STATEMENT OF NEIL M. BAROFSKY

SENIOR FELLOW AND ADJUNCT PROFESSOR
NEW YORK UNIVERSITY SCHOOL OF LAW

BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON INSURANCE, HOUSING AND COMMUNITY OPPORTUNITY

OCTOBER 6, 2011

Chairman Biggert, Ranking Member Gutierrez, and members of the Committee, I am honored to appear before you to discuss the Department of the Treasury's Home Affordable Modification Program ("HAMP") and lessons that may be learned from its failed design and implementation.

In March 2011, I stepped down as the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"). Since then, I have been working at NYU School of Law as an Adjunct Professor and a Senior Fellow at its Center on the Administration of Criminal Law as well as its Jacobson Leadership Program in Law and Business. The Center is an apolitical advocacy organization and think-tank dedicated to promoting good government practices in the criminal justice system, particularly focusing on prosecutorial power and discretion, while the Leadership Program is designed for students who aspire to a non-traditional career path that requires intensive training grounded in legal and business curricula. In addition, I am pleased to be teaching a seminar on the government's response to the financial crisis, including the Troubled Asset Relief Program ("TARP").

HAMP emerged from Treasury's initial promise that TARP would be used to bail out homeowners on Main Street as well as the megabanks on Wall Street. As originally sold to Congress, TARP funds would be used to purchase "troubled assets"—the mortgages and mortgage-backed securities whose plummeting value helped trigger the financial crisis. Treasury promised that once it purchased those mortgages, it would then modify them where appropriate, potentially helping millions of struggling homeowners keep their homes. It was this promise, of course, that helped deliver many of the votes from Congress that ultimately authorized TARP.

After Treasury shifted the focus of TARP from the direct purchase of mortgage-related assets to capital injections into the struggling Wall Street behemoths, President Obama announced the mortgage modification program in February 2009 to address the government's still-unfulfilled promise to assist struggling homeowners. As announced, HAMP was intended to help 3 to 4 million homeowners stay in their homes through permanent government-subsidized mortgage modifications. By any meaningful definition, that effort has been a failure.

When I last testified before this committee in March 2011, I warned that HAMP was falling far short of its stated goals and even further short of meeting the urgent needs of American homeowners. Unfortunately, there has been little improvement since then. The foreclosure crisis continues to wreak havoc on millions of American homeowners. While the number of foreclosure filings has "dropped" in the first half of 2011 to a still-devastating 1.2 million properties (compared to 1.6 million properties in the first half of 2010, and a record-setting 2.9 million for all of 2010), this improvement is illusory. RealtyTrac notes that the drop-off in foreclosure filings is not due to improvements in the housing market, but rather to processing and procedural delays arising out of the robo-signing scandal. In yet another example of the foreclosure can being kicked down the road, the firm estimates that these delays will merely push as many as 1 million foreclosure actions from 2011 to 2012 or later, adding to the uncertainty in the market. Indeed, there are already gathering signs that the foreclosure machine is once again being restarted, with first-time default notices being sent to 78,000 homes in August, a 33% increase over the previous month. Meanwhile, RealtyTrac's data reveal that bank repossessions continue even in the aftermath of the scandal: more than 400,000 homes were taken back in the first half of the year. And compounding the ill effects, as the *Wall Street Journal* recently

reported, banks are increasingly seeking deficiency judgments against foreclosed-upon borrowers, potentially driving them into bankruptcy.

In contrast, the number of permanent mortgage modifications under HAMP remains feeble. There were just 675,000 ongoing permanent modifications as of July 2011. As of the last time that the data was made public, less than 46% of HAMP modifications were actually funded by TARP, with the remainder executed by the Government Sponsored Entities ("GSEs"). In contrast, a combined total of just less than 880,000 trial and permanent modifications had been cancelled, with more than 106,000 trial modifications still in limbo. Obviously, HAMP's permanent modification numbers pale in comparison not only to foreclosure filings and failed HAMP modifications, but also to the initial prediction that the program would "help up to 3 to 4 million at-risk homeowners avoid foreclosure" "by reducing monthly payments to sustainable levels."

