TESTIMONY OF DR. CHRISTOPHER J. MAYER
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
HEARING: PRIORITIES FOR THE NEXT ADMINISTRATION: USE OF TARP FUNDS UNDER EESA
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Good morning Chairman Frank, Ranking Member Bachus, and Members of the Committee. Thank you for inviting me to speak today. My name is Christopher J. Mayer. I am the Paul Milstein Professor of Real Estate and Senior Vice Dean at Columbia Business School. I have spent the last 16 years studying housing markets and credit while working at the Federal Reserve Bank of Boston and serving on the faculties of Columbia Business School, the University of Michigan Business School, and the Wharton School of the University of Pennsylvania. I am an expert in real estate and credit markets, so I cannot comment about the questions of taxpayer accountability of TARP funds or on restrictions for recipients of TARP funds. Instead I will focus my comments on the use TARP expenditures to facilitate economic recovery, reduce foreclosures, and help struggling homeowners.

Accelerating declines in the housing market and growing foreclosures are placing a serious strain on American households and economy. While it is crucial to deal with the broader economic crisis through a comprehensive stimulus package and tax cuts, the economy is unlikely to recover without addressing the housing crisis directly. More than two-thirds of all American households own their own home. Most homeowners have relatively modest stock holdings; the bulk of their wealth is tied up in their home. As house prices keep falling, these households suffer increasing wealth declines, making them more likely to further retrench and cut spending. We must do as much as we can to stem house price declines and prevent foreclosures, while at the same time also protecting the financial system. Further mortgage-related losses may cause additional bank failures, lead the credit markets to continue spiraling downward, and impose additional losses on taxpayers through the almost $6 trillion of outstanding debt and mortgage guarantees from Freddie Mac, Fannie Mae, and Ginnie Mae, loans to AIG, and other securities owned by the Federal Reserve and the Federal Government.

The problems in the housing market have been stunning and unprecedented. House prices have fallen about 18 percent in the last year according to Case and Shiller/S&P, likely the largest national decline in prices since the Great Depression. This has led to crisis of foreclosures, with 2.25 million foreclosures started last year (Federal Reserve)[1] and the forecast of 1.7 million foreclosures started in 2009 (Credit Suisse Foreclosure Update)[2]. Foreclosures contribute to a

[1] http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm

[2] http://www.nhc.org/Credit Suisse Update 04 Dec 08.doc

further decline in house prices and deteriorating communities. Despite good intentions and appreciable effort, public policy to stem foreclosures has had limited success.

And the problem will likely get worse without prompt action. As of September 2008, there were more than 2.2 million vacant homes, 4 million vacant rental properties, and 4.5 million houses on the market, unsold. Without reducing this inventory, house prices will keep falling. The likelihood of growing foreclosures looks equally bleak. As of October 2008, sixty-day delinquency rates exceeded thirty-three percent among the 2.8 million outstanding securitized subprime loans and seventeen percent among the 2.2 million securitized alt-A loans. Even worse, many securitized option ARMs will hit negative amortization limits between 2009 and 2011, resulting in rising payments and higher default rates.

I am here to suggest a two-pronged approach to stabilizing the housing market and preventing foreclosures. First, I believe the federal government should immediately act to reduce mortgage rates and stabilize the mortgage market. Lower mortgage rates represent the single best way to reduce foreclosures by stabilizing house prices. Academic studies show that falling house prices are the single strongest contributor to the growth in foreclosures. Lower mortgage rates could attract new homebuyers to absorb inventory and allow as many as 25 million existing homeowners to refinance their mortgages, saving about $450 per month. This would provide a fiscal stimulus of $175 billion PER YEAR. This plan is not a substitute for the currently considered $775 billion stimulus, but unlike that program, the stimulus from lower mortgage rates would require no new federal appropriations. The government could simply arrange for lower rates by issuing US Treasury securities to fund new mortgages.

Nonetheless, even if we immediately stabilize the housing market, millions of homeowners will face the possibility of foreclosure in the coming years. Thus the second part of my testimony addresses a new proposal prepared with Edward Morrison and Tomasz Piskorski to reduce foreclosures through a combination of an incentive fee program to encourage servicers to avoid foreclosures and a legislative initiative to modify servicing agreements to clarify that servicers have the right to modify any loan where modification makes better economic sense than foreclosure. The cost of this proposal is incredibly modest compared to other proposals. We estimate that as many as one million foreclosures could be prevented at a cost of $10.7 billion that could be paid for by TARP funds.

