Written Testimony
In
"Legislative Proposals to End Taxpayer Funding for Ineffective Foreclosure Mitigation Programs"

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by

Satya Thallam
Director, Financial Markets Working Group
Mercatus Center at George Mason University

and

Anthony Sanders
Senior Scholar
Mercatus Center at George Mason University

I. Introduction

There are a variety of Federal government programs and initiatives for attempting to create more sustainable mortgage payments for borrowers in imminent risk of default on their home loans. We focus here on the Obama Administration's "Home Affordable Modification Program" (HAMP).

According to the HAMP reporting, 1.71 million trial modification plans have been offered to borrowers and there have been 1.47 million trial modifications made.[1] Given the "fall off the cliff" of housing prices in many states, the surge of unemployment and the evaporation of liquidity for banks and related institutions in the second half of 2007, we are surprised that the servicing industry has moved so quickly to make loan modifications in such large numbers.

This is especially true when one considers how the very nature of the residential servicing industry has changed since 2007 in terms of number of problem loans to be serviced so dramatically. With 12.85 percent of borrowers in foreclosure or delinquent on their mortgages (as of 4th quarter 2010),[2] this creates an incredible challenge to the servicing industry. It is a real challenge to servicers to make loan modifications succeed when 70 percent of modifications that have only interest rate cuts have gone into re-default after 12 months. If the loan modification affordability calculation, as done under HAMP, only uses the first lien position, taxes and insurance and fails to include home equity loans, car leases, credit card debt and other debt burdens, the failure of a large proportion of loan modifications should be anticipated. The negative equity problem in the "sand states" of California, Arizona, Nevada and Florida is going to be considerably challenging for the servicing industry; loan modifications must take into consideration the negative equity position of households to determine their likelihood of success for making mortgage payments. The problem will be exacerbated once short term rates begin to rise.

But it is unclear how many trial modifications will become permanent modifications. The most recent "conversion" rate of trial to active permanent modifications is less than 36 percent, although the total number of permanent modifications started has been increasing steadily.[3] And the re-default rate on those trial loans that survive the challenge of making three months of consecutive mortgage payments during the trial period will likely be about 50 to 60 percent or even higher.[4] Say that only 25 percent of borrowers convert from trial to permanent modifications and then 50 percent of those go into re-default, that translates into 12.5 percent of eligible borrowers actually receiving permanent loan modifications and keeping them current. And it is entirely possible that the "success" rate could even fall below 10 percent of eligible loans.

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[1] "December 2010 Making Home Affordable Program Report," Making Home Affordable Program, January 31, 2011.

[2] "Economic and Mortgage Finance Commentary – February 2011," Mortgage Bankers Association, February 18, 2011.

[3] *Supra note 1.*

[4] Lender Processing Services in late May 2009 reported that nationwide modification efforts as of April achieved a re-default rate of nearly 50% six months after modification (with the Office of the Comptroller of the Currency showing a 55% re-default rate within six months).

II. A Critique of the HAMP Approach

There are several reasons why so few loans will make the transition from temporary modification to successful permanent modification.

1. The first reason for the projected failure rate is the degree to which many residential loans in the United States are in a negative equity situation. According to a Deutsche Bank research report, 25 million homes or 48 percent are expected to be in negative equity position by the first quarter of 2011.[5] A less pessimistic estimate is by First American CoreLogic of 10.7 million households (23 percent) having negative equity as of third quarter 2009.[6] These estimates may not be inconsistent since home prices are not expected to hit bottom until the end of 2011 (J.P. Morgan Chase, November 23, 2009). Although negative equity in small amounts is not a problem, larger negative equity positions such as 125-150 percent LTV are difficult to modify (even if the HAMP allowed such large modifications). Therefore, permanent loan modifications in areas with large house price declines will be extremely difficult. Realistically, without significant principal write-downs, modifications are unlikely to be successful. But the write-down approach entails its own problems.[7]

2. The second reason behind the poor prediction for successful permanent loan modifications is the increasing unemployment or declining employment. While a 9 percent reported unemployment rate nationally is bad enough, the true unemployment rate (including wage and salary curtailment) is much higher. This is a challenging obstacle to overcome for the servicing industry. When high unemployment rates and declining employment are combined with a severe negative equity position, a "perfect storm" is brewing of bad conditions, placing enormous burdens on the mortgage servicing and banking industries.