Rather than 3 to 4 million promised mortgage modifications, HAMP's output looks on pace to meet the Congressional Oversight Panel ("COP")'s December 2010 projection of just 700,000 to 800,000 effective permanent modifications through the lifetime of the program, a small fraction of the original goal. Nor is there any reason to suspect that HAMP will see any significant improvement, with only a net increase of about 23,000 permanent modifications per month over the most recent quarter. This is a far cry from the 20 to 25,000 trial modifications *per week* that Treasury officials once predicted. Worse, these figures mirror a slowdown in modification in the broader market: after surveying financial institutions representing 63% of all first-lien residential mortgages nationwide, the Office of the Comptroller of the Currency ("OCC") recently found that the number of new permanent modifications (HAMP and private) has declined every quarter since June 2010.

HAMP's administrative failures have also been breathtaking. In May 2011, the Government Accountability Office ("GAO") released a survey of housing counselors who work with borrowers seeking HAMP modifications. The results confirmed the widespread anecdotal evidence of the servicers' failures. A staggering 76% reported their views of borrowers' overall experiences with HAMP as "negative" or "very negative." Asked to list borrowers' three most common complaints, 59% of counselors answered "lost documentation"; 54% answered "long trial periods"; 42% answered "wrongful denials"; and 37% answered "difficulty contacting servicer." Counselors also reported excessive servicer delays in reviewing HAMP applications. Other studies and investigations, including the important work of ProPublica and anecdotal evidence from SIGTARP's hotline, confirm the widespread abuse suffered by homeowners at the hands of the mortgage servicers charged with implementing HAMP. Sadly, accountability for these deficiencies has gone largely unaddressed, with Treasury offering only the feeblest gestures at penalizing servicers for their misconduct even though, as ProPublica's recent report indicates, it has been aware of servicer misconduct since 2009.

In short, HAMP continues to suffer from design and implementation deficiencies. To assist Congress as it contemplates new government programs to deal with the foreclosure crisis or considers expanding existing programs, I will focus my testimony today on three "lessons learned."

First is the importance of *comprehensive planning*. Treasury rushed HAMP out the door in a manner best described as "ready, fire, aim," leading to mistakes that are still ricocheting today. Second is the importance of *clearly articulated goals*. HAMP began with the goal of 3 to 4 million permanent modifications, but rather than acknowledge the failures and adapt the program, Treasury has simply made up new goals, followed by an instant declaration that these new goals have been met. Third is the necessity of *meaningful incentives and sanctions for third parties*. HAMP was unable to secure meaningful compliance from mortgage servicers when it mattered most because it has neither effective carrots nor sticks.

1. Comprehensive planning. HAMP launched in March 2009 with inadequate analysis, an insufficient incentive structure, and without fully developed rules—all of which has required frequent tinkering with program guidelines. The modification effort was first announced with no guidance in place, leading to an avalanche of calls and applications to the severely underequipped mortgage servicers. This announcement was followed by a hurried rollout that required change after change after change in the technical apparatus for implementing HAMP, such as the Net Present Value test that servicers must employ to evaluate borrowers. These changes caused mass confusion without the benefit of addressing the program's deeper design flaws. For example, in response to a GAO questionnaire in June 2009, several servicers reported that they would not participate in the Program in part because of the constantly shifting requirements, benefits, and guidelines. SIGTARP's review indicated similar frustration with the constantly changing guidelines and modifications, which made the task of the already overburdened servicers even more difficult.

Treasury has been eager to blame servicers for HAMP's early failings, emphasizing that "when HAMP was launched in early 2009, servicers were totally unequipped to deal with a crisis." While much of the servicers' subsequent behavior was inexcusable, Treasury had to have known that they were "totally unequipped" to handle HAMP at the time of the program's launch. Rather than recognize and address this reality, Treasury rushed out the poorly designed program and pressured the servicers to meet the artificial and politically motivated goal of 500,000 trial modifications by November 1, 2009, even though the servicers simply did not have the capacity to effectively do so. Making matters worse, Treasury then pressured the servicers to accepted undocumented trial modifications in an obvious attempt to artificially increase the trial modification numbers for public relations purposes. In other words, while it is true that servicers were unequipped to handle the volume of modifications at the start of the program, it was Treasury's design and rollout of HAMP that made the program so completely dependent on servicer competence in the first place. The harm from Treasury's flawed design and tactics has been significant. Countless homeowners were placed in trial modifications that could never convert into permanent ones, which caused harm to those homeowners who unnecessarily lost their savings, their credit ratings, and their homes. While the paltry number of incoming trial modifications, along with Treasury's eventual adoption of some recommendations (such as eliminating undocumented trial modifications) has limited the ongoing harm caused by HAMP, any future program must avoid these mistakes by planning for expected demand and contingencies, with the aim of setting clear expectations for all participants.