Finally, I address some provisions of the recently published draft legislation (1/9/2009) entitled “TARP Reform and Accountability Act of 2009” from this Committee. In particular, I suggest specific improvements that could be made to this legislation. Nonetheless, I believe that this legislation represents an appreciable step forward and that such an approach represents a step to addressing the foreclosure crisis. As argued below, this legislation could accomplish much of what proponents have claimed would be true with mortgage “cramdowns,” without the negative repercussions.

Stabilize the Mortgage Market and House Prices

I briefly describe a program to return mortgage markets to normal operations and stabilize house prices. Along with R. Glenn Hubbard, I have proposed that the government allow new mortgages to be issued at a rate that is 1.6 percent above the rate of the 10-year Treasury bond. With 10-year Treasury rates as low as 2.4 percent, this would immediately lower mortgage rates as low as 4 percent for conforming mortgages.

Lower mortgage rates would accomplish many things at once. Lower rates will stabilize house prices. A recent paper that I wrote with R. Glenn Hubbard suggests that house prices have already fallen at or below where fundamentals suggest, but are likely to continue to decline due to the mortgage market meltdown and the deteriorating economy.[3]

Lower mortgage rates also provide a strong fiscal stimulus, allowing as many as tens of millions of American households to refinance their mortgages, with a monthly savings of $425 that is not a temporary stimulus but permanently lower payments.[4] These lower mortgage payments could make the difference for millions of homeowners in allowing them to obtain affordable mortgages and avoid foreclosure. As well, lower rates would provide a fiscal stimulus that would total more than $174 billion per year and would almost surely induce an increase in consumption relative to a temporary tax stimulus.

Moreover, a low mortgage rate will raise housing demand significantly. We estimate that anywhere between 800,000 and 2.4 million additional owner occupants could enter the housing market in 2009.[5] These gains in new homeowners would help absorb the inventory of vacant houses, putting a floor on house price declines. TARP money might facilitate larger gains in new homeowners by helping finance low down payment mortgages through the Federal Housing Administration.

While lower mortgage rates do not require any additional government expenditure, TARP funds could provide additional help to homeowners struggling to pay off a mortgage on a house that is worth less than the mortgage. The federal government could also help facilitate many of the refinancings by offering to share some of the losses with lenders in return for taxpayers receiving a portion of the future appreciation of houses that participate in these new refinancings. These losses would be funded from the TARP. Our initial estimates were that a plan to share

[3] See "House Prices, Interest Rates, and the Mortgage Market Meltdown" by Christopher Mayer and R. Glenn Hubbard available at http://www2.gsb.columbia.edu/faculty/cmayer/Papers/Mayer-Hubbard-BEP-10-2008-v7.pdf

[4] Calculations are available at http://www4.gsb.columbia.edu/null?&exclusive=filemgr.download&file_id=53340

[5] See calculations at www4.gsb.columbia.edu/realestate/research/mortgagemarket

losses 50-50 with lenders would cost the government $121 billion. It would allow millions of additional homeowners to refinance their mortgages to an affordable level. The government would recoup some of its expenditures by retaining a stake in the future appreciation of houses refinanced under this program.

Moreover, trillions of dollars of refinancings would retire a large number of the existing mortgage-backed securities. This would reduce uncertainty about the value of existing mortgage-backed securities. It would flood the market with additional liquidity that the private sector could deploy to other uses such as auto loans, credit cards, commercial mortgages and general business lending.

Reduce Foreclosures and Help Struggling Homeowners

Even if we stabilize the housing market, with the economic downturn, the resetting of mortgage rates, and the end of negative amortizing mortgages, millions of Americans will face the loss of their home in the coming years. It is essential for the government to take action to help prevent this crisis.

I discuss in more detail a proposal recently put forward with Edward Morrison and Tomasz Piskorski, both colleagues and professors at Columbia University. The proposal is attached to this testimony and provides more detail on the proposal, the cost-benefit calculations, and the supporting constitutional arguments.