3. The third reason for only minimal success is the documentation problem. To qualify for a trial loan modification, the HAMP program is following the borrower "stated" income approach that does not require documentation.[8] Like stated income loans, stated income qualification for temporary loan modification is a fertile ground for moral hazard problems where borrowers/applicants who are insulated from risk may behave differently from the way they would behave if fully exposed to the risk. In this case, borrowers may

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[5] *Bloomberg*, http://www.bloomberg.com/apps/news?pid=20603037&sid=adBYDzUMt68k

[6] Ruth Simon and James R. Hagerty, "1 in 4 Borrowers Under Water," *Wall Street* Journal, November 24, 2009, p. A1.

[7] Megan McArdle, "Principal Write-Downs Still Popular with Wonks," *The Atlantic Online*, February 28, 2011, http://www.theatlantic.com/business/archive/2011/02/principal-write-downs-still-popular-with-wonks/71820/.

[8] See Gerald Hanweck (2007), "Subprime Mortgage Delinquency Rates by Metropolitan Area: An Analysis by Origination Vintages and Projections for 2007," working paper, for estimates of the effect of low or no documentation had on the rate of delinquency by vintage of subprime and Alt-A mortgages within metropolitan.

not want to submit the required documentation since they may be denied a permanent modification. While there have been stories of servicers making it "difficult" for borrowers to submit the necessary documentation, one has to consider the flip side of the argument. Borrowers may claim that the servicers are making it difficult to obtain documentation when, in fact, they may just simply be hoping that the permanent modification will be approved without full documentation. In fact, a recent article discusses how willing the servicers were to make loan modifications, only to find that borrowers were not completing the submission of the required paperwork.[9] This is not to say that some borrowers have not experienced "true" documentation problems, which would be consistent with the dramatic growth in demand for loan modifications through HAMP as servicing entities ramp-up their servicing efforts to meet the demand.

4. The fourth reason is that many borrowers are having trouble making their three consecutive mortgage payments during the trial modification period.[10] In addition, borrowers may not qualify for the temporary modification by having 1) too much income, 2) not enough income, or 3) have a house that has fallen too much in value.

III. Servicer Performance

The Making Home Affordable Program provides a "Servicer Performance Report" that rank orders servicers in terms of "Active Trial Modifications as a Share of Estimated Eligible 60+ Day Delinquencies." The higher the ranking, the more active trial modifications the servicer is making. The problem with this accounting method for "success" is that it does not control for servicers with loans in particularly hard hit areas such as "bubble" states like California, Arizona, Nevada and Florida. Servicers in states where house prices have collapsed, sometimes by as much as over 50 percent, are going to be **heavily** challenged to perform these loan modifications. When you add in the already high unemployment rate in these states, these are indeed challenging areas to perform loan modifications.

In addition, the highest unemployment rates by large metropolitan area (as of December 2010) are Las Vegas, NV (14.9), Riverside-San Bernadino, CA (13.9), Sacramento, CA (12.5), and Tampa-St. Petersburg (12.0).[11] While Arizona has "only" a 9.6 percent unemployment rate, the difficulty of loan modifications must be considered when combined with the crash of housing prices that occurred there.[12] The states and metropolitan areas with the highest unemployment

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[9] Floyd Norris, "Why Many Home Loan Modifications Fail," *The New York Times*, December 3, 2009, http://www.nytimes.com/2009/12/04/business/economy/04norris.html?_r=1.
[10] *Ibid*
[11] Local Area Unemployment Statistics, U.S. Department of Labor.
[12] Anthony B. Sanders, "The Subprime Crisis and its Role in the Financial Crisis," *Journal of Housing Economics*, Volume 17, Issue 4, December 2008.

rates should be taken into consideration by Treasury when determining loan modification trial success rates.

Our recommendation for reporting servicer performance is to adjust the service performance by percentage of loans in 1) bubble states and 2) Midwest “economic malaise” states such as Ohio and Michigan. In short, modifying loans in Nebraska is likely to be far easier than modifying loans in Arizona, Nevada or the Inland Empire of California or various condo-laden areas in Florida. Therefore, servicers should be given additional credit for attempting to modify loans in these challenging areas.

