think are a few bright spots as well as a few dark spots.

First, despite all the talk about negative equity and strategic default, the vast majority of underwater borrowers continue to pay their mortgages. For prime borrowers, over 75 percent of underwater borrowers are current. Even the majority of subprime borrowers are current. The fact is that most Americans believe they have an obligation to honor their commitments. According to a recent Fannie Mae National Housing Survey, only about 10 percent of respondents thought it was appropriate to walk away from a mortgage they could not otherwise pay. On the other hand, about a fifth of subprime borrowers with significant positive equity are currently 90 days late or more—60 days late or more. We have to keep in mind that foreclosure is driven by far more than just equity.

On the gloomier side, about 40 percent of loans currently in foreclosure have not made a payment in over 2 years. Over 70 percent of loans have not made a payment in over a year. Quite frankly, it is hard for me to imagine many of these borrowers ever becoming current again.

Almost half of loans currently entering foreclosure today were previously in foreclosure at some point in the past. The good news is that new problem loans, that is, loans that were current 6 months previous to becoming late, actually peaked in the spring of 2009 and have been steadily declining ever since.

Before turning to where I disagree with my fellow panelists, let me first emphasize there is a considerable amount of agreement. For instance, I believed increased bulk sales by the GSEs can serve as a useful way to get properties back into the marketplace. I believe there is a substantial amount of investor money willing and able to purchase GSE REOs in bulk. These purchases could then be converted into rental or rehab and sold for home ownership. Of course, this must be done in a way to maximize the return for the taxpayer.

Let me emphasize another point of agreement, which is that improving credit availability is perhaps, you know, in my opinion, the most important piece. What is holding back our housing market is a combination of weak demand and excess supply. Part of that weak demand is a result of excessively tight credit standards. My estimate is that between 2006 and today, about a fifth of the mortgage market has disappeared. Obviously, some of that credit we do not want to come back, but some of it, we do. Of course, drawing the appropriate line is always harder in practice than in theory.

One line that I believe that has been drawn too tightly are the Federal Reserve's 2008 changes to HOEPA. Under these changes, and at today's interest rate, any mortgage over 5.5 percent would be considered high cost. We all know that, historically speaking, 5.5 percent is not a bad rate. Some would say it is actually a great rate and is certainly not per se predatory. We also know the HOEPA label carries with it substantial regulatory, reputational, and litigation risk. While it is hard to measure the exact impact of this regulation, the evidence indicates to me that the 2008 HOEPA changes have eliminated a significant part of our mortgage market.

Laurie in her testimony also touches upon the qualified mortgage definition. I think that is something that needs to be rethought, as well. It would have a detrimental impact on mortgage availability.

Now moving to the point of disagreement, namely the topic of principal reduction, first, let me say I applaud those lenders and investors who have found a way to make it work. I think other lenders should take a look at that. I think other investors should try to take a look at it.

But I think that it is important to remember that the Government plays by a different set of rules and incentives. Lenders have been able to do principal reduction on a case-by-case basis. I think in a world of both politics and, just as importantly, due process, we should not pretend that the GSEs should be able to operate in the same manner.

My fellow panelist modified his suggestion for principal reduction by saying, quote, "done correctly and in a targeted manner." Quite frankly, these are not terms that I would generally use to describe our Federal foreclosure efforts. My fellow panelist has also stated that his firm uses principal reduction for borrowers who have experienced an adverse life event and not simply for those who do not want to pay. I think this is an incredibly important qualification.

Ms. Goodman also suggests in her testimony to limit principal reduction to those who are already delinquent. I would agree with that here. But if you are going to do principal reduction, which I have a great deal of skepticism about, I do believe you need to limit it to borrowers who are both already late and have exhibited some inability to pay. For those who simply do not want to pay, quite frankly, I think we should treat them as anyone else who does not want to honor their obligations. Let us be clear that anybody who defaults on a GSE or FHA loan is costing the taxpayer and should be treated as such.

Now, I believe the reason that the GSEs should not be forced to preserve principal reduction is that loan forbearance, in my opinion, is already an effective and generous method for dealing with the inability to pay. If a borrower cannot pay now, then we should not require them to do so. In the future, when we hope that they can pay, we can require such. I will note that this also allows for the preservation of GSE assets that is consistent with the statutory language of HERO.

Again, I thank you for your attention. I look forward to your comments and questions.

Chairman MENENDEZ. Thank you.

Dr. Goodman.

STATEMENT OF LAURIE S. GOODMAN, SENIOR MANAGING DIRECTOR, AMHERST SECURITIES

Ms. GOODMAN. Chairman Menendez and Members of the Subcommittee, thank you for the invitation to testify today. My name is Laurie Goodman and I am a Senior Managing Director at Amherst Securities Group, a leading broker-dealer specializing in the trading of residential and commercial mortgage-backed securities. I am in charge of our strategy effort, which performs extensive data-intensive studies in an effort to keep ourselves and our customers informed of critical trends in the market.

As you know, the housing market remains in very fragile condition. To strengthen the market, we need to decrease the number of distressed homes for sale. This is best done by increasing the success rate on modification through greater reliance on principal reduction. We also need to increase the demand for distressed homes, both through a ramp-up of the bulk sales program coupled with financing for these properties and a careful vetting of new rules that affect already tight credit availability.

Investors recognize that foreclosure is the worst outcome for both the borrower and the investor. If a home is foreclosed on, it will sell at a foreclosure discount and the recovery to the investor will be further reduced by the heavy costs and expenses that are associated with long foreclosure timelines. It is far more economic for the investor if the borrower is given a sustainable modification.

The types of modifications have changed dramatically over time. There are fewer capitalization modifications in which neither interest rate nor principal balance are decreased. There are many more rate modifications, and more recently, increased use of principal reduction. As you point out, banks have long used principal reduction on their own portfolio. They are now using it extensively for loans and private label securities as it has been shown to be the most effective type of modification. This makes sense, because you are re-equifying the borrower.

The one place principal reduction is not being used is on Fannie and Freddie loans. Fannie and Freddie have no regulatory obstacles to using principal reduction but have chosen not to. Ed DeMarco submitted a letter to Congress detailing the results of an FHFA study showing that principal reduction does not result in a higher value to the GSEs than forbearance. We have reviewed the study and have a number of very substantial objections.

First, there are quite a number of serious technical flaws in the conduct of the study, which is outlined in my written testimony, all of which have the effect of making forgiveness a less attractive option. One example: The results assume that either all borrowers will modify using forgiveness or all modified using forbearance. Looking at the benefit to the GSEs of using multiple strategies was not considered.

Second, the Treasury NPV model, a theoretical model, was used for the analysis. The principal reduction alternative under HAMP has been available for almost 18 months. We have real results and they should have been used.

Finally, the FHFA did not break out loans with and without mortgage insurance. Principal forgiveness is most likely not going to be NPV-positive for loans with mortgage insurance because the GSEs bear the entire cost of the write-down. The insurer does not cover the written down amount if the borrower defaults. We believe that if the analysis was done correctly, the FHFA would have found principal forgiveness makes sense for loans without mortgage insurance, which is two-thirds of their book of business.

FHFA and the GSEs are very concerned about the moral hazard issue. Will borrowers who are current default in order to get a principal write-down? This is a particular worry as more than 90 percent of their book of business is current. We think the moral hazard issue can be easily contained. A provision can be included that the borrower has to be delinquent by a certain date to take advantage of it. Alternatively, a feature can be included such that if the borrower takes the principal reduction, he shares future appreciation with the lender. Senator Menendez, I know you have been supportive of this idea.

New measures permitting the GSEs to be eligible for principal reduction incentive payments and the recent tripling of these incentives should make it more attractive for the GSEs to do forgiveness. In light of these changes, I would urge the FHFA to redo their results, correcting the technical flaws in their study and separating loans with and without mortgage insurance.

Now, I would like to turn to measures that will increase the demand for housing, bulk sales, and credit availability. We are very pleased to see Fannie Mae initiate their bulk sales program. We believe the execution will be very favorable to taxpayers because large-scale investors will pay a bulk sales premium in order to buy a block of homes in a given geographic area. A bulk purchase makes it easier to justify the costs of initiating a professional property management organization in that area. Providing financing will allow for even more favorable execution, encouraging increased use of these programs. I testified before this Subcommittee last September on this issue.

Finally, we are very concerned about credit availability. Lending standards were certainly too loose in the 2005 to 2007 period, as Dr. Calabria pointed out, but are now too tight, and we are concerned that every single action that is being contemplated will actually make it tighter. Our particular concern is the qualified mortgage, or QM, standards. Dodd-Frank required the CFPB to define a qualified mortgage, which is an ability-to-pay measure. The CFPB is unlikely to provide servicers with a safe harbor. Most likely, this will be done as a rebuttable presumption. If this is the case, a bright line test is critical, as lenders are concerned that default itself is evidence of a lack of ability to repay. There is unlikely to be a vibrant market for non-QM loans because of the liability associated with originating these loans. Careful crafting of the QM rule is critical. A greater uncertainty for lenders means that already tight credit availability will get tighter.

In my testimony today, I have discussed three actions that can strengthen the mortgage market at no or minimal cost to taxpayers: Increasing reliance on principal reduction modifications, a ramp-up of the bulk sales program coupled with financing for these properties, and a careful vetting of new rules that affect already tight credit availability. We urge Congress to do everything they can to facilitate these actions.

Thank you very much.

Chairman MENENDEZ. Thank you all for your testimony. I appreciate it.

Let me start off the line of questioning. I have a lot of questions, but let me start off with one line with you, Ms. Goodman, and it is to follow some of your testimony. You know, you cited a number of reasons why FHFA's analysis of principal reduction is either flawed or incomplete and I wanted to go through those with you.

First, I would note that FHFA's own analysis show that principal reduction and principal forbearance are extremely close in their value to taxpayers, so even forgetting about the benefits to homeowners of the overall stability of the housing market, just on that basis alone, there is an argument to be made from their own analysis. Did the FHFA analysis of principal reduction versus principal forbearance include the effect of the Administration's tripling of incentives for principal reduction?

Ms. GOODMAN. It did not.

Chairman MENENDEZ. Could you put your microphone on.

Ms. GOODMAN. It did not include it.

Chairman MENENDEZ. Do you think that if they had included those incentives, the analysis would change the outcome?

Ms. GOODMAN. Absolutely. As you point out, it was very close to begin with. Their study was done before the triple incentives were announced and before Fannie and Freddie were eligible for any of these payments. Including these results would most certainly have changed the analysis, which, as you point out, was very close to begin with.

Chairman MENENDEZ. You also stated in your testimony that FHFA should use principal reduction data in its analysis, not just the NPV analysis which has problems. Why is it important to use actual data on principal reduction or shared appreciation?

Ms. GOODMAN. If you were looking to extend a medical drug and had some trial results, you would be using those results in your case to seek approval to extend the drug. If you have got real results, you should use those real results rather than some theoretical model which was done before those results were available. And remember, we have almost 18 months of real HAMP data on the principal reduction alternative that should be mined.

Chairman MENENDEZ. Let me ask you, you went on to say that the FHFA should have analyzed loans with mortgage insurance and without mortgage insurance——

Ms. GOODMAN. Yes.

Chairman MENENDEZ. ——separately, and that the analysis would have likely shown that principal reduction makes sense for many loans without mortgage insurance.

Ms. GOODMAN. Correct.

Chairman MENENDEZ. Can you explain why breaking down the analysis this way matters in terms of targeting loans for which principal reduction would be both beneficial to the taxpayer as well as the homeowner?

Ms. GOODMAN. That is correct. You know, the problem with doing principal reduction on loans with mortgage insurance is that Fannie and Freddie are essentially subsidizing the mortgage insurer. That is, the mortgage insurer does generally not cover the amount of forgiven principal. So if you have got a Fannie or Freddie loan that a mortgage insurer will cover down to, say, 70 percent—and Fannie does principal reduction on that loan down to, say, 80 percent, the mortgage insurer's liability is limited to 10 percent rather than to 30 percent as it originally was.

Chairman MENENDEZ. Now, let me ask you one other thing. What does not make sense to me, and maybe you can explain it to me, is that the FHFA seems to be saying that there are no GSE borrowers in the entire country for whom principal reduction makes sense. I mean, this is not a question of just using it across the board. But they say it does not make sense anywhere. And yet the private sector seems to be saying it makes sense—and they make decisions based on the bottom line—for about 20 percent of their loans. How does one reconcile that?

Ms. GOODMAN. I think the FHFA study was seriously flawed in that it did not allow some borrowers to get forbearance and some borrowers to get forgiveness. It required either all forbearance or all forgiveness. And in reality in the private sector, we optimize each loan. That is how it should be done and that is how the GSEs should be doing it, as well. If they had done this analysis in that manner, they would have found that for some loans, principal forgiveness was beneficial both to the taxpayer and to the borrower.

I think, to some extent, their fears of moral hazard sort of clouded the analysis, because every single decision that was made in the analysis skews the analysis against finding principal forgiveness to be a profitable strategy.

Chairman MENENDEZ. And on that question, Mr. DiIorio, you said you wanted to talk about moral hazard, the challenge it has presented that you did not find in your experiences. Can you talk about that for a moment.

Mr. DIIORIO. Sure. I think one of the problems with moral hazard is it is often misunderstood. Moral hazard is really the assumption that one party in a contractual agreement is going to act irresponsibly because there is lack of consequence.