We offer a new approach to foreclosure prevention that focuses on what has been the most intractable part of the foreclosure problem: the behavior of third-party servicers who manage portfolios of securitized portfolios. Why focus on servicers of securitized mortgages? Because securitized subprime, alt-A, and prime/jumbo loans accounted for more than one-half of foreclosure starts in 2008 despite representing about fifteen percent of all outstanding mortgages.[6] While the Fannie Mae, Freddie Mac, the FHA, and the largest private banks and portfolio lenders have announced their own aggressive programs to pursue mortgage modification, servicers of securitized mortgages lag behind.

Our approach to combating foreclosures builds on research by Tomasz Piskorski, Amit Seru, and Vikrant Vig[7] showing that portfolio lenders—lenders who service loans that they own—are significantly more successful in stemming foreclosures than third-party servicers, who

[6] According to the Mortgage Bankers Association, about 1.64 million loans started the foreclosure process as of the third quarter of 2008. Our own calculations from data obtained from Braddock Financial shows that about 900,000 securitized loans began the foreclosure process as of October, 2008.

[7] See "Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis" by Tomasz Piskorski, Amit Seru, and Vikrant Vig available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646

service loans owned by other parties. The research shows that portfolio lenders achieve foreclosure rates that are nineteen to thirty-three percent lower than the rates experienced by third-party servicers. In fact, portfolio lenders are even more successful in reducing foreclosures for the highest quality loans, where current delinquency rates are rising the fastest (portfolio lenders achieve foreclosure rates thirty to fifty percent lower than third-party servicers). Third-party servicers, however, are often unable or unwilling to use the same tools as portfolio lenders are currently using.[8] Recent research documents the failures of servicers to successfully modify loans.[9]

Our proposal eliminates barriers that prevent third-party servicers from effectively managing the foreclosure crisis. Commentary and evidence suggests servicers face two appreciable barriers: 1) Servicing contracts makes little economic sense in the current crisis. No one anticipated the extent of the current crisis and servicers are poorly compensated as a result. As well, servicers have too few incentives to pursue loan modification instead of foreclosure, even when modification makes good economic sense for investors. Most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification. Consequently, servicers often choose to foreclose, even when modification makes good economic sense for borrower and investors. 2) Servicers face explicit and implicit legal barriers to modifying mortgages successfully. Some pooling and servicing agreements (PSAs) place explicit limits on loan modifications. In other cases, vague provisions in the PSAs, and the consequent threat of lawsuits, serve to limit servicers' ability to modify loans successfully.

We propose two steps to get around these barriers: 1) an Incentive Fee structure that increases payments to servicers and better aligns their incentives with investors, and 2) a Legislative Proposal that removes explicit barriers to modification in PSAs and that reduces the litigation exposure of servicers who do modify loans. Our proposal might prevent as many as one million foreclosures at a cost of no more than $10.7 billion that can be funded by TARP money. Other proposals do not address both barriers that servicers face. As well, our proposal would cost taxpayers considerably less money than other programs currently under consideration, with no requirement to provide costly loan guarantees. Losses for bad loans remain with private investors rather than taxpayers.

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[8] Of course, many other foreclosures come from FHA programs and Fannie Mae and Freddie Mac, where the government already has appreciable influence in guiding programs to reduce foreclosures.

[9] See "Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports" by Alan White available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538 and a recent update available at http://www.hastingsgroup.com/Whiteupdate.pdf.

Incentive Fees: We believe that servicers need greater resources and stronger incentives to modify loans. We propose that servicers of privately securitized mortgages be paid a monthly Incentive Fee equal to ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of $60 per month ($720 per year). The servicer would also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage, rewarding servicers that accept short sales. These payments would be in addition to the normal servicing fees as specified by the PSA. The program would be limited to any securitized mortgage that is below the conforming loan limit at the origination date. The Incentive Fees, which would equal about $9 billion, can be paid from money authorized under the US Treasury's TARP program. The Incentive Fees should remain in place for a period of three years, after which improvements in the economy will likely reduce the need for the incentive program.

Our Incentive Fee program would substantially encourage servicers to modify mortgages. Servicing fees would now more than cover the direct costs of modifications, estimated to be as much as $750 to $1,000.[10] Equally important, the Incentive Fee program better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few Incentive Fees.[11] Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender deals with in its own loans. Of course, there will still be circumstances when costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Legislative Proposal: We propose specific, temporary legislation to eliminate legal barriers to loan modification in PSAs for all securitized loans. We believe that Congress has the authority, under the Commerce and Spending Clauses, to modify the terms of securitization contracts.