IV. Lack of Principal Write-downs

When financial institutions and other holders of mortgages (investors) accept loan modifications that reduce principal, short sales and short payoffs, they take an immediate hit, causing them to reduce earnings and receive pressure from regulators to raise additional capital.[13] To provide an incentive for financial institutions/investors to sell their distressed mortgage loans to the private markets, government regulators, including the SEC, should allow financial institutions/investors to amortize the losses for up to 5 years, with greater proportions in the early years, so as to spread the accounting consequence of a loss over time. This would enable the financial institutions/investors to sell distressed assets from their books and free up funds to be invested elsewhere such as loans to small businesses that will increase employment.

While programs like HAMP are meant to keep people in their houses, an incentive needs to be provided to financial institution to avoid becoming “zombie banks” as has occurred in Japan. While the HAMP program might keep some people in their homes, the program maintains the loan with the lender and does not free funds for uses other than housing until the loan is paid off or refinanced. And with a 40-year extension of loan maturity for some modifications, this would mean that these loans would be on the balance sheets of the lenders/investors for almost a half century.

V. Critique of Mortgage Modification as a Solution the Mortgage Crisis and Use of Taxpayer Resources to Subsidize House Buyers In Default

Policies by our Federal government to encourage banks/servicers to modify mortgages to as low as two percent interest rate and up to 40 years to maturity have the potential to load up the already fragile U.S. banking industry with billions of dollars and possibly up to $5 trillion of

[13] There are other reasons for difficulties in loan modifications and principal write-downs such as HELOCs held by other entities and mortgage insurance companies where there third party has the right to prevent the servicer from modifying the first lien.

these mortgages. It is known that many of these mortgages carry considerable default risk because of the nature of borrower loan modification history. From this perspective it is a dangerous program for the survival of the banking industry and the GSEs. Based on their latest 10Q filings with the SEC, Fannie Mae currently has $700 billion of mortgage loans and MBS in portfolios. In addition, Fannie Mae has approximately $3 trillion of mortgage guarantees on their books.[14] Unfortunately, the problem extends beyond the banks and the GSEs, but to the Fed as well. It is sitting on nearly $1 trillion of MBS at the present time from open market purchases and portfolios taken over from Bear Stearns now called the Maiden Lane funds.[15] The problem comes from potential increases in inflation and interest rates.

Considering the current fragile state of the banking system and the GSEs, taking on more mortgage assets with very large durations opens them up to increased interest rate, market and liquidity risks. Macaulay's duration of a 40-year mortgage when mortgage market rates are 5 percent or less is 8 years or more (a 30-year mortgage has a duration of 7.9 years), regardless of the stated coupon rate (the rate actually paid by the borrower). What this level of duration means is that if market rates rise by 2 percentage points (200 basis points), the fair value and market value of the mortgage asset declines by 15 percent—very meaningful change.

Using duration as an indicator of interest rate risk exposure for a mortgage instrument, the duration of a portfolio of mortgages is equal to the remaining balance-weighted average of each mortgage's duration. For the GSEs they have virtually their entire portfolios in mortgages so that the duration of their asset portfolio is about 7 to 7.5 years (including MBS). They state that the companies' interest rate exposure as a whole is controlled by borrowing callable bonds and matching liability duration with asset duration. The problem with this strategy is that historically mortgages were prepaid as market mortgage interest rates fell, decreasing the effective duration of their assets. The current situation is that the possibility of prepayments of any magnitude is slim since current rates at historic lows with the much greater likelihood that they will rise, not fall. The implication of this expectation is that loan prepayments from current loans will be slow in the future and much slower for loans modified in the HAMP program. Thus, GSE financing mortgages with say 5-year callable bonds with a Macaulay's duration of about 3 years will cause a considerable mismatch with mortgage assets and substantially increase the interest rate risk exposure of the GSEs. Not only will interest risk exposure increase, but as rates rise, market values fall and the ability to trade mortgages decreases. Thus, market liquidity of the mortgage portfolio will also be impaired.

The banking system faces an even more serious interest rate risk exposure problem in taking on a meaningful amount of modified mortgages. As of the September 30, 2009 Call Reports, banks

[14] SEC Filing, Form 10-Q for Federal National Mortgage Association, Table 37. Freddie Mac also carries a similar total value of mortgages as well as guarantees also in the trillions.