We do not see that, and these borrowers are referred to us directly by sophisticated counterparties who are making the decision that this is their best economic option. And the borrower really does not have much choice as to whether or not that transaction proceeds. It is really more in the hands of the current holder of the asset.

So the idea that that is somehow going to lead to mass default just does not seem to be supported by reality. It is just not what we see every day.

Chairman MENENDEZ. Thank you.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank all of you for being here.

Mr. DiIorio, I appreciated your comments about this being tailored appropriately and you all knowing your customers. And I guess one of the concerns that people have had with the HAMP program is that when Government is doing this in a very broad-based way and does not know its customers, it is very difficult for principal reduction programs that, you know, you have a "check the box," you do this box, you do this box. It is a very different arrangement than the way you deal with your customers. And I wonder if you might have any additional comments regarding the differences between an entity like you that knows your customers and deals with them in a tighter way versus these massive programs that we put in place that cannot work in that manner.

Mr. DIIORIO. Sure. I think that Dr. Goodman's testimony was spot on when she talked about the FHFA analysis, right. They were assuming either one blanket solution for their entire portfolio or another blanket solution for the entire portfolio.

Senator CORKER. But is that not the way HAMP is?

Mr. DIIORIO. Uh——

Senator CORKER. I know we are not talking about HAMP for the GSEs——

Mr. DIIORIO. Yes——

Senator CORKER. ——but that is the way our HAMP program is, is it not?

Mr. DIIORIO. Yes, to a certain extent. But I think our experience with private investors, right, and all of this is driven by the private market, which we think is imperative, is that they are making these decisions in sort of a waterfall fashion. So they will say, I have got loss mitigation refinance, I have short sale, I have got foreclosure, and they have got these different options where they can measure their economic recovery based upon a specific situation. We think that is exactly how it needs to be done, that it needs to be done on a loan-by-loan analysis.

Senator CORKER. But the way we set up programs is more of a one-size-fits-all process and it is more difficult to do when you are just laying out, this is the way the Government is going to do it. Is that yes or no?

Mr. DIIORIO. I do not believe there is a one-size-fits-all solution to this problem.

Senator CORKER. OK. Yes, sir, Dr. Calabria.

Mr. CALABRIA. If I could just make a quick comment, we do have to keep in mind that with any Government program, there are basic due process concerns. I mean, to say that one person would be eligible and one person would not, all those things are going to be repealed. I mean, we do not sit around with unemployment insurance and ask who is going to try harder to find a job or not. You are eligible, you get it.

Senator CORKER. That is right. Following up on that, the principal reductions that we have been talking about, talk a little bit about how—let me give an editorial comment. It is my opinion the second lien holders are benefiting and the primary lien holder is basically having a transference of wealth here, and that is one of the big problems with these principal reductions, is it not? Both of you.

Mr. CALABRIA. I think that is absolutely the case. Parties bargain for different places in the line, chains of priority. The second liens get a higher return. They take a higher risk. You know, quite frankly, before any first lien takes a hit, it is my opinion that the second lien should be completely wiped out, not a proportional change but completely wiped out before the first lien takes a hit at all.

Senator CORKER. And that is not the way the massive settlement that we did in the AG's Office worked, was it? I mean, the second lien holders are ending up having the same rights as the first lien holders.

Mr. CALABRIA. Very much a transfer from the first lien holders to the second lien holders, which, I will note, more often than not, the first lien holders are the investors, whether it is pension funds and such, and the second lien holders are the banks.

Senator CORKER. Yes. Dr. Goodman, do you want to comment?

Ms. GOODMAN. I agree with everything Dr. Calabria just said, and the one thing I would like to emphasize is there is no one who has been more of an advocate of principal reduction over the last almost 3 years than I have. Nonetheless, the Attorney General's settlement scares me a great deal because, essentially, banks are getting credit for writing down investor loans, and it was pointed out——

Senator CORKER. And, by the way, those investor loans, I am so glad that especially you are saying that at this hearing. But those investor loans, those are 401(k) programs and pension programs, and so what we did was cram down——

Ms. GOODMAN. Yes, and there is no——

Senator CORKER. ——people's 401(k)s and investments and we benefited second lien holders——

Ms. GOODMAN. Yes.

Senator CORKER. ——did we not?

Ms. GOODMAN. Yes. The second lien and first lien take a write-down proportionately and the second lien holder should have been written off completely before the first lien holder takes a hit. And what is even more frightening here is that the banks have broad authority to figure out how exactly they want to fulfill the credits under this, be it to write down their own loans or to write down investor loans. And the potential for abuse is there.

Senator CORKER. I know the time is up, but let me just ask one last question. The rebuttable presumption issue that you have brought up that is in Dodd-Frank basically says, I mean, if a lender makes a loan and it ever goes bad, then, in essence, as if they should have known better in the first place, which is going to be incredibly dampening on credit, and not having a safe harbor is going to be a killer going down the road as it relates to credit, is that not correct?

Ms. GOODMAN. Absolutely correct.

Senator CORKER. Thank you so much for this hearing.

Chairman MENENDEZ. Thank you, Senator Corker.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you to all of you for your testimony.

I wanted to start, Dr. Goodman, with your testimony about the NPV model that FHFA used. I was really struck because Members of this panel have asked for the details of how that model was constructed to be shared with the U.S. Senate and we have gotten basically nothing, nothing in detail. And I look at what—you are able to note the attributes of the loan at origination were used in those models rather than current attributes, for example, in FICO scores. Were you able to get access to all of the data they generated, and how did you do that? We need some education on this, on how to get information.

Ms. GOODMAN. I made about 50 phone calls.

Senator MERKLEY. Well, good job.

Ms. GOODMAN. You are correct. The information was not available in one place. We looked through the documentation we had on the NPV model and were unable to construct exactly what was done in the study and made a bunch of phone calls to figure it out.

Senator MERKLEY. And so it was not because the FHFA cooperated with you and said, yes, we should make this fully transparent. It should be analyzed. It was not because you got that sort of cooperation.

Ms. GOODMAN. That is correct. We are very persistent.

Senator MERKLEY. Well, well done, and I am going to renew my call to Mr. DeMarco to share his study. It is important for analysts to be able to look at the details, because as a former analyst myself, I can tell you the assumptions that are hidden deep inside a model, you can bend the outcome pretty much where you want to take it, and I think that was your conclusion here.

Ms. GOODMAN. Absolutely. Thank you.

Senator MERKLEY. I want to turn to the bulk sale premium program, and I note your enthusiasm for it. And you mentioned a bulk sale premium. I assume that is that someone would pay more in order to have all the properties in a particular location to facilitate a management company being able to service those properties.

Ms. GOODMAN. That is correct.

Senator MERKLEY. What level of premium would come from that sort of thing?

Ms. GOODMAN. We will see when the first pilot program is actually executed. You have got a lot of private capital being raised for exactly this purpose, and accumulating 3 homes in Indianapolis, 12 in Atlanta, and 15 in Dallas does a large-scale investor absolutely no good because they cannot put into place a professional property management organization.

Being able to accumulate 200 homes in a given area is really, really important to being able to put into place that organization. So if you want to get into an area, you are willing to most likely pay a premium in order to do that, and more of a premium if financing is provided. We will see exactly what the premium looks like as a result of the trial program.

Senator MERKLEY. OK. So I am going to share with you why I was not quite as excited as you were, and maybe you can tell me where my perspective is off here. But everything that I had seen before said that there would be a 30 to 40 percent discount for people who bought the homes in bulk, just because of the large transaction, and I have seen those sorts of deals done in the past, so that sounded reasonable to me.

And I thought, you know, here are all these families out there who have a chance to buy a home at historically low prices, low interest rates. Why do we not offer that 30 to 40 percent discount for working families to buy these homes first, you know, create a 2-month window, and then if they are not sold, then offer them to the bulk investors. And I just feel like ordinary families, they do not even benefit from the home mortgage interest deduction, and the simple math of a $200,000 home with 10 percent down, so you are talking $180,000 at 5 percent, that is $9,000 in interest and the standard deduction is $11,000. So ordinary families do not even benefit from the home mortgage interest deduction. Here is a historic opportunity. Why should we not give families that 30 to 40 percent discount opportunity, and then if they do not take it, offer it to investors?

Ms. GOODMAN. I think there are a couple of things. Basically, there is a benefit to the entire housing market of having the overhang sort of sopped up in bulk. To the extent that you offer it on one-off deals first, you end up with extremely adversely selected homes available for sale in bulk.

In addition, another benefit of bulk sales is quick execution. Remember, every day that a home is sitting there, whoever the lender is is paying the taxes and insurance on that home. Every day the home is sitting vacant or with a borrower who is not paying their mortgage, the home is deteriorating and losing value. So to the extent you do bulk sales and you are able to do a lot of properties very quickly, it is a benefit to the entire housing market.

I do not think you are going to see a 30 to 40 percent discount on those properties. I would be absolutely shocked. And furthermore, Fannie and Freddie would not sell them at a 30 or 40 percent discount. There would just be no trade. And there are advantages to a quick sale in terms of the ultimate savings to the taxpayer.

Senator MERKLEY. I take your point. I take your point if there is not a substantial discount for the bulk sales, then we are not talking about bypassing that for working families. I have seen it argued otherwise, but maybe in this pilot project that will not exist. I will be interested in following that.

And your point on quick execution, absolutely. But if there is a discount of 30 to 40 percent, you would get quick execution for those homes to families, as well. Some of the folks in the audience here are reminding us about the 99 percent in America. Sometimes we structure deals that continue to benefit really big investors and we miss opportunities to help out working families and I just want to make sure we do not do that in this case.

Ms. GOODMAN. Let me just remind you that between Fannie, Freddie, and FHA, they have about 211,000 properties in REO alone, let alone what is in foreclosure. I think there is enough to go around for everyone.

Senator MERKLEY. Thank you. Thank you, Mr. Chair.

Chairman MENENDEZ. Thank you.

I have one or two quick questions. First of all, I want to follow up on Senator Corker's line of questioning. Notwithstanding what the AGs did and the consequences to first and second lien holders, but particularly first lien holders, is there anything in the line of questioning that you and I went back and forth over that would be altered by the answer you gave him?

Ms. GOODMAN. No. Principal reduction is still the best form of modification. It still makes more sense to the first lien investor than any other alternative.

Chairman MENENDEZ. Dr. Calabria, let me ask you, on another question, you mentioned that one of the major constraints on the market is mortgage availability, and I agree that credit issues is a problem. Certainly, the odds of a person getting a mortgage if you are not in the prime borrowers with substantial downpayment is pretty dismal at this time, at least without FHA. What needs to happen to increase credit availability for good potential borrowers, and is QRM part of this issue, because I am concerned that a QRM that some are suggesting is 20, 25 percent down as the standard, at the end of the day, eliminates—without looking at a series of other factors—eliminates a large swath of responsible borrowers at the end of the day. Give me your insights.

Mr. CALABRIA. Let me say, I absolutely agree that part of the problem is credit availability. Part of the problem is obviously we do not fully want to go back to, say, 2005, 2006. Some of that credit, we do not want to come back. But absolutely, today, if you are a prime borrower who can put a lot down, you can get a great rate. If you do not fit into that box, you do not get a loan.

And so I absolutely have very strong concerns about the risk retention and QRM rules. I have strong concerns about the QM. And I have strong concerns about existing HOEPA and TILA regulations in terms of that affecting it. So I do think it is very difficult for anybody who is Alt-A or even the higher quality of previous subprime to get a loan today in the absence of FHA. And so because I do think we need to have a long-term path to have the taxpayer less backing behind FHA and Freddie and Fannie, we need to find ways to get private investors back into this.

I do not want to beat a dead horse with the AG settlement, but the things that do transfer the losses from the lenders to the investors, in my opinion, pushes private capital out of that market. And so I do think we need to be concerned about bringing private capital back in the market and not subjecting it to political risk. So to the extent that we can rethink any of that and make sure that we are drawing the line appropriate so that we do not have predatory lending come back but we do have higher-cost responsible lending come back that reflects the credit risk of the borrower, we absolutely need to do that.

Chairman MENENDEZ. Let me ask you one other question. You said that a third of all FHA borrowers are now underwater and that FHA should exercise their power under Section 203(b)'s program to aid borrowers. Explain to me how that would work.

Mr. CALABRIA. OK. Well, first, let us start with that most of these FHA borrowers, about a third of which are underwater, these loans were made since the burst in the bubble, and this is why I think we need to draw the line correctly, because it is important to get credit availability, but it is also important not to simply create additional foreclosures.

And so under 203(b), one of the things I have suggested is that these loans, by statute, have recourse. And so if a borrower can pay, should be expected to pay, and the FHA can exercise that. They do not. And I would emphasize that is very different than the situation for somebody who cannot pay. And so I think you need to be able to separate that.

And a lot of the talk about principal reduction is about changing borrower incentives. I think I would characterize a lot of what Laurie has talked about is providing carrots. I would say that the Federal Government has some ability to provide some sticks for those who simply choose not to honor their obligations. For those who cannot honor their obligations, we can have a different set of rules.

Chairman MENENDEZ. For those who cannot honor their obligations, do you consider the possibility—of course, this is a case-by-case basis—of principal reduction as a possibility in the portfolio, in the tool of things to be used?

Mr. CALABRIA. Well, my preference would be that we have to keep in mind that it is always the interaction of negative equity with something else—job loss, unexpected expense of some sort. So my first—one way of sort of parsing out those who can pay but do not want to versus those who cannot pay is to look at the underlying cause. So if there is something we could have programs targeted directly toward—if you have lost your job—that, to me, is the No. 1 driver.