Finally, from the earliest days of HAMP, SIGTARP warned of the necessity of launching an extensive marketing campaign to educate the public about the program, both to maximize its effectiveness and to help deter those who would seek to profit criminally off of HAMP. Treasury ignored this recommendation until it was far too late. Not surprisingly, there have been countless cases of mortgage modification fraud related to the program as predators took criminal advantage of desperate homeowners who were uneducated about the details of the program. And basic misunderstandings led to abuses by mortgage servicers, such as directing homeowners who were current on their mortgages to default. As part of its comprehensive planning, any new program must include a strong public relations effort, including radio and television advertising.

2. Clearly articulated goals. As noted above, HAMP began with the laudable goal of "help[ing] up to 3 to 4 million at-risk homeowners avoid foreclosure" through sustained permanent HAMP modifications. Though the current 675,000 permanent modifications falls far short of this goal, Treasury has still managed to declare success on multiple occasions—though its justification has changed each time. At various points, HAMP has been "successful" because its goal was only to make 3 to 4 million "offers" for modifications (regardless of whether they were accepted or successful, a goal that SIGTARP correctly labeled as "meaningless"); because it has produced a substantial number of trial modifications (even though trial modifications are by definition temporary, and can result in lasting financial and emotional harm when not converted into permanent modifications); because it has encouraged private modifications (even though private modifications are typically far less advantageous than HAMP modifications and have a much higher rate of redefault); or simply because it helped forestall an even greater outbreak of foreclosures at a time when banks were in dire straits (a kicking-the-can-down-the-road tactic that SIGTARP warned back in March 2010 would "merely spread[] out the foreclosure crisis over the course of several years . . . at the expense of those borrowers who continued to make modified, but still unaffordable, mortgage payments for months more before succumbing to foreclosure anyway").

These various justifications are no substitute for a measured assessment of progress against clearly stated goals, which provide public accountability as well as guidance for reform. Undoubtedly Treasury encountered difficulty in meeting HAMP's goal of 3 to 4 million sustainable mortgage modifications. But upon encountering difficulty, it is an axiom of good government that policymakers must change the program to meet the goals, not change the goals to meet the program. Steady goals and metrics allow for meaningful oversight, promote accountability, and provide guidance for useful change. Any future program must have clearly articulated goals that can function as a benchmark for performance, and not repeat the costly error of putting politics over performance.

3. Meaningful incentives and sanctions for third parties. By design, HAMP relies on the cooperation of loan servicers, who operate as the point of contact for distressed homeowners and administer the loans on behalf of investors. In theory, HAMP's incentive payments are supposed to overcome the expenses associated with executing a permanent modification and encourage active participation in HAMP, while the threat of sanctions is supposed to ensure compliance. In

reality, neither the incentives nor the sanctions have been sufficient to drive servicer participation or keep abuses in check.

Earlier this year, Secretary Geithner acknowledged that incentive payments to servicers have "not been powerful enough" to maximize participation. But puzzlingly, there has been no meaningful change since then. Moreover, the current incentive structure does not always incentivize permanent mortgages: in some cases, as we demonstrated in SIGTARP's October 2010 Quarterly Report, it can be more profitable for a servicer to stretch out a trial modification and then foreclose, rather than to install a permanent modification. Thus, the problem of inadequate incentives dovetails with the two previous lessons learned. It is vital to properly address incentives in the first instance, and be willing to meaningfully change the program if performance is not meeting its goals. In HAMP, Treasury did neither.

A similar analysis *would* apply to HAMP's sanctions—except that the program lacks any meaningful sanctions at all. In November 2009, Treasury announced that "servicers failing to meet performance obligations" would face "consequences which could include monetary penalties and sanctions." But when serious and widespread abuses emerged, Treasury hesitated and then backtracked, confessing to the Congressional Oversight Panel in October 2010 that the voluntary nature of HAMP "makes aggressive enforcement difficult" because it may lead to servicers exiting the program, and then claiming in testimony in January 2011 that the $30 billion in contracts that Treasury itself negotiated lacked the provisions necessary to meaningfully discipline servicers. Finally, on February 14, 2011, SIGTARP sent a letter to Treasury seeking its legal justifications. Treasury did not respond to this request while I was at SIGTARP, but instead announced in June 2011 that it had taken the meaningless step of temporarily withholding incentives from just three servicers—Bank of America, JPMorgan Chase, and Wells Fargo—until they stop violating HAMP rules. (A fourth servicer, Ocwen Loan Servicing, was also found in need of "substantial improvement" but continued to receive incentives.) Of course, the three sanctioned servicers had essentially already agreed to stop violating HAMP rules in a previous unrelated settlement with regulators. In September 2011, just three months after its initial wristslap, Treasury deemed Wells Fargo in compliance and paid it in full; it is obviously only a matter of time before both Bank of America and JPMorgan Chase are also made whole. Worse yet, Treasury has not even been able to effectively administer this so called "sanction." As ProPublica recently reported, Treasury *still* made nearly $3 million in payments to the allegedly suspended servicers during this "time out," citing problems with "system limitations."