[15] "Federal Reserve System Report of Assets, Liabilities, and Capital of the Federal Reserve System as of November 25, 2009"

and thrifts hold $4.5 trillion in mortgage loans and MBS. These represent 37.0 percent of total domestic assets at these institutions. If $1 trillion of HAMP modified mortgages were added to bank portfolios, the interest rate risk exposure of depository institutions would rise considerably. Not only would the composition of the mortgage portfolio would change, but the size of the mortgage portfolio would increase to perhaps $5.5 trillion. Unlike GSEs, banks finance asset positions with deposit liabilities with very short durations - usually 1year or less. Thus, by adding 8-year duration assets to the mortgage portfolio would increase the asset and liability duration mismatch and expose banks to greater interest and market risk of their portfolios.

However, the good news is that this increase will not be as severe as for the GSEs since the banking system has portfolios that are much less concentrated in mortgages and carry durations that are more like 3 years – 37 percent for banks and nearly 100 percent for the GSEs. An increase in interest rates will have a deleterious effect on the value of banking portfolios and reduce the liquidity of them with more mortgage lending. Furthermore, additions of HAMP modified mortgages to GSE or banking system portfolios exposes each to considerably greater default risk. Perhaps most important, each are left with extremely illiquid loans that will be a burden on their portfolios for years perpetuating the same over-investment in housing that caused the crisis in the first place. This will force these institutions, particularly the banks, to retard growth of lending to small businesses (which are responsible for much of job creation) as a consequence.

VI. Bringing More Equity into the Market

Once the financial institutions/investors can dispose of distressed loans from their portfolios, private market groups can acquire these loans and enact private market loan modifications.[16] In fact, allowing financial institutions/investors to sell their distressed assets without immediate devastating consequences would enable them to pursue loan modifications through their services more aggressively, if economically appropriate.

Another advantage of allowing financial institutions/investors to sell the assets without immediate adverse consequences is that it opens the door for broader approaches to dealing with the foreclosure crisis such as 1) short payoffs, 2) short sales, 3) foreclosure, 4) conversion to leases and 5) broader loan modifications if they make economic sense. Particularly given the vacancy rates in many states in the housing market, conversion to leases makes sense given the comparatively low rental rates relative to mortgage payments. Private funds have offered interesting loan modification examples as converting the loan to a rental agreement with an

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[16] For example, Selene Residential Mortgage Opportunity Fund (“SRMOF”) is a private fund that is actively purchasing, servicing and restructuring loans. See also Fortune Magazine, December 21, 2009, p.88.

option for the former borrower to purchase the house, a shared appreciation approach where the borrower shares part of the upside with the lender in return for a principal write-down on the loan. Essentially, the market-based approach brings sorely needed equity into the mortgage market while the HAMP approach retains nearly 100 percent debt financing of its modified mortgages.

Accounting changes to permit financial institutions, investors and servicers to ignore fair value accounting and retain book values of their distressed assets that clearly dominate alternatives such as “cramdowns” or other judicial interventions into the mortgage market. Helping financial institutions and servicers dispose of their distressed assets was one of the original purposes of TARP and we should now consider the wisdom of cleaning-up financial institution balance sheets rather than judicial interventions or Federal government debt financed mortgage modification programs.

VII. Conclusion

The HAMP program is designed to modify mortgages by reducing the monthly payment of the borrower to no more than 31 percent of state gross income and extend the maturity of the mortgage. Once the borrower qualifies by meeting an initial NPV test and a 3-month trial period at the modified monthly payments, they become eligible for a permanent modification once all documentation requirements are met. Essentially HAMP creates a modified mortgage with the same unpaid balance as the original mortgage, except at a much lower interest rate (as low as 2 percent) and up to a 40-year maturity. However, HAMP still leaves borrowers whose mortgages were upside down before modification, upside down after modification. In addition, HAMP leaves banks and GSEs with mortgages on their books with considerable default and interest rate risk with a need to continue financing.

Helping financial institutions and servicers dispose of their distressed assets was one of the original purposes of TARP and we should now consider the wisdom of cleaning-up financial institution balance sheets rather than judicial interventions or Federal government debt financed mortgage modification programs.