But I would say in a very roundabout way to get back to answering your question, yes, that is a legitimate tool for those subset of families that I think want to pay, want to stay in the house, but are having difficulty, and the solution to me is address that difficulty directly and to remember that it is not the negative equity in and of itself causing the difficulty.

Chairman MENENDEZ. All right.

Mr. DIIORIO. Senator Menendez——

Chairman MENENDEZ. Yes, Mr. DiIorio, go ahead.

Mr. DIIORIO. I would—unfortunately, Senator Corker has left. On the second lien issue, I can promise you, every single transaction that goes through our firm, all subordinate liens are extinguished, not just second mortgages. And what we see happen is usually the first mortgage holder and the subordinate lien holders engage each other and they negotiate some sort of agreement that leaves the borrower with a single lien.

So I understand the concerns that are being communicated today about the AG settlement and I think that they are somewhat valid, but that is not what is happening. Second liens are getting out of the way, usually for pennies on the dollar.

Chairman MENENDEZ. You preempted my question. Thank you for that comment.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you for your testimony. I was on the floor, so forgive my late arrival.

Mr. DiIorio, you noted your clients consist of major banks, investment banks, very sophisticated financial institutions. And you further state that, as I understand it, they are in favor of principal reduction, quote, "not out of a sense of charity but because they believe it is in their best financial interest to do so." And so I just want to be clear that I presume from your perspective there is a very strong business case for principal reduction. It is not a matter of being kind to people. It is the bottom line.

Mr. DIIORIO. Absolutely. Our counterparties, they are making financial decisions. There is a lot of talk about NPV, and it is interesting because they all have different NPV models and they are all proprietary and they are all figuring it out in different ways.

But at the end of the day, what we see, what we see happening in the private marketplace is not only are they making the decision, quite frankly, for a segment of their portfolio, it is their first choice, and it is their first choice for one specific reason. It is the most economically viable solution.

So that is—back to Dr. Goodman's testimony about the FHFA analysis, you cannot blanket this. It cannot be done. It needs to be analyzed. There are certain segments of the portfolio. It is data driven. And there is no doubt that for a certain segment of every portfolio, principal reduction is the best answer.

Senator REED. And that would include, obviously, Fannie and Freddie.

Mr. DIIORIO. I believe it does.

Senator REED. Thank you. You know, just to follow on, what is usually thrown up is just not an analytical but an emotional, oh, it is moral hazard, and you go on very specifically about the issue of moral hazard, "To the more specific criticism that we are engaging in moral hazard by giving homeowners an incentive to stop paying their mortgage, I emphasize, that is not our experience." Could you just elaborate.

Mr. DIIORIO. Sure. It is absolutely not our experience. First, these sophisticated counterparties that we were speaking about earlier, they refer these borrowers to us to be analyzed. So the borrower is not making a conscious decision to have all of this happen. It just kind of happens as a normal course of business.

And our experience is—and we deal with literally hundreds and hundreds of people—there is not this real desire for a handout. There is a desire for a solution.

So is intentional default a real thing? It is real. It is absolutely real, but it is very identifiable. If someone is struggling and there is no identifiable change event that got them to the point of struggling, that is pretty easy to see.

My personal view is that moral hazard is overplayed politically. I just do not see it as being a real issue. It is certainly not being talked about with the people that we are dealing with, that is for sure.

Senator REED. Just a final point, and then I want to go on to Dr. Calabria and Dr. Goodman, but your analysis and your clients' analysis is very much because of their duties to their shareholders and to the institutions focused exclusively on the benefits to that enterprise. But there is a broader benefit here. For example, avoiding foreclosure in neighborhoods, that also adds, and I think it goes to some of the failure of the analysis of the FHFA about the systemic effects.

And just to, again, you are saying there is a business case in the specific institutional example, but there might be even a stronger argument when you consider the cumulative effect of many enterprises doing that. Is that fair?

Mr. DIIORIO. It is fair, and, you know, I think it is interesting that the number that was mentioned by Senator Menendez was 20 percent, because we find about 20 percent of our referrals are the ones that qualify and actually make it through. So there is probably—and I do not think that is coincidental. So, yes, there is—and I think Dr. Goodman referred to the just massive portfolio that Fannie and Freddie is holding. I mean, that is clearly where the biggest impact can be had from my perspective.

Senator REED. Let me just skip for a moment over Dr. Calabria to go to Dr. Goodman and just follow up on that point. In individual business cases, Mr. DiIorio is better versed on the case that in many times, the economics dictate reduction. Fannie and Freddie have also the fact that the sheer size of their portfolios, that as they began to move in this direction, that will have effects beyond the individual properties and even beyond their individual portfolios. Is that an accurate assessment, in your view?

Ms. GOODMAN. Yes, it is.

Senator REED. And I think you have been, Dr. Goodman, very critical of the, just the technical analysis FHFA has done on why they do not think principal reduction makes any sense. Could you elaborate on what you think the—and I do not want to be redundant. If you have covered that already, let us know. But if you can give us sort of the top three or four points that they have missed in your view.

Ms. GOODMAN. Yes. I think there were four serious technical issues, ignoring the mortgage insurance issue and ignoring the Treasury NPV issue, which we have already talked about.

First, they used State price level indices, not MSA level indices, so they picked up far fewer high LTV borrowers than there actually are, and these high LTV borrowers are aided more by principal forgiveness than their lower LTV counterparts.

Second, and I mentioned this earlier, the results were done on a portfolio level, not an individual loan level. So the FHFA did not consider the possibility of following a forgiveness strategy for some borrowers and a forbearance strategy for others, which clearly would have dominated the use of a single strategy.

Third, the actual HAMP program was not evaluated. That is, the actual forgiveness in the HAMP program is the lesser of the current LTV minus the target LTV or 31 DTI. The FHFA automatically assumed principal reduction equal to the current LTV minus the target LTV, so they overstated the amount of principal reduction that would have been granted, and that overstatement was most severe for higher-income borrowers.

And last, attributes of the loan at origination, not current attributes, were used for the analysis. So delinquent borrowers, on average, have suffered a deterioration in FICO scores. By using origination characteristics, the health of the borrowers overstated. Hence, the assumed likelihood of success is too high, which overstates the cost of forgiveness. Those were sort of the four technical issues.

Senator REED. I could not have said it any better myself.

[Laughter.]

Senator REED. Thank you, Dr. Goodman. I think what is emerging from both your testimony and Mr. DiIorio's testimony is that this is a tool that should be in the FHFA inventory, as it is in the private sector, not used perhaps in every situation, but certainly used. That is fair. I think I am getting an affirmation there.

Dr. Calabria, again, thank you for your efforts. I know one of the areas where you have been encouraging is REO rental, and that is something that FHFA, to be fair, has begun a process. I will not get into how there should be more deliberation and speed. But that is something, I presume, that you would see as a positive development of FHFA?

Mr. CALABRIA. I would. If done correctly, to be able to speed those properties back into the marketplace, I think that would be an important effect, and not just an effect on the overall market, but importantly, maximizing the value of the assets of the conservatorship.

Senator REED. Thank you.

You know, one of the issues here, too, and it goes to the statutory responsibility of FHFA. I know you have considered it, Dr. Calabria. And they have repeatedly come back, we cannot do certain things. But there is another aspect of this. We have the Inspector General here and he has made some, based on his analysis, conclusions essentially saying that FHFA cannot ensure the efficiency and effectiveness of the oversight program because they do not have the staff. FHA is overly deferential to GSEs, that they do not try to—even though they seem to have absolute authority over them under the legislation, at least that is one impression, and that they are not effectively requiring servicers to use, for want of a better term, best practices.

To me, that seems to be a central aspect of their sort of avowed statutory purpose of protecting the taxpayers. So if they cannot do these things, are they falling down on their first, primary responsibility?

Mr. CALABRIA. Well, let me preface with, as you know and as I fondly remember, one of the reasons we all worked on passing the Housing and Economic Recovery Act after three Congresses of trying to do GSE reform was trying to deal with the staffing issues of OFHEO, trying to deal with the undue deference. Unfortunately, I think a lot of those aspects have remained with FHFA.

I do think that there is a tension between having these entities in conservatorship with the notion that they are still private entities. I think we need to move past, quite frankly, the fraud that they are not owned by us. We, the taxpayers, own Freddie and Fannie. We should admit it. We should take charge of it. And I would encourage, for instance, that we take them into receivership. I think if we regulate it, we would have far greater flexibility. I would also encourage that any principal reductions or modifications that are done are passed on to the debt holders. We are past the financial crisis in that regard. So I do not think this needs to be passed on to the taxpayer repeatedly. And, of course, that also maximizes the return.

But we do need to make a decision. I think it is fair to say that FHFA lacks the staff to run these organizations from the top and has had to rely on that, and that certainly is an issue that needs to be fixed.

Senator REED. A final point—and the Chairman has been very gracious in his time—is that in the immediate weeks, months, *et cetera,* action is called for, my view. And even though there might be a more preferential form, there might be more powers inhibiting receivership, again, working with you and your colleagues on the legislation creating the conservator, it was envisioned that this conservator would have some strong powers that could require the agencies to do certain things, would, in fact, insist that they took every reasonable step to fix it. And when we talked to them, they say they are doing that, and then we have an IG come in and say, well, they are not—under their current legal mandate, not doing all that they can.

Mr. CALABRIA. The distinction I would draw, and I agree that I think that their conservatorship powers are quite broad, where I would draw the distinction is I do not believe they allow, in my opinion, FHFA to take systemic overall marketwide effects into account in what they do. I think that they have a lot of flexibility in trying to preserve and conserve the assets of the enterprises, and I think that is what they are—so to me, for those who want to make the argument and make the push about principal reduction, it really needs to be done in context of you are going to preserve the assets in a better way within that statutory framework.

I will say that I have a lot of sympathy for Mr. DeMarco in the sense of he is not elected as you are. He is not appointed. And I think he has tried to be very conservative in the decisions he has made, given that he lacks the legitimacy of someone who has actually been Senate-confirmed, and so that is a very difficult position to be in.

Senator REED. No, I think this is a tough, tough job for anybody. I will be the first to say that.

Can I have a minute? Thank you. Again, the Chairman has been very gracious.

But under the Emergency Economic Stabilization Act of 2008, there is at least an argument that not only is there a duty to minimize loss to the taxpayer, FHFA, there is also a responsibility to maximize assistance for homeowners and to minimize foreclosures and we seldom hear that in the discussion of the FHFA. It is this drumbeat of minimizing taxpayer losses. Do they have that, also, that dual, or at least complementary responsibility?

Mr. CALABRIA. What I would say is I believe my read of the statute is that their primary mandate is to nurse the companies back to financial health, despite the fact that we all know that they will never be back to a position of financial health.

Quite frankly, I think this is something that Congress needs to be resolving. Again, there is—the ambiguities there are beyond what would give clear guidance, in my opinion, to the regulator.

Senator REED. Thank you very much.

Chairman MENENDEZ. Thank you, Senator Reed. Let me thank all of our witnesses for sharing their expertise today.

I will just make one observation. It seems to me that there are two ways to preserve and conserve the assets. One is through foreclosure, and there are times in which that may be the only reality in which the greatest preservation or conservation of assets takes place. But when the private sector believes that it is in their financial interest, which they seek obviously the greatest return on the dollar—for all my friends who are market-driven, well, here is an example of 20 percent of the market saying this is the best way for us to get the best bottom line.

So I think in the broad context of preserving and conserving assets, that when you have a universe within a very large portfolio in which principal reduction can preserve and conserve assets better than foreclosure, without looking at all the other societal benefits, it is something they should consider. And I hope that what we have gleaned from this hearing is that the Government needs to be flexible enough to adopt policies that can meet both those goals as well as meeting some greater societal values, including maintaining the stability and growth of both the housing market and the whole economy, which inures to the benefit of every American.

So I have asked the FHFA to redo its analysis to take into account the Administration's tripling of its incentives for principal reduction, to use real data from actual principal reductions rather than the NPV analysis alone, which seems to have significant problems, and looking at whether there are any differences in the outcomes between those loans that have mortgage insurance and those that do not, and the FHFA needs to do this all quickly and efficiently since we are already years into the foreclosure crisis and we have not had enough adequate answers to questions that many Members of this Committee have posed. So again, my thanks to all of you. The record will remain open for a week from today if any Senators wish to submit questions for the record. We look forward to, if anyone does, for your answers. And again, with the gratitude of the Subcommittee, this hearing is adjourned.

[Whereupon, at 3:36 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF JOHN C. DiIORIO

CHIEF EXECUTIVE OFFICER, 1ST ALLIANCE LENDING

MARCH 15, 2012

Chairman Menendez, Ranking Member DeMint, and other Members of the Subcommittee, I appreciate the opportunity to testify before you today.

I am the CEO of 1st Alliance Lending, a mortgage origination firm that is a leader in originating FHA loans that offer both affordability and principal reduction. We specialize in these loans, which reduce principal for underwater borrowers and provide affordable monthly mortgage payments.

There are a number of programs and loan options that have been created in the last several years to help troubled homeowners—including HAMP loan modifications, HARP Fannie Mae and Freddie Mac refinancings, FHA streamlined refinancings, and assistance to unemployed homeowners. While these programs address affordability, generally they do not provide for principal reduction. We argue, and our experiences substantiate, that principal reduction is critical, in concert with affordability efforts, in providing long term solutions to American homeowners. Moreover, we are finding that sophisticated financial entities with their own money at risk in the mortgages are using principal reduction in a targeted manner to maximize the recovery value of these mortgages. There is a growing consensus that supports these conclusions, and I appreciate the opportunity to share our experiences on this subject.

