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to the

Subcommittee on Insurance, Housing and Community Opportunity

of the

U.S. House of Representatives, Committee on Financial Services

Topic: The Obama Administration's Response to the Housing Crisis

Chairman Biggert and Members of the Subcommittee, 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 mortgage-backed securities. I am in charge of the strategy and business development efforts for the firm. We perform data-intensive research as part of our efforts to keep ourselves and investors globally informed of critical trends in the residential housing markets. That work has shaped our view of the housing crises, and I will share some of our results with you today.

The Obama Administration has pursued a number of measures to try to soften the effects of the collapse in house prices. In February 2009, the Administration announced the Home Affordability and Stability