We propose two kinds of legislated changes to PSAs. First, Congress should enact legislation that eliminates explicit limits on modification, including both outright prohibitions and provisions that constrain the range of permissible modifications. The legislation should be temporary, lasting only three years. Second, Congress should create a "litigation safe harbor" that insulates servicers from costly litigation, provided they modify loans in a reasonable, good faith belief that they are acting in the best interests of investors as a group. The safe harbor is an affirmative defense, which servicers can assert in the event of litigation. Importantly, the defense

[10] See for example Barclays 2008 Global Securitization Annual.

[11] Evidence suggests that more than one half of loan modifications in the first quarter of 2008 re-defaulted within 6 months, so it is important only to reward servicers for pursuing successful loan modifications (OCC/OTS Report, 12/2008).

is based on evidence that the servicer held a reasonable, good faith belief in the benefit of modification, not on evidence that the modification was in fact successful or not. If investors bring suit, but a servicer successfully invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees. Finally, our proposal therefore requires servicers to make public the details of any modification.

Our Legislative Proposal raises no meaningful constitutional concerns and has been vetted by leading constitutional scholars. The Proposal is a temporary program to moderate an avalanche of foreclosures during an economic crisis. It is more tailored and potentially less burdensome on investors than temporary legislation enacted during the Great Depression and upheld by the Supreme Court. Indeed, our program should benefit investors, because it fosters loan modification only when it increases returns—relative to foreclosure—to investors as a group.

Our Legislative Proposal addresses a number of flaws in existing PSAs, which were created when investors and underwriters did not envision a housing collapse of the magnitude we are now seeing. Although the proposed legislation will abrogate contractual rights of investors, it will also free servicers to undertake loan modifications that increase payments—relative to a foreclosure—to investors as a group. Thus, the bulk of investors will benefit from this legislation, despite the loss of contractual rights. Most PSAs do not explicitly limit modifications, but instead contain vague language that can paralyze servicers. With respect to these securitizations, our proposal can best be viewed as clarifying the interpretation of the PSAs.

Our Legislative Proposal is slightly more complicated for the minority of PSAs that contain explicit provisions barring modifications, limiting the types of available modification, or requiring that a servicer purchase any modified loans—at par value—from the securitization trust. Our proposal will abrogate provisions like these. It is important to note, however, that our legislation enables modification only when it increases overall investor value. To be sure, some junior tranche holders might be harmed. We believe that policymakers should provide compensation to these investors, who have suffered economic losses. Note, however, that compensation to junior-tranche investors will be necessary only when legislation abrogates contractual provisions that would have guaranteed, absent abrogation, cash flow rights to these investors. Our computations indicate that the total cost of this compensation would be no more than $1.7 billion.

A key feature of our proposal bears emphasis: it benefits homeowners as much as servicers and investors. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that, over time, exceed the foreclosure value of her home. Competing proposals do less for homeowners, do more harm to investors, or are more costly to taxpayers.

One oft-discussed alternative would allow a homeowner to file Chapter 13 bankruptcy and then write-down mortgage debt to current home value (so-called “strip down”). This proposal is deeply problematic. First, the risk of moral hazard is significant. Our current housing problems would be much worse if the fifty-two million homeowners that are now current on their mortgages believe that they can stop paying their mortgage and not risk losing their homes.

Bankruptcy reform also assumes that one kind of modification—strip down—is always appropriate. We know that, among lenders who successfully modify loans, a broad range of modifications are used. One, for example, leaves the original debt intact (no strip down) but obligates the homeowner to pay a lower interest rate on only a fraction of the debt (a five percent rate, for example, might be paid on eighty percent of the debt). Instead of permitting servicers to tailor modifications to the needs and abilities of homeowners, bankruptcy reform imposes a one-size-fits-all solution.

Proponents argue that bankruptcy reform would give borrowers a tool to fight back against servicers. Yet, the opposite might be the case. Servicers might prefer bankruptcy to loan modification for the same reason that they now prefer foreclosure: the typical securitization agreement reimburses servicers for expenses incurred in a bankruptcy, just as they now recover expenses incurred in a foreclosure. This could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and delay resolution of the current crisis for years.