According to Core Logic, at the end of 2011, 11.1 million homes (over 23 percent of all homes nationwide) are underwater. A home is underwater when the amount of the mortgage or mortgages a homeowner has on their home exceeds the value of that home. It is hard to see how we can address our underlying housing problems and restore health to housing markets without addressing this issue.

Homeowners who are underwater are house-locked—unable to sell their home should they need to move for new employment, or any other reasons. Homeowners who are significantly underwater, particularly in areas where housing prices are less likely to recover, face the prospect of a very long period in which they will have no equity in their home. HAMP and other proprietary loan modifications address affordability problems, but even HAMP assistance phases out over time and ultimately borrowers receiving payment modifications will continue to be faced with the challenge of negative equity.

An often overlooked fact is that principal reduction, done correctly and in a targeted manner, is sometimes the best economic option for the holder of the mortgage; and often significantly enhances the value of the asset. In fact, we increasingly see holders of underwater mortgages utilizing principal reduction as part of their asset maximization efforts. These are sophisticated counterparties, acting in their own financial interest. Of course, where they utilize this option, it is also good for the homeowner, and by extension, for housing markets by reducing the risk of default and foreclosure.

1st Alliance Lending works with a number of major banks, investment banks, and sophisticated financial counterparties who hold or purchase pools of single family loans, including loans to currently distressed and underwater borrowers. 1st Alliance analyzes these pools of loans to identify borrowers who qualify for our programs and for whom it makes sense financially to utilize this option. We have utilized FHA refinance principal reduction programs, which provide opportunities for these types of distressed homeowners to refinance their existing loan, but only if the existing first mortgage holder forgives a portion of the principal in order to meet FHA's loan to value (LTV) requirements.

For homeowners that qualify, we do far more than the calculations that are done for loan modifications; we do a complete underwrite. Unlike the typical loan modification analysis, we don't just make sure a homeowner's loan payments are affordable, we also address subordinate liens; often extinguishing multiple liens through our transaction. We analyze the borrower's total debt burden and income, to make sure the homeowner is financially sound and capable of meeting their debt obligations. These steps are important in reducing redefault and foreclosure risk, because modifications which focus only on the payment affordability of the first mortgage loan do not take into account the financial stress of other debt that the homeowner has that can negatively impact their ability to pay their first mortgage.

Again, let me emphasize—these investors and mortgage holders that we work with agree to principal reduction in these situations voluntarily. Moreover, they make the decision to do principal reduction not out of a sense of charity, but because they believe it is in their best financial interest to do so. They are sophisticated, and are doing these transactions to maximize asset value.

1st Alliance has been underwriting FHA loss mitigation loans long enough that we now have a track record, with seasoned loans. From the perspective of the FHA, I am pleased to report that our default rates on these loans are in the single digits. This performance rate is significantly better than original program projections for FHA principal reduction loans, and much better than redefault rates in the HAMP program, and we believe even better than for proprietary mods without principal reduction. This performance, we contend, shows the powerful impact of principal reduction.

There has been much discussion over the last few years about the role of Net Present Value, also known as NPV, in determining which borrowers should be candidates for any assistance, and, whether or not to use principal reduction as part of a loan modification. I would point out that NPV results are highly dependent on assumptions you feed into the calculation. I would further point out that many sophisticated market players, with their own money at risk, have made the business decision that principal reduction does make sense for certain segments of their portfolios. Therefore, although parties like the FHFA have used NPV calculations to conclude that principal reduction is not justified (in their case, for Fannie Mae and Freddie Mac loans), I would suggest that they if they have doubts about the value of principal reduction, they need not commit wholesale to principal reductions, but could start by dipping their feet into the water on a pilot or limited basis, to test out how and whether principal reduction is effective.

Finally, I would like to address the issue of moral hazard. Moral hazard is where individuals or firms engage in risky or careless conduct because they are insulated from the consequences of such conduct. Over the years, there has been extensive discussion about Government intervention and moral hazard—during the reckless lending period by allowing zero down and no document loans; in 2008 by bailing out financial institutions through TARP; post crisis by helping homeowners who have become distressed; and even now as we discuss targeted principal reduction.

I am not here to debate the question of whether or not to help distressed homeowners, except to note that since early 2009 we have put in place a number of Federal programs to do so. I am here to discuss how to help homeowners fairly and effectively. As my testimony indicates, I believe principal reduction should be a component of any comprehensive loss mitigation program. To the more specific criticism, that we are engaging in moral hazard by giving homeowners an incentive to stop paying their mortgage, I emphasize that is not our experience. Our borrowers have experienced an objective adverse event over which they had little or no control, such as a loss of income or a serious health issue or problem; a true and validated hardship. None of our borrowers are suspected of intentional default.

I am not here to advocate for beneficial loans for irresponsible homeowners. I have come here to testify to the effectiveness of targeted principal reduction, and its role in any responsible and comprehensive loss mitigation strategy. I would argue that it is very effective; and I believe the experience of my firm shows how responsible, targeted principal reduction can not only be good for the homeowner, the housing market, and our communities, but also good for the holders of the existing mortgages.

Thank you again for the opportunity to testify today.

PREPARED STATEMENT OF MARK CALABRIA

DIRECTOR OF FINANCIAL REGULATION STUDIES, CATO INSTITUTE

MARCH 15, 2012

Chairmans Menendez and Reed, Ranking Members DeMint and Crapo, and distinguished Members of the Subcommittees, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria,* Director of Financial Regulation Studies at the Cato Institute, a nonprofit, nonpartisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official

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policy positions of the Cato Institute. In addition, outside of my interest as a citizen, homeowner, and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Some Observations on Our Mortgage Market

Policy options should be informed by facts. A few facts, which I believe are directly relevant to the state of our mortgage markets, particularly the trend in foreclosures and delinquencies are as follows:

- The vast majority of underwater borrowers are current on their mortgages. Even the majority of deeply underwater borrowers are current. For prime borrowers with loan-to-values (LTV) over 125 percent, over 75 percent are current. Over half of deeply underwater subprime borrowers are current. (Fitch)
- GSE underwater borrowers are also preforming, with almost 80 percent current. The GSEs' book of underwater loans has actually seen the percent current increasing over the last year.
- GSE loans display a smaller percentage (9.9 percent) underwater than loans in private label securities (35.5 percent underwater).
- According to Fannie Mae's National Housing Survey only about 10 percent surveyed believed it was appropriate for underwater borrowers to simply "walk away." While higher than I would prefer, this does indicate that the risk of widespread strategic default is limited.
- Credit quality of the borrower continues to be the primary predictor of default. For borrowers with FICOs in excess of 770, of those deeply underwater (125 percent LTV) 85 percent are still current. (Fitch)
- About a fifth of subprime borrowers who have significant equity (LTV < 80 percent) are 60 or more days delinquent. Clearly their situation has nothing to do with equity, and everything to do with borrower credit quality. (Fitch)
- Total delinquencies are down over 25 percent from the peak in January 2010, having declined from 10.97 percent to 7.97 percent in January 2012. (LPS)
- Over 40 percent of loans in foreclosure are over 2 years past due. These loans will likely never cure. Only 19 percent of loans in foreclosure are less than 8 months past due. No one can say, with a straight face, that foreclosures, in general, are happening "too fast."
- Almost half of loans, currently entering foreclosure, were previously in foreclosure, that is they are "repeat foreclosures." (LPS)
- The rate of new problem loans, those newly seriously delinquent that were current 6 months previous, peaked in Spring 2009, when the economy was hitting bottom, and have been steadily declining since.
- Including distressed transactions, the peak-to-current change in the national HPI (from April 2006 to January 2012) was -34.0 percent. Excluding distressed transactions, the peak-to-current change in the HPI for the same period was -24.2 percent. (CoreLogic)

The last point is particularly relevant, as the number of underwater borrowers greatly depends upon current home values. If home values are based upon distressed transactions, then the number of underwater borrowers would be far greater than if one excludes distressed sales. There is some reason to believe the distressed sales are not representative of the overall market, for instance they are likely to have seen greater physical deterioration.

State of the Housing Market

The U.S. housing market remains weak, with both homes sales and construction activity considerably below trend. Despite sustained low mortgage rates, housing activity has remained sluggish in 2011. Although construction activity picked up in 2001, housing starts are still below half the levels seen in 2007. In fact I believe it will be at least until 2015 until we see construction levels approach those of the boom. In addition to the 4.7 percent decline in existing home prices in 2011, we are likely to see additional, but small, declines in 2012. Consensus estimates run around a 3 percent decline in home prices for 2012.

Housing permits, on an annualized basis, increased 0.7 percent from December 2010 to January 2011 (671,000 to 676,000). Permits for both single family units and permits for larger multifamily properties (5+ units) increased slightly, but permits for smaller multifamily units fell 4.2 percent. Single family permits increased from 441,000 to 445,000 in December. Permits for 2–4 unit properties fell (24,000 to 23,000) in January. Permits for 5+ units climbed to 206,000 in January from 204,000 in December.

According to the Census Bureau, January 2012 housing starts were at a seasonally adjusted annual rate of 699,000, up slightly from the December level of 689,000. Overall starts are up, on an annualized level, from 2011's 610,700 units. This increase, however, is mostly driven by a jump in multifamily starts, as single-family starts decreased slightly. Total residential starts continue to hover at levels around a third of those witnessed during the bubble years of 2003 to 2004.

As in any market, prices and quantities sold in the housing market are driven by the fundamentals of supply and demand. The housing market faces a significant oversupply of housing, which will continue to weigh on both prices and construction activity. The Federal Reserve Bank of New York estimates that oversupply to be approximately 3 million units. Given that annual single family starts averaged about 1.3 million over the last decade, it should be clear that despite the historically low current level of housing starts, we still face a glut of housing. NAHB estimates that about 2 million of this glut is the result of "pent-up" demand, leaving at least a million units in excess of potential demand. [1] Add to that another 1.6 million mortgages that are at least 90 days late. My rough estimate is about a fourth of those are more than 2 years late and will most likely never become current.

The Nation's oversupply of housing is usefully documented in the Census Bureau's Housing Vacancy Survey. The boom and bust of our housing market has increased the number of vacant housing units from 15.6 million in 2005 to a current level of 18.4 million. The rental vacancy rate for the 4th quarter of 2011 declined to 9.4 percent after increasing to 9.8 percent the previous quarter, although this remains considerably above the historic average. The decline in rental vacancy rates over the past year has been driven largely by declines in suburban rental markets. The vacancy rate for newly constructed rental units is approaching the rate for old construction, but for newly constructed homeowner units it remains considerably higher than old construction.

The homeowner vacancy rate, after increasing from the 2nd and 3rd quarters of 2010 to the 4th quarter of 2010, declined slowly over the year 2011 to reach 2.3 percent last quarter, a number still in considerable excess of the historic average.

The homeowner vacancy rate, one of the more useful gauges of excess supply, differs dramatically across metro areas. At one extreme, Greensboro, NC, has an owner vacancy rate of well over 6 percent, whereas El Paso, Texas, has a rate of 0 percent. Other metro with excessive high owner vacancy rates include: Dayton, OH (6.2); Las Vegas (5.5); Columbia, SC (5.1); New Orleans (4.6); and Phoenix (3.6). Relatively tight owner markets include: Albany, NY (0.0); Norwalk, CT (0.2); and Tucson, AZ (0.3).

The number of vacant for sale or rent units has increased, on net, by around 3 million units from 2005 to 2011. Of equal concern is that the number of vacant units "held off the market" has increased by about 1.5 million since 2005. In all likelihood, many of these units will re-enter the market once prices stabilize.

The 4th quarter 2011 national home ownership rate fell to 66.0 percent, which is approximately where it was in 1997, effectively eliminating all the gain in the home ownership rate over the last 12 years. Declines in the home ownership rate were the most dramatic for the youngest homeowners, while home ownership rates for those 55 and over were generally stable or even increasing. This should not be surprising given that the largest increase in home ownership rates was among the younger households and that such households have less attachment to the labor market than older households. Interestingly enough, the decline in home ownership was higher among households with incomes above the median than for households with incomes below the median, which held steady.

Home ownership rates declined across the all Census Regions except for the Northeast (which held steady), the steepest decline was in the West, followed by the Midwest. The South witnessed the smallest decline in home ownership since the bursting of the housing bubble.

Homeowner vacancy rates differ dramatically by type of structure, although all structure types exhibit rates considerably above historic trend levels. For 4th quarter 2011, single-family detached homes displayed an owner vacancy rate of 2.0 percent, while owner units in buildings with 10 or more units (generally condos or coops) displayed an owner vacancy rate of 8.3 percent. Although single-family detached constitute 95 percent of owner vacancies, condos and co-ops have been impacted disproportionately. Over the last year homeowner vacancy rates have declined slightly for single-family structures but more dramatically for condos or coops, albeit from a much higher level.

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[1] Denk, Dietz, and Crowe, "Pent-up Housing Demand: The Household Formations That Didn't Happen—Yet", National Association of Home Builders. February 2011.

Owner vacancy rates tend to decrease as the price of the home increases. For homes valued between $100,000 and $150,000 the owner vacancy rate is 2.5 percent, whereas homes valued over $200,000 display vacancy rates of about 1.3 percent. The clear majority, almost 63 percent, of vacant owner-occupied homes are valued at less than $300,000. Owner vacancy rates are also the highest for the newest homes, with new construction displaying vacancy rates twice the level observed on older homes.