This regime, described by one servicer as having an impact that "mean[t] very little," was clearly designed to try and placate the many critics of Treasury's enablement of servicer abuse through HAMP. Through its adoption of this approach, Treasury has effectively given the servicers a free pass for the multitude of abuses they have committed in this program. There can be no question that Treasury's fear of the servicers, as opposed to the servicers' fear of Treasury, has helped define this program as the failure that it has become. Any future program must have real sticks to go with its carrots, and not rely on political theater and gimmicks to get by.

Going Forward

With these lessons in mind, it is of course up to Congress and the relevant policymakers to chart the path forward, even as another year passes with the foreclosure crisis stalling economic recovery. Meanwhile, the rampant mortgage servicer abuse that has so strongly characterized the crisis, both inside and outside of HAMP, continues to go unpunished. There are no easy answers, but I believe that any government solution must contend with underwater mortgages (that is, mortgages where the amount of the outstanding principal owed exceeds the value of the home) and servicer accountability.

Today, CoreLogic estimates that there are 10.9 million underwater mortgages, or 22.5% of all outstanding loans. Recovery will continue to be frustrated until there is a reasonable solution to this problem. Too many would-be employees are unable to move to find employment because they are chained to a house they cannot sell; too many homeowners understandably choose to walk away from their home rather than make payments without any hope of regaining equity (causing additional foreclosures and additional downward pressure on housing prices); and there are too many unaffordable mortgage payments based on too much outstanding principal. There needs to be a recognition that many borrowers will never make the required payments on their underwater mortgages, and that the owners of these mortgages have already lost any meaningful chance of obtaining a full recovery of the outstanding principal. The sooner that this reality is recognized and addressed, the sooner a recovery can take hold. As such, an aggressive principal reduction program is necessary, and can possibly be accomplished through: (a) government subsidies (such as the SIGTARP recommendation that principal reduction be mandatory in HAMP when it is in the best interests of both the borrower and the investor), including potentially tapping the tens of billions of dollars of obligated but unlikely-to-be-used HAMP funds; and (b) compulsion through a meaningful settlement of the allegations of servicer fraud and abuse.

Unfortunately, the failure of the government's response to the foreclosure crisis to date gives little reason to hope that either of these potential solutions will soon come to pass. Treasury should have negotiated principal reduction right from the start, utilizing its TARP investments as leverage over the parent companies of the mortgage servicers. Instead, it incompetently administered an ineffective program that seems to have better served the banks than homeowners. At this point, it may prove difficult to even attract homeowners to yet another government program. Too many have suffered the experiences detailed in the GAO survey, and housing counselors describe a condition they call "HAMP fatigue," where borrowers just don't trust the government to help them anymore.

Similarly, there seems to be little hope for an effective settlement guaranteeing principal reduction, judging from the almost farcical and all-too-public drama underlying the rapidly unraveling Department of Justice/State Attorneys General settlement discussions with the largest servicers. Based on the comments of the defecting State Attorneys General, it appears that a year of valuable investigative time has been lost in an ill-conceived process that put the cart of settlement discussions before the all-important horse of a comprehensive investigation. This too seems to be another opportunity lost.

As a result, while I have consistently advocated that *fixing,* and not abandoning the government-sponsored programs is the right solution, and while I still believe that is the right course *if* the government is finally willing to commit to the necessary steps to forcefully and competently deal with the ongoing crisis, it is becoming increasingly difficult to argue against those who advocate that the government should simply get out of the way and let the market's cruel efficiencies take over. Such a process will inevitably result in near-term losses that are higher for both homeowners and lenders, but absent an effective alternative, it may be the only way to finally end the painful and ultimately fruitless game of kick-the-can that Treasury has been playing. And perhaps, in its aftermath, that will lead to recovery.

Chairman Biggert, Ranking Member Gutierrez, and members of the Committee, I want to thank you again for this opportunity to appear before you. I would be pleased to respond to any questions that you may have.