Finally, bankruptcy reform would make it harder for many people to own a home in the future. Lenders will be reluctant to extend credit to people who have struggled in the past and have tarnished credit records. Recent empirical research has proven this effect. Even if bankruptcy reform applies only to existing mortgages, lenders may worry that it will be extended to new mortgages in the future.

Another alternative is the FDIC proposal that would have the government pay servicers $1,000 every time they modify a loan, and have taxpayers share up to fifty percent of losses from post-modification default. This proposal is a big step forward, and shares features with ours, but it has important risks and drawbacks. For one, the mortgage guarantee imposes a potentially large burden on taxpayers instead of investors. It is difficult to estimate the cost of such a loan guarantee, but we should expect that servicers will “modify” as many loans as possible to access the guarantee as well as the $1,000 incentive payment. This proposal does not guarantee that the modification will ultimately be successful. Additionally, under the FDIC plan, servicers would still be face appreciable legal barriers to modifying large numbers of loans.

Commentary on H.R. 384: “TARP Reform and Accountability Act”[12]

[12] See: http://www.house.gov/apps/list/press/financialsvcs_dem/press0109093.shtml

This draft legislation has many merits and is a big step forward in addressing the current foreclosure crisis. I include a few comments.

The legislation requires an expenditure of between $40 and $100 billion to reduce foreclosures. While I heartily support the goal of reducing foreclosures, my proposals can accomplish this goal with much lower cost to taxpayers. In particular, Section 204 of the Act contains language allowing the Secretary to provide taxpayer-funded loss sharing or mortgage guarantees. Under the FDIC plan, such loss sharing would represent up to fifty percent of the newly modified loan. I believe that such mortgage guarantees or loss sharing is unnecessary. A well-funded payment plan for servicers to modify mortgages that better aligns servicers interests and a legal safe harbor will be enough to ensure that servicers modify a substantial number of mortgages. Both of these provisions are allowed under the Act.

Furthermore, the mortgage guarantees might well be extremely expensive to taxpayers, even as they are likely unnecessary to ensure mortgage modifications. The FDIC estimates from its own proposal likely substantially underestimates the cost of mortgage guarantees. The FDIC calculations assume that only one-third of mortgage modifications would fail, even if historical evidence suggests that more than two-thirds of modifications are unsuccessful. As well, the FDIC cost estimates assume that only one-half of mortgages will be modified, despite paying servicers to modify loans. It is my view that more mortgages would be modified and that the number of failures would also be higher. Thus the FDIC program could be very expensive, costing $70 billion or more, and mortgage guarantees are not needed to accomplish the Act's goals.

Second, I would encourage the addition of a provision ensuring that compensation is paid to aggrieved bondholders who are impacted by the safe harbor provisions for servicers (Section 205). While my proposal with Edward Morrison and Tomasz Piskorski argues that compensation might not be strictly necessary to meet constitutional requirements, I believe that the government should tread very carefully in changing explicit contract terms. It is important to uphold the principal that the government will not change explicit contract provisions without compensation. Our compensation proposal would affect a minority of pooling and servicing agreements. We estimate total expenditures of $1.7 billion, which is relatively small compared to other expenditures in this Act. This compensation will help ensure the efficient operation of capital markets in the future so that investors can have confidence in contracts that they sign.

Conclusion

I believe it is essential for the incoming Administration and Congress to address the housing crisis. Existing policies have not successfully fixed the mortgage or housing markets. Even aggressive Federal Reserve purchases of mortgage-backed securities issued by Fannie Mae and Freddie Mac have not succeeded in returning mortgage rates to their normal relationship to the 10-year US Treasury rate.House prices continue to spiral downward in much of the country.

Foreclosures are already taking place at an alarming rate and will only grow if we do not take immediate action.

Nonetheless, it is important to protect taxpayers. I have put forward two plans. One plan helps restore the normal functioning of the mortgage market at little cost to taxpayers. The second plan addresses the large growth in foreclosures in securitized mortgages. That plan relies on incentive payments and legislated changes in securitization agreements to induce servicers to undertake modifications that would benefit both homeowners and investors, without relying on changes to bankruptcy laws. The plan can prevent up to a million foreclosures at a modest cost to taxpayers of $10.7 billion.

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