While house prices have fallen considerably since the market's peak in 2006—over 23 percent if one excludes distressed sales, and about 31 percent including all sales—housing in many parts of the country remains expensive, relative to income. At the risk of oversimplification, in the long run, the size of the housing stock is driven primarily by demographics (number of households, family size, *etc.*), while house prices are driven primarily by incomes. Due to both consumer preferences and underwriting standards, house prices have tended to fluctuate at a level where median prices are approximately 3 times median household incomes. Existing home prices, at the national level, are close to this multiple. In several metro areas, however, prices remain quite high relative to income. For instance, in San Francisco, existing home prices are almost 8 times median metro incomes. Despite sizeable decline, prices in coastal California are still out of reach for many families. Prices in Florida cities are generally above 4 times income, indicating they remain just above long-run fundamentals. In some bubble areas, such as Phoenix and Las Vegas, prices are below 3, indicating that prices are close to fundamentals. Part of these geographic differences is driven by the uneven impact of Federal policies.

Household incomes place a general ceiling on long-run housing prices. Production costs set a floor on the price of new homes. As Professors Edward Glaeser and Joseph Gyourko have demonstrated,[2] housing prices have closely tracked production costs, including a reasonable return for the builder, over time. In fact the trend has generally been for prices to about equal production costs. In older cities, with declining populations, productions costs are often in excess of replacement costs. After 2002, this relationship broken down, as prices soared in relation to costs, which also included the cost of land.[3] As prices, in many areas, remain considerably above production costs, there is little reason to believe that new home prices will not decline further.

It is worth noting that existing home sales in 2010 were only 5 percent below their 2007 levels, while new home sales are almost 60 percent below their 2007 level. To a large degree, new and existing homes are substitutes and compete against each other in the market. Perhaps the primary reason that existing sales have recovered faster than new, is that price declines in the existing market have been larger. Again excluding distressed sales, existing home prices have declined 23 percent, whereas new home prices have only declined only about 10 percent. I believe this is clear evidence that the housing market works just like other markets: the way to clear excess supply is to reduce prices.

State of the Mortgage Market

According to the Mortgage Bankers Association's National Delinquency Survey, the delinquency rate for mortgage loans on one-to-four-unit residential properties decreased to a seasonally adjusted rate of 7.58 percent of all loans outstanding for the end of the 4th quarter 2011, 41 basis points down from 3rd quarter 2011 and down 67 basis points from 1 year ago.

The percentage of mortgages on which foreclosure proceedings were initiated during the fourth quarter was 0.99 percent, 9 basis points down from 2011 Q3 and down 28 basis points from 2010 Q4. The percentage of loans in the foreclosure process at the end of the 4th quarter was 4.38 percent, down slightly at 5 basis points from 2011 Q3 and 26 basis points lower than 2010 Q4. The serious delinquency rate, the percentage of loans that are 90 days or more past due or in the process of foreclosure, was 7.73 percent, a decrease of 16 basis points from 2011 Q3, and a decrease of 87 basis points from 2010 Q4.

The combined percentage of loans in foreclosure or at least one payment past due was 12.53 percent on a nonseasonally adjusted basis, a 10 basis point decrease from 2011 Q3 and 107 basis points lower than 2010 Q4.

Extent of Negative Equity

Despite that the vast majority of underwater borrowers continue to pay their mortgages, concerns about negative equity dominate policy debates surrounding the

[2] Edward Glaeser and Joseph Gyourko, "The Case Against Housing Price Supports", *Economists' Voice,* October 2008.

[3] *Also see,* Robert Shiller, "Unlearned Lessons From the Housing Bubble", *Economists' Voice,* July 2009.

mortgage market. According to CoreLogic, 11.1 million, or 22.8 percent, of all residential properties with a mortgage (recall that about a third of owners own their homes free and clear) are in a negative equity position. This situation is highly concentrated in terms of geography. The top five States (NV, AZ, FL, MI, and GA) display an average negative share of 44.3 percent. The remaining States have a combined average negative share of 15.3 percent. Any taxpayer efforts to reduce negative equity would largely be a transfer from the majority of States to a very small number.

Of those with negative equity, 4.4 million have both first and second mortgages. The average LTV of these borrowers is 138 percent, implying that in the event of a foreclosure, the second lien would likely have little, if any value. Efforts to modify first liens only, or to modify firsts and seconds in proportion, are, in effect, transfer from the first lien holder to the second. We should reject such transfers, as they violate the basic principles of contract and property, and require all seconds to be eliminated before any loss are taken on first liens.

While less than half of those with negative equity have second liens, those that do constitute a far greater share of negative equity borrowers. Those with both first and second liens display a negative equity share of 39 percent, twice that for borrowers with a first lien only. Of the estimated $717 billion in negative equity just over half is from borrowers with both first and second liens. My estimate is that about a fourth of negative equity is in the form of second liens.

For pressing importance for policy makers is the fact that just under 2 million FHA borrowers are underwater. The vast majority of these borrowers took out mortgages since the beginning of the housing bust. Just under a third of all FHA borrowers that took loans out since the housing bust are now underwater. That giving borrowers near-zero equity loans in a deflating housing market would result in widespread negative equity should have been obvious (it was to me), but that is of course “water under the bridge.” The important issue now is mitigating that risk. As FHA’s 203(b) program does have the power of full recourse, I urge FHA to advertise that power and implement programs to exercise it. In addition delinquent FHA borrowers should be reported immediately the to IRS, so that any tax refunds can be used instead to off-set losses to the taxpayer. My estimates are that FHA is likely to require between $10 and $50 billion over the next 5 to 6 years in order to honor all claims.

New York Federal Reserve Study

An August 2010 study by economists at the Federal Reserve Bank of New York has generated considerable interest as a road-map for reducing mortgage defaults. [4] Specifically the study has been used to argue for increased principal reduction as a way to reduce defaults. While the study has a number of flaws, for instancing assuming that all redefaults only occur within 12 months of a modification, the study does take the appropriate approach in examining borrower incentives. The study correctly treats borrowers as choosing to default, rather than modeling default as something that simply “happens” to the borrower. The impact of principal reduction is also relative small, lower the author’s estimated 12 month redefault rate of 56 percent by 4.5 percent to 51.5 percent. So even if we adopted the author’s proposal, over half of modified loans would still redefault.

Not surprisingly proponents of principal reduction are choosing which parts of this study they like and discarding the parts they do not. For instance the study finds that “each additional month that a borrower can expect to live rent-free in the house increases the 12 month redefault rate by 0.6 percentage points.” To put that in perspective, the difference in the overall foreclosure process between judicial States and nonjudicial foreclosure States in about 18 months. At 0.6 percentage points a month, if judicial States switched to an administrative process, redefault rates would decline by an estimated 10.8 percentage points or twice the impact one gets from a 10 percent reduction in principal. States with allow recourse have redefault rates that are 1.8 percentage points lower. Interestingly enough the authors find that the lower are area house prices, compared to their 2000 values, the lower are redefault rates. Attempts to keep prices above their pre-bubble rates have, to some extent, increased defaults. The logic is that a borrower’s decision to default is based not solely on current equity but also on the expected path of future home prices. If we can get to the bottom, which I believe we are nearing, then borrowers will have greater incentives to maintain their mortgage.

[4] Andrew Haughwout, Ebiere Okah, and Joseph Tracy, “Second Chances: Subprime Mortgage Modifications and Re-Default”, Federal Reserve Bank of New York Staff Reports no. 417. August 2010.

If You Are Going To Modify . . .

While I remain quite skeptical of many of the efforts at mortgage modification, as most seem aimed at dragging out the problem and avoiding the inevitable correction of the housing market, if we are going to continue offering modifications to delinquent and/or underwater borrowers, we should include the following provisions:

- All modifications should include and exercise recourse.
- Modifications should be limited to those have been current at some point within the previous year.
- Modifications should be targeted to those who display a "willingness to pay" but lack the ability to do so.

Current modification programs have often been inspired by the creation of the Home Owners Loan Corporation (HOLC) in 1933, which refinanced borrowers into "affordable" long term loans. Apparently the nostalgia for the HOLC has encouraged an ignorance of its actual workings. The HOLC practiced aggressive recourse, for instance. So much so that a third of its total revenues were derived from deficiency judgments. The HOLC also limited assistance to creditworthy borrowers who demonstrated a willingness to pay. If we wish to mimic the claimed success of the HOLC than we also need to understand how it functioned.[5]

There are some reports that the recent robo-signing settlement with give banks up to $1.7 billion in credit against the overall settlement if they waive their right to pursue deficiency judgments.[6] The empirical literature is fairly robust on this point: the existence of deficiency judgments reduces foreclosures. This aspect of the settlement will likely increase foreclosures.

What's a Conservator For?

Criticism has been directed at FHFA for not either allowing or forcing Fannie Mae and Freddie Mac to engage in principal reductions. Much of this criticism has take the form of claims that the GSEs, and hence FHFA, are not "doing enough" to turn around the housing market. Blogger Matt Yglesias suggests that "clearly the purpose of creating the FHFA and taking Fannie and Freddie into conservatorship can't have been to minimize direct taxpayer financial losses on agency debt." This claim, and others like it, are mistaken. The Housing and Economic Recovery Act (HERA) of 2008 is quite clear when it comes to the duty and responsibilities of FHFA when acting as a conservator.

A simple read of the statute, Section 1145 of HERA, which amends Section 1367 of the 1992 GSE Act, clearly states the purpose, duties, and role of a conservatorship. What does the law say the powers of a conservatorship are? They are to "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."

Some proponents of principal reduction have found language elsewhere in HERA which they believe allows for considerations beyond those found in Section 1145. But this argument relies on general introductory sections of the statute, not the powers and duties of FHFA as a conservator. Statutory interpretation requires that more specific sections trump general introductory sections. General sections have "no power to give what the text of the statute takes away" (*Demore v. Kim,* 538 U.S. 510, 535).

Given FHFA's estimate that a broad based program of principal reduction would cost almost $100 billion, the argument that an unelected, unappointed, acting agency head should, in the absence of statutory authority, spend $100 billion on taxpayer money is simply inconsistent with our system of Government. While agencies such as the Federal Deposit Insurance Corporation felt free to violate the law during the crisis, Acting FHFA Director DeMarco should be commended for his faithfulness to the letter of the law. If $100 billion of taxpayer dollars is to be spent on principal reduction, it is the responsibility of Congress to make that decision. To suggest this action be implemented without Congressional approval would only further erode the already diluted powers of Congress relative to the other branches of Government. Members had the opportunity during the passage of HERA to increase the powers and duties of FHFA as conservator. Congress decided not to.

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[5] *See,* C. Lowell Harriss, "History and Policies of the Home Owners' Loan Corporation", National Bureau of Economic Research, 1951. *http://www.nber.org/books/harr51-1*

[6] Nick Timiraos, "Mortgage Deal Built on Tradeoffs", *Wall Street Journal,* Monday, March 12, 2012, C1.

The Problem Is Mortgage Availability

The problem facing our housing market is a combination of weak demand and excess supply. All policy proposals should first be evaluated on that basis. One of the constraints on demand is mortgage availability. If one is a prime borrower, who can make a substantial down payment, then mortgages are both cheap and plentiful. If one is not, then a mortgage is difficult, if not impossible to get.

This decline in mortgage availability derives from a variety of factors, some good, some bad. For instance the most irresponsible lending, with the exception of FHA, is gone (for how long, who knows). That is a good thing. Unfortunately much of the Alt-A and higher quality subprime lending is also gone. That is not such a good thing. By my estimate about a fifth of the mortgage market has disappeared, holding back housing demand. One of the factors contributing to that disappearance is the combination of Federal Reserve interest rate policy with Federal mortgage regulation. For instance under HOEPA, today any mortgage over 5.5 percent is considered "high-cost." Such mortgages now carry considerable regulatory, reputation, and litigation risk. Anyone with just a basic knowledge of financial history knows that 5.5 is, historically speaking, a great rate, not a predatory one. Charts, at the end of this testimony, display the distribution of mortgages rates charged in 2006 and 2011. It should be immediately clear that 2006 largely resembled a normal distribution. 2011, however, has seen the right side of that distribution largely eliminated. Clearly the distribution of mortgage rates in 2011 is near normal nor symmetric. I believe the Federal Reserve's 2008 HOEPA regulation has contributed to this abnormality. Of course there are other factors, again some good, some bad.

Foreclosure Mitigation and the Labor Market

There is perhaps no more important economic indicator than unemployment. The adverse impacts of long-term unemployment are well known, and need not be repeated here. Although there is considerable, if not complete, agreement among economists as to the adverse consequences of jobless; there is far less agreement as to the causes of the currently high level of unemployment. To simplify, the differing explanations, and resulting policy prescriptions, regarding the current level of unemployment fall into two categories: (1) unemployment as a result of lack of aggregate demand, and (2) unemployment as the result of structural factors, such as skills mismatch or perverse incentives facing the unemployed. As will be discussed below, I believe the current foreclosures mitigation programs have contributed to the elevated unemployment rate by reducing labor mobility. The current foreclosures mitigation programs have also helped keep housing prices above market-clearing levels, delaying a full correction in the housing market.

First we must recognize something unusual is taking place in our labor market. If the cause of unemployment was solely driven by a lack of demand, then the unemployment rate would be considerably lower. Both GDP and consumption, as measured by personal expenditures, have returned to and now exceed their precrisis levels. But employment has not. Quite simply, the "collapse" in demand is behind us and has been so for quite some time. What has occurred is that the historical relationship between GDP and employment (which economists call "Okun's Law") has broken down, questioning the ability of further increases in spending to reduce the unemployment rate. Also indicative of structural changes in the labor market is the breakdown in the "Beveridge curve"—that is the relationship between unemployment and job vacancies. Contrary to popular perception, job postings have been steadily increasing over the last year, but with little impact on the unemployment rate.

Historically many job openings have been filled by workers moving from areas of the country with little job creation to areas with greater job creation. American history has often seen large migrations during times of economic distress. And while these moves have been painful and difficult for the families involved, these same moves have been essential for helping the economy recover. One of the more interesting facets of the recent recession has been a decline in mobility, particular among homeowners, rather than an increase. Between 2008 and 2009, the most recent Census data available, 12.5 percent of households moved, with only 1.6 moving across State lines. Corresponding figures for homeowners is 5.2 percent and 0.8 percent moving across State lines. This is considerably below interstate mobility trends witnessed during the housing boom. For instance from 2004 to 2005, 1.5 percent of homeowners moved across State lines, almost double the current percentage. Interestingly enough the overall mobility of renters has barely changed from the peak of the housing bubble to today. This trend is a reversal from that witnessed after the previous housing boom of the late 1980s burst. From the peak of the bubble in 1989 to the bottom of the market in 1994, the percentage of homeowners moving across State lines actually increased.

The preceding is not meant to suggest that all of the declines in labor mobility, or increase in unemployment, is due to the foreclosure mitigation programs. Far from it. Given the many factors at work, including the unsustainable rate of home ownership, going into the crisis, it is difficult, if not impossible, to estimate the exact contribution of the varying factors. We should, however, reject policies that encourage homeowners to remain in stagnant or declining labor markets. This is particularly important given the fact that unemployment is the primary driver of mortgage delinquency.

Minimizing Losses to Taxpayers

As the title of today's hearing implies an important objective of policy should be to protect the taxpayer from further loss. We should never forget that the taxpayer has already poured $180 billion in the rescue of Fannie Mae and Freddie Mac. It is unlikely that much, if any, of this will ever be recovered. In addition the taxpayer potentially faces the cost of rescuing the Federal Housing Administration (FHA). I believe there is a significant likelihood that the taxpayer will have to inject somewhere between $10 to $50 into FHA over the next 5 to 6 years.

The most effective way to protect the taxpayer would be to simply stop. Stop covering the losses of Fannie Mae and Freddie Mae and do not impose policies that would dig the current hole any deeper. We are well past the height of the financial panic. And as the recent mortgage settlement demonstrated, policy makers appear to have no problem with imposing losses on investors. The same should be applied to Fannie Mae and Freddie Mae. Future losses should be borne by the debt-holders of those companies, not the taxpayer. Accordingly Fannie Mae and Freddie Mac should be moved immediately out of conservatorship and into receivership, where losses can be imposed upon those investors who willingly risked their own money (the same cannot be said for the taxpayer).

As FHFA estimates that a program of principal forgiveness for all underwater GSE mortgages could cost as much as $100 billion, it should be very clear that such would not minimize losses to the taxpayer.

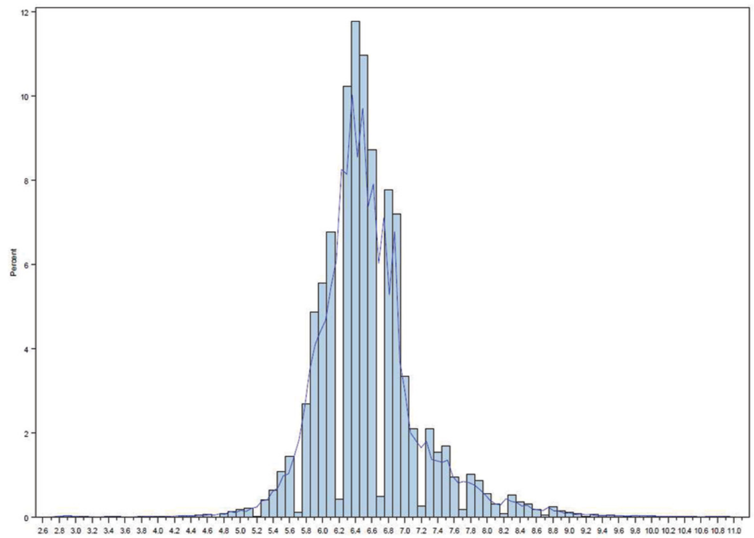
Summary of Policy Proposals

- Repeal/Suspend/Modify Existing HOEPA Regulations.
- Require recourse for all federally related modifications.
- End programs, like "Neighborhood stabilization," that add to housing supply. If spending, use such to increase demand, not supply.
- Reform FHA to minimize embedded losses.

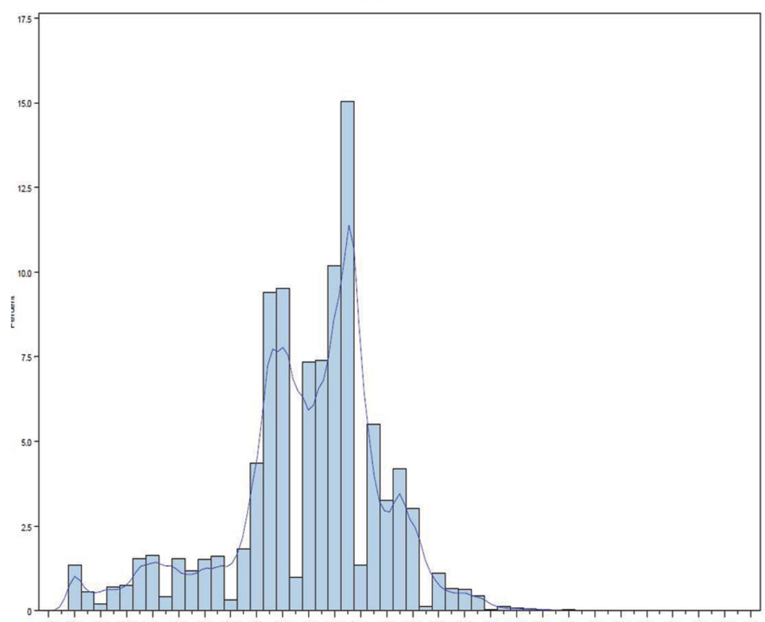
Conclusion

The U.S. housing market is weak and is expected to remain so for some time. Given the importance of housing in our economy, the pressure for policy makers to act has been understandable. Policy should, however, be based upon fostering an unwinding of previous unbalances in our housing markets, not sustaining said unbalances. We cannot go back to 2006, and nor should we desire to. As the size and composition of the housing stock are ultimately determined by demographics, something which policy makers have little influence over in the short run, the housing stock must be allowed to align itself with those underlying fundamentals. Prices should also be allowed to move towards their long run relationship with household incomes. Getting families into homes they could not afford was a major contributor to the housing bubble. We should not seek to repeat that error. We must also recognize that prolonging the correction of the housing market makes the ultimate adjustment worse, not better. Lastly it should be remembered that one effect of boosting prices above their market-clearing levels is the transfer of wealth from potential buyers (renters) to existing owners. As existing owners are, on average, wealthier than renters, this redistribution is clearly regressive.

2006



2011



PREPARED STATEMENT OF LAURIE S. GOODMAN

SENIOR MANAGING DIRECTOR, AMHERST SECURITIES

MARCH 15, 2012

Chairman Menendez and Members of the Subcommittee, I thank you for your invitation to testify today. My name is Laurie Goodman, and I am a Senior Managing Director at Amherst Securities Group, LP, a leading broker/dealer specializing in the trading of residential and commercial mortgage-backed securities. We are a market maker and intermediary in these securities, dealing with many of the largest financial institutions, insurance companies, money managers and hedge funds. I am in charge of the Strategy effort, which performs extensive, data-intensive studies as part of our efforts to keep ourselves and our customers informed of critical trends in the residential mortgage-backed securities market.

In my testimony today, I will discuss three actions that can strengthen the mortgage market, at no or minimal cost to taxpayers: increasing reliance on principal reduction modifications; a ramp up of the bulk sales program, coupled with financing for these properties; and a careful vetting of new rules that affect already tight credit availability.

Sizing the Challenge

As we look across the U.S. housing landscape, our empirical studies have convinced us that there are a huge number of borrowers (7.4–9.3 million) yet to face foreclosure and eventual liquidation. The expected liquidations break down into the following categories:

3.5 – 4.0 million borrowers already 60+ days past due on loans (many seriously past due)

+

1.5 – 2.0 million borrowers with a compromised mortgage payment history (used to be 60+ past due, now not)

+

2.4 – 3.3 million borrowers with excellent payment history, but underwater (owe more than value of home)

EQUALS

7.4 – 9.3 million borrowers yet to face foreclosure/liquidation

Thus, if we stay on the present course, of the 52.5 million total U.S. homes with a mortgage, 14.1–17.7 percent, or 7.4–9.3 million of these borrowers face foreclosure and eventual liquidation. To absorb this large number of housing units that will face foreclosure and eventual liquidation, we need to both limit the supply of AND increase the demand for distressed properties. To limit supply, we need more successful loan modifications. For this, we believe increased reliance on principal reduction is the key. To increase demand, we need a successful bulk sales program to bring institutional investors into the housing market. We also need broader credit availability standards, yet every single governmental action that is being considered seems to further constrain credit availability.

Most of my testimony will be focused on supply side measures; namely, improving modification success through greater reliance on principal reductions. Then I will take up demand side measures. I will touch upon the new Government program to sell single family properties to investors (for turning into rental units; a program we believe will be ultimately very successful). Finally, I will delve into the negative impact of constrained credit availability, and my concern about impending regulations that will exacerbate this issue. All of my recommendations in this testimony (expanded use of principal reductions, the bulk sales program, and fully vetting the impact of new rules or guidelines that affect credit availability) require very limited use of taxpayer money.

Why Investors Support Modification Activity

Modification success has improved dramatically over time. In private label (nonagency residential mortgage) securitizations, for modifications performed during the first half of 2011, the average redefault rate after 12 months is down to 30 percent, versus 70 percent performed during the first half of 2009. The improved results reflect two factors: (1) the way modifications are counted has changed, which has improved reported success rates, and (2) modifications have become much more significant, increasing the appeal to borrowers remaining in the home. This has genuinely improved success rates.

1. Change in modification count methodology—There was no trial period for modifications completed in early 2009 and earlier. The modification was "counted" the minute it was initiated, yet many modifications failed in the first 3 months, which boosted the failure rate of those early modifications. The trial period was introduced as part of the HAMP program, and was quickly adopted for proprietary modifications.
2. Modifications have become more significant over time—The HAMP modification program has been important in that it provided a blueprint for significant pay relief for the borrower. And modifications that provide more significant relief have resulted in much lower redefault rates than earlier modifications that did not.

It's the investors in private label securitizations who bear the cost of any modification on those securities, be it a principal reduction or an interest rate decrease. However, investors in private label securitizations have been very supportive of modification efforts. Why? Investors recognize that foreclosure is both the worst outcome for the borrower AND the investor. A simple example in Exhibit 1 (next page) makes this argument concrete. The data in the exhibit are real, drawn from the universe of private label securities that were liquidated in the past month. The average loan balance is $279,184, but if we marked these homes to market, the current market value of the homes averaged only $227,046 (thus "underwater" with a loan-to-value ratio of 123 percent) due to price depreciations on the properties. If the property were liquidated the investor would not realize that market value of $227,046, since homes in foreclosure usually sell at a discount. The investors should have realized a gross recovery, net of broker commission, on the property of $173,591 (amounting to a 62.2 percent of the current loan balance, or 76 percent of current market value). Furthermore, there are other costs to subtract from the sale proceeds due the investor, arising from the borrower having been, on average, 26 months delinquent at liquidation. These costs are sizeable; advances for tax and insurance total $21,927 and other direct costs associated with foreclosure and liquidations total $7,452. Finally, every day a house remains in nonperforming status, with either a homeowner who is not maintaining the property, or the home sitting vacant—the property is deteriorating. We estimate that the deterioration factor decreases property value by another $13,842 over the 26-month average period of delinquency. These costs are all captured in Exhibit 1. Note that collectively an investor nets $130,370 ($173,591–$43,221), for a 46.7 percent net recovery (or a 53.3 percent loss per loan balance). The recovery to the investor in private label securitizations will be even lower, because, upon the liquidation of the trust, the servicer will be reimbursed for any payments of delinquent principal and interest that he has made to the trust.

Exhibit 1: Variables Driving Loss Severity

	Liability	Asset	% of UPB
Current Loan Balance	$ 279,184		100.0%
Gross Recovery		$ 173,591	62.2%
Tax	$ 14,084		5.0%
Insurance	$ 7,843		2.8%
Other Monthly Cost	$ 13,842		5.0%
Foreclosure Cost	$ 2,452		0.9%
Fixed Cost of Liquidation	$ 5,000		1.8%
	$ 322,405	$ 173,591	
Loss/Severity		$ 148,814	53.3%
Net Recovery		$ 130,370	46.7%

Original Purchase Price	$ 360,000
Current Market Value of Home	$ 227,046
Home Price Depreciation	-37%
Original LTV	77
Current LTV	123
DQ Months	26
P&I for PLS Loans	$ 30,800

Legend: UPB = Unpaid Principal Balance; LTV=Loan-To-Value; DQ=Delinquent; P&I=Principal and Interest; PLS=Private Label Securities

Source: CoreLogic 1010data, Amherst Securities as of February 2012

An investor would be far better off if a substantial payment reduction had been offered to the borrower, to reduce the loan payment to an affordable level, rather than going through foreclosure and liquidation (and the investor ending up with only 46.7 percent of the loan being repaid). If the borrower were offered a principal reduction to 100 percent of the current market value of the home ($227,046) and was able to make the payments associated with this loan, both the borrower and the investor would be much better off. The investor now has a loan worth $227,046 rather than $130,370.

My representation that investors are in favor of modifications is not to say that there is no room for improvement—there is. Here are some of the most important weaknesses from the point of view of investors:

- Servicers are in charge of performing the modification. But they are massively conflicted, as they often own the second lien on the same property, but service both the first lien and the second lien. We believe that special servicers, who specialize in dealing with nonperforming loans, are apt to demonstrate a track record for better modification success, as: (1) they are not in a position of conflict; and (2) they can review the full range of alternatives in order to maximize the value of the loan, not just whether a given modification is better than foreclosure (which sets a low bar for a standard of delivering final proceeds to settle a loan, as illustrated above).
- A modification considering the borrower's total debt situation (including second liens, credit cards, auto loans, *etc.,* which are often collectively referred to as "back-end debt-to-income ratio") will be more successful than one only considering the payments on the first lien, plus taxes and insurance (the "front-end debt-to-income ratio"). In fact, we believe the best way to have structured the modification program was to re-underwrite the loan for sustainability, while respecting lien priority. In many cases, this means the second lien would be written off entirely, and the first lien would be resized. In a more optimal world other debts would also be resized.
- Re-equifying the borrower is critical. Borrowers who are deeply underwater are less likely to commit to a successful modification. This suggests that principal reductions should be more effective than other types of modifications (rate modifications or capitalization modifications)—and they are proving to be so.

It is important to take a step back and outline the three basic modification types: principal balance modifications, rate modifications, and capitalization modifications. In a principal modification, the principal balance is reduced. This can take the form of principal forbearance (deferral), in which the borrower still owes the money, but does not pay interest on it, and principal forgiveness, in which the borrower does not owe the money. In a rate modification, the interest rate is reduced. In a capitalization modification, neither the interest rate nor the principal balance is reduced, but the term may be extended to reduce the payment.

Principal Reduction Is the Most Effective Form of Modification

It has become increasingly common to modify principal balances rather than just modifying the rate and term on a mortgage. For example, in 2009 for private label securities, only 5 percent of modifications were principal modifications, whereas now a full 32 percent are. The reason is that this is the most effective type of modification.

While available data on private label securities does not allow us to distinguish forgiveness from forbearance modifications, the OCC/OTS report[1] does. It provides some very interesting numbers, based on information reported by the largest servicers. The data shows the types of modifications that were received, sorted by the bearer of the risk. Note that each column adds to more than 100 percent, as more than one type of action is generally taken in a modification. Thus, a servicer may recapitalize delinquent balances, reduce the rate, and extend the term (length to maturity) of the loan. Or—they may recapitalize the delinquent balances, and forgive (reduce) the balance or forbear (defer) the principal.

Look first at the data from Q4 2010 (left side, Exhibit 2, next page). Note that banks were doing principal reduction solely for their own portfolio (17.8 percent of banks' own portfolio loans received a reduction), but few loans serviced by the banks for others received principal reductions. By Q3 2011 (the most recent data available, shown on the right side of Exhibit 2), banks were doing principal reduction both for their own portfolio (18.4 percent of the loans) as well as for loans serviced on behalf of private label investors (15.3 percent of the loans). Note that the share that received reduction on loans insured by Fannie Mae, Freddie Mac, or the U.S. Government is zero, as servicers are not permitted to do principal reduction on these loans. The bottom part of the table in Exhibit 2 shows that the success rate on banks' portfolio loans is better than that on loans serviced for others. We would really like to know the success rate on principal reduction modifications versus other types of modifications (controlling for other characteristics, of course) but this information is not disclosed.

[1] OCC Mortgage Metrics Report—Third Quarter 2011, Office of the Comptroller of the Currency/Office of Thrift Supervision, dated 12/21/2011.

Exhibit 2: Principal Reduction — Banks Doing It For Their Own Portfolio (And It Works!)

Percentages of Each Type of Modification by Investor in Fourth Quarter 2010

	Fannie Mae	Freddie Mac	Government-Guaranteed	Private Investor	Portfolio	Overall
Capitalization	98.6%	98.6%	99.4%	79.2%	73.9%	91.6%
Rate Reduction	78.6%	70.4%	98.2%	86.2%	85.1%	84.1%
Rate Freeze	3.5%	5.4%	0.2%	1.4%	2.2%	2.4%
Term Extension	49.2%	71.6%	81.0%	36.6%	49.1%	56.1%
Principal Reduction	0.0%	0.0%	0.0%	1.8%	17.8%	2.7%
Principal Deferral	7.9%	11.6%	0.4%	13.5%	16.3%	9.0%
Unknown	0.3%	0.2%	0.1%	1.5%	5.6%	1.2%

Percentages of Each Type of Modification by Investor in Third Quarter 2011

	Fannie Mae	Freddie Mac	Government-Guaranteed	Private Investor	Portfolio	Overall
Capitalization	96.8%	99.1%	98.3%	85.3%	67.4%	88.5%
Rate Reduction	70.4%	74.0%	93.7%	71.5%	83.6%	77.5%
Rate Freeze	3.6%	7.6%	0.8%	5.8%	5.6%	4.6%
Term Extension	68.1%	69.5%	84.4%	24.2%	63.5%	57.8%
Principal Reduction	0.0%	0.0%	0.0%	15.3%	18.4%	7.8%
Principal Deferral	25.6%	18.2%	0.1%	23.0%	29.2%	20.5%
Unknown	0.6%	0.2%	0.7%	1.7%	1.2%	1.0%

Re-Default Rates for Portfolio Loans and Loans Serviced for Others (60 or More Days Delinquent)*

Investor Loan Type	Three Months After Modification	Six Months After Modification	Nine Months After Modification	12 Months After Modification
Fannie Mae	12.1%	19.4%	24.5%	28.8%
Freddie Mac	11.7%	18.9%	24.3%	28.2%
Government Guaranteed	17.4%	34.9%	45.0%	50.8%
Private	24.3%	35.7%	43.0%	48.3%
Portfolio Loans	8.0%	15.6%	21.4%	25.2%
Total	16.2%	26.7%	33.6%	38.5%

* Data include all modifications implemented since January 1, 2008, that have had time to age the indicated number of months.

Source: OCC Mortgage Metrics Report – Fourth Quarter 2010 , Third Quarter 2011

Moreover, our discussions with individual servicers show that they are increasingly relying on principal forgiveness. Under HAMP, servicers are required to test a borrower for a modification using the regular HAMP waterfall (first reduce the interest rate, then extend the term, then forbear principal) and the principal reduction alternative (first forgive principal, then reduce the interest rate, then extend the term, then forbear principal). However, if the principal reduction alternative has a higher net present value (NPV) they are not required to use it. In May 2011, Bank of America announced that when the NPV test showed the superiority of the principal reduction alternative, they will start using it. And we see that the number of Bank of America serviced loans receiving principal modifications is up sharply since then. We also see large increases in the number of principal modifications on Chase- and Ocwen-serviced loans.

At Amherst, we have done extensive empirical work and shown that there are 3 determinants of modification success:

1. The amount of pay relief is important.
2. The number of months delinquent at the time of modification is quite important. If you offer a borrower a modification with 30 percent pay relief at the point when the loan is 2 months delinquent, the borrower is apt to regard that as a terrific deal. But that same modification offered to a borrower who is 12 months delinquent is apt to be regarded as a huge increase over the then-present (defaulted) payment of "zero." We were pleased to see changes in the HAMP incentive structure to encourage earlier modifications.
3. Finally, we found that principal modifications (as opposed to interest rate or capitalization modifications) have the highest success rate, even controlling for these 2 first factors.

We at Amherst are not the only market participants who have discovered that principal modifications have a higher success rate than other types of modifications. A study [2] by Moody's Investor Services looked at modification success by LTV (loan-to-value) bucket (a group of loans grouped along similar characteristics), and showed that loans with lower LTVs have higher modification success. Most importantly, they showed that the difference in modification success between loans grouped by

[2] "Principal Reduction Helps To Reduce Re-Default Rates in the Long Run", Moodys ResiLandscape, Moodys Investor Service, dated 1/20/2012.

LTV buckets becomes more pronounced over time. That is, the difference between LTV buckets is much greater after 18 months than it is after 6 months from modification. Clearly, principal reduction will reduce the LTV on the loans, whereas other types of modifications will not. In further studies at Amherst, we have independently come to the same conclusion.

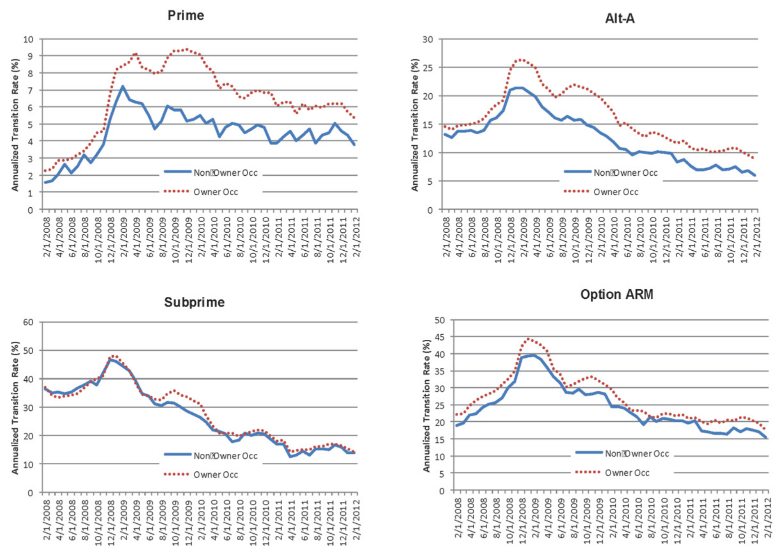
We very much like the construction of the principal reduction alternative under HAMP. It is done as "earned forgiveness"; the principal is initially forborne, and ⅓ is forgiven per year, but only as the borrower continues to make ontime payments. We believe this is a very important feature for a principal reduction program. Moreover, the recent tripling of the HAMP incentives under the principal reduction alternative, with the incentive going to the owner of the risk (the lender), should further spur the use of this alternative. We applaud the Treasury for taking this action.

The moral hazard issue is the single largest mental obstacle many market participants face when thinking about principal reductions. Will performing borrowers intentionally go delinquent in order to get a principal reduction? We have two responses to this. First, the moral hazard issue is present even under the present program. In fact, while we believe a successful modification program is essential to restore a healthy housing market, no modification program can be designed to completely eliminate moral hazard. Second, you can structure the principal reduction to minimize the moral hazard issue.

In order to show that moral hazard exists under the present program, look at Exhibit 3 (next page). We divided the universe of private label securities between owner-occupied borrowers and nonowner-occupied borrowers, as only owner-occupied borrowers were eligible for the HAMP modification program, which started in early 2009.[3] We have confined our work to the private label securities universe, as we have very good payment information about these loans. Exhibit 3 shows the rate at which performing borrowers are going 2 payments behind for the first time; this is referred to as the "default transition rate." Note that for borrowers whose loans are considered "Prime" and "Alt-A," the default transition rate between owner-occupied and nonowner-occupied borrowers diverged significantly around the time the HAMP program was announced, as borrowers believed it was necessary to be 2 payments behind to receive a modification. BOTTOM LINE—Under the present program, some borrowers have clearly gone delinquent in order to qualify for a modification.

[3] On March 9, 2012, under HAMP Supplemental Directive 12-02, HAMP eligibility was extended to investors. However, this was not a consideration for the period covered in Exhibit 3.

Exhibit 3: Transition Rates (cTr) — 2004-2007 Vintages (by Occupancy, as % of Always Performing)



Strategic defaults appear to be happening in Owner-Occupied Prime and Alt-A

Source: CoreLogic, 1010Data, Amherst Securities

It is possible to structure a principal reduction program to minimize the moral hazard issue (that is, to counter the incentive that otherwise healthy borrowers have to default on their loan to obtain a modification). There are several ways to do that. The first is to require that the borrower already be delinquent at the start of the program, so borrowers are unable to plan to go delinquent to obtain the modification. Secondly, a shared appreciation feature can be offered. If a borrower accepts a principal write-down modification, the lender is entitled to some share of future appreciation. For the borrower whose loan is at 120 LTV—a write-down to 110 or 115 percent LTV along with giving up some percent of the upside will look unattractive. But for a borrower at 150 LTV, who is far more likely to default, this will appear very attractive. Senator Menendez, I know shared appreciation is an idea you have championed.

While we are huge fans of principal reduction, we are concerned about the moral hazard issue for both the borrower and the servicer. We have just discussed how it can be mitigated for the borrower. We are also concerned about the recent Attorneys' General Settlement allowing servicers to do "abusive" modifications in order to get "credit." We applaud the use of principal reductions on loans in a bank/servicer's own portfolio to meet these credits. But we have a problem with spending investor dollars to meet a penalty which was the result of sloppy foreclosure practices on the part of the servicer.

The GSEs and Principal Reduction

We were very pleased to see that under the Obama plan, incentive payments for principal reduction are now being offered to the GSEs. Prior to this (as Exhibit 2 has shown), the GSEs (and FHFA as their regulator) have been reluctant to approve principal forgiveness modifications, as they believe it is not NPV-positive to their agencies, and is hence inconsistent with the idea of conservatorship.

FHFA Chairman DeMarco recently responded[4] to a request from the House Committee on Oversight and Government Affairs to look at whether principal forgiveness on GSE loans would serve the interests of the taxpayer. That letter contained the results of the FHFA study (FHFA Analysis of Principal Forgiveness Loan Modifications) that compared losses to the GSEs from principal forgiveness versus prin-

[4] FHFA letter to the Honorable Elijah E. Cummings, Ranking Member, Committee on Oversight and Government Reform, January 20, 2012.

cipal forbearance, using the HAMP NPV model. They found that the losses were very similar.

We have three major criticisms of the methodology used for in the FHFA study:

First—A hypothetical model (the Treasury NPV Model) was used for the analysis, and there was no effort to look at actual HAMP results. Actual results (not hypothetical ones) should clearly be used where the data are available. If I am testing a new medical drug and have actual data on effectiveness in humans, I would clearly use that rather than data on theoretical effectiveness. And in this case, the data are available. The Principal Reduction Alternative under HAMP went into effect in October 2010. This suggests that the HAMP program has 16 months of data which can be used to measure the success of the Principal Reduction Alternative (the forgiveness program) versus the standard HAMP waterfall (which reduces the interest rate, extends the term, and forbears principal if necessary). These actual HAMP results should have been examined.

Second—There were four serious technical issues in the conduct of the study, which made principal forgiveness less appealing:

A. State level price indices were used, not MSA level indices. Thus, the FHFA picked up fewer high LTV borrowers than there actually are. These high LTV borrowers are aided more by principal forgiveness than their lower LTV counterparts.

B. The results were done on a portfolio level, not an individual loan level. Thus, the FHFA did not consider the possibility of following a forgiveness strategy for some borrowers and a forbearance strategy for others. This would have clearly dominated the use of a single strategy.

C. The actual HAMP program was not evaluated. The principal forgiveness in the HAMP program is the lesser of (the current LTV—the target LTV) or 31 debt-to-income. The FHFA automatically assumed principal reduction equal to (the current LTV—the target LTV). Thus, they overstated the amount of principal reduction that would have been granted for higher income borrowers. (For these higher income borrowers, the 31 DTI target would have required less forgiveness.)

D. Attributes of the loan at origination, not current attributes, were used for the analysis. Delinquent borrowers, on average, have suffered a deterioration in FICO scores. By using origination characteristics, the health of the borrower is overstated, hence the assumed likelihood of success is too high. This overstates the cost of forgiveness.

Third—The FHFA study did not consider any differentiation between loans with mortgage insurance versus loans without it. If the overall result for the GSE book of business were very similar for forgiveness versus forbearance, forgiveness on loans with mortgage insurance should be more NPV-negative to the GSEs than would be forbearance, and forgiveness on loans without mortgage insurance should be more NPV-positive than forbearance.

The mortgage insurance point is critical. Roughly 32 percent of the GSE portfolio of seriously delinquent loans carries mortgage insurance. If the GSEs do a principal write-down, they take the loss on loans irrespective of whether or not they have mortgage insurance. If the loan with mortgage insurance would otherwise (no modification or a different type of modification) have defaulted, the mortgage insurer would have paid the GSEs the coverage amount due. We'll use an example to make this clearer. Assume a borrower has a $100,000 loan, on a house worth $75,000. The GSEs have mortgage insurance from a mortgage insurer, which covers any loss down to $70,000.[5] Assume that the borrower defaults, and the GSE offers the borrower $20,000 of principal reduction, which reduces the loan balance to $80,000, and gives the loan a 75 percent chance of eventual success. If the loan does not redefault (there's a 75 percent chance of that happening), the GSE loses the $20,000 principal amount they gave up. But if the loan redefaults and the house then sells for $70,000 (25 percent chance), the mortgage insurance pays $10,000 to the GSE for the lost principal, in which case the GSE still loses $20,000. If principal is forborne, and the borrower defaults, the mortgage insurer would cover the loss. So when there is mortgage insurance, it is generally not NPV-positive to the GSEs to do principal forgiveness—forbearance creates the preferred outcome, as the MI does not cover the forgiven amount.

For loans without mortgage insurance, it is generally NPV-positive to the GSEs to do principal forgiveness. Let's assume the same defaulting borrower as above.

[5] In this case, the mortgage insurance covers the first $30,000 in losses. It does not cover additional losses to the holder if the loan repays $70,000 or less.

The borrower achieves the same payment relief under the standard HAMP waterfall and under the principal reduction alternative, so the NPV of the cash flows will be very similar (the difference will be the discounted value of the forborne amount; and remember that the present value of $20,000, 40 years from now, assuming a 5 percent interest rate, is approximately $2,800). However, the default rate will be lower on the forgiveness modification (as it will have a lower postmodification LTV), lowering any further loss as well as the expenses associated with that loss, thus making it the more attractive option for the GSEs.

And there is no question in my mind that forgiveness could be implemented for part of their book of business, without implementing it on the entire book of business. Precedence for this comes from the HARP program, where only loans issued before the June 1, 2009, cut-off date are eligible for a streamlined refinance.

We understand that the primary issue in the mind of the FHFA is that more than 90 percent of GSE loans are current, and FHFA is very concerned about the moral hazard issue. The fear is that principal write-downs encourage borrowers to default who otherwise would have stayed current. As we point out above, there are two easy solutions to the moral hazard issue. The first solution is to require that the borrower be delinquent as of a certain date, so performing borrowers do not intentionally go delinquent in order to get the principal reduction. The other choice is to establish a series of frictions so that only those borrowers who need the principal reduction take advantage of the program. This could involve the inclusion of a shared appreciation feature or other frictions to default.

We hope that new measures permitting the GSEs to be eligible for the principal reduction incentive payments would allow the FHFA to reevaluate their stance on principal forgiveness. And the newly announced triple incentive payments will be incorporated in Version 5.0 of the Treasury NPV model. We would urge the FHFA to rerun their results, using the new model which incorporates the triple incentives, correcting the technical flaws in their analysis, and breaking out loans with and without mortgage insurance separately. We believe when this is done, it will be clear that forgiveness is the better solution for the bulk of the ⅔ of their book of business without mortgage insurance. Moreover, we believe that once the GSEs start doing principal forgiveness, the program will become even more widespread in PLS (private label securitizations), as servicers will make the investment in the technology to make it available for all delinquent loans.

Demand Side Action—Bulk Sales

I can't tell you how pleased we are to see the announcement of the Fannie Mae bulk sales pilot program. I testified before the Senate Committee on Housing, Transportation, and Community Development last September on the need for bulk sales. The argument in favor of bulk sales is that there is a huge shadow inventory of homes that needs to be absorbed. Roughly 2.7 million borrowers have not made a payment on their home in over a year. Another 400,000 homes are in REO (the "real estate owned" category, which consists of troubled properties that have been repossessed). Collectively, they constitute a shadow inventory of 3.1 million units. There isn't insufficient demand from owner-occupants to absorb this number of units. Thus many of these properties must transition to investors. Currently, some of the properties are transitioning to smaller investors, but, prior to this program, there was no mechanism for institutional investors to buy properties in bulk.

Buying in bulk is important to an institutional investor, as they want to put into place a professional property management organization and a rental organization, both staffed locally. If an institutional investor has only accumulated a few homes, it is difficult to justify the cost of building out the necessary service organizations. But if they are able to accumulate a large number of homes at once, it becomes economic to do so. It also suggests that institutional investors will pay a premium to accumulate the properties in bulk than one-by-one. We believe that both Fannie Mae and FHFA will be very pleased with the execution of the pilot program, and will choose to implement on a larger scale, by selling both nonperforming loans and REO properties.

What about the argument that selling homes one-by-one is more profitable? We believe that will prove to be incorrect. First, institutional investors will pay a premium to accumulate in bulk. Second, when you sell homes individually, all the properties sell more slowly, plus many don't sell at all. Marketing costs are also higher. Consider the costs of a slower sale: tax and insurance payments still have to be kept current until the home is sold. Plus, the GSEs are either paying to maintain the property, or realizing a lower sales price because the condition of the home is deteriorating.

In the construction of this pilot program, we encourage the provision of financing. Currently, there is no mechanism for financing scattered site single home purchases of more than a small number of properties (Fannie will finance a maximum of 10 properties; Freddie a maximum of 4 properties). It makes little sense to have a cutoff based on the number of properties. Rather, very conservative financing should be provided—and by conservative, we mean at least 30 percent down payment. The provision of financing would be reflected in higher bids on the property. Hence, the financing would be a benefit to the taxpayers, not a cost.

We believe that by giving institutional investors the ability to purchase homes in bulk, large amounts of shadow inventory can be absorbed. This will make substantial progress toward cleaning up the shadow inventory, which is critical to stabilizing home prices. Once home prices stabilize, the hope is that credit availability will increase.

Credit Availability Standards

There is currently a disconnect in the housing market between affordability and the level of housing activity. The National Association of Realtors Home Affordability Index is at its highest since they began tracking it in 1986. This Index measures the ability of the median family to purchase the median priced home, putting down 20 percent and taking out a 30-year fixed rate mortgage at prevailing interest rates. With the Case Shiller Home Price Index down 34 percent from the peak, and 30-year fixed rate mortgage rates at the lowest level they have been since the 1960s, it is not surprising that housing looks quite affordable. The real question is—Why is the Mortgage Bankers' Association Index measuring purchase activity at a 15-year low?—why are existing home sales so low?

The answer is that credit availability is very tight. Affordability based on median income is at an all-time high but, at the same time, the median family balance sheet cannot afford to put down 20 percent on a home purchase, nor can they qualify for a 30-year fixed rate mortgage at today's qualification standards. (And if a borrower wants to put down more less than 20 percent on a conventional loan, they will need either mortgage insurance or a second lien; both have become increasingly difficult to obtain.) In reaction to the extremely sloppy underwriting standards prevailing in the 2005–2007 period, the GSEs and bank originators have dramatically tightened origination standards. The average GSE origination for 2009–2011 has a 762 FICO, and a 68 LTV. The average bank portfolio loan has a 756 FICO, 67 LTV. Moreover, almost 20 percent of the 2007 borrowers have defaulted or gone more than 90 days delinquent on their existing loan, thus ruining their credit score and making them unable to buy another property.

Yes, lending standards were certainly too loose in the 2005–2007 period, but they are now too tight everywhere, with the exception of FHA/VA loans. And every single action that is being contemplated will actually make them tighter. One point of particular concern for us is the Qualified Mortgage (QM) Standards.

We expect the CFPB (Consumer Finance Protection Bureau) to finalize an ability-to-repay rule that does not contain a safe harbor from liability for lenders who make a QM (Qualified Mortgage) loan. Instead, preliminary discussions indicate the CFPB is most likely to provide lenders with a rebuttable presumption and establish a "bright line" test of what constitutes a QM loan. If a real "bright line" test is drawn, lenders might be comfortable doing QM loans even with a rebuttable presumption.

However, it will clearly crimp credit availability for all loan applications that do not clearly meet the "bright line," and any ambiguity in the "bright line" will further crimp the market. Moreover, the greater the consideration of "compensating factors" which makes for more rational lending standards, the less "bright line" the QM test can be. For example, a 43 percent back-end DTI does not sound like an irrational limit; however a borrower with limited income and substantial assets with little of those assets in cash, who is putting down 40 percent, may not be able to take out a QM loan.

From a lender's point of view, the fear is that default is itself evidence of lack of ability to repay. The penalties for non-QM compliance are substantial. Moreover, for loans done outside of a safe-harbor and/or the "bright line" test—*i.e.*, non-QM loans—lenders will be subject to Truth in Lending Act (TILA) litigation risks; it is reasonable to expect borrowers to commonly allege lack of ability-to-repay, and to seek TILA damages. Litigation is expensive—on average costing lenders about $70,000–$100,000 per loan—costs that far exceed the few thousand dollars that a lender might make on originating any one loan.

Some predict that there will be a vibrant market for non-QM loans, but that is not likely because of the liability associated with originating those loans. Suppose an investor were willing to purchase MBS backed by non-QM loans. If the non-QM borrower were to allege a lack of ability-to-repay, the investor could look to the originating lender for recovery, under the lender's representations and warranties that the loan met the ability-to-repay requirements. We expect that investors may be willing to buy MBS backed by non-QM loans originated by well-capitalized lenders, but those lenders may not be willing to make non-QM loans because the liability far exceeds the potential profit from loan origination. Lenders with limited capital may be willing to make non-QM loans, but those lenders will not be able to attract investors. There will be no ability to make higher cost loans to more risky borrowers.

We expect the ability-to-repay rule to further constrain mortgage credit under any circumstances. However, unless the final rule includes either a safe harbor and a "bright line" test or, at a minimum, a very clear "bright line" test in conjunction with the rebuttable presumption, the rule will limit the availability of mortgage credit.

Conclusion

In my testimony today, I have discussed three actions that can strengthen the mortgage market, at no or minimal cost to taxpayers: increasing reliance on principal reduction modifications; a ramp up of the bulk sales program, coupled with financing for these properties; and a careful vetting of new rules that affect already tight credit availability.

We urge Congress to do everything they can to facilitate these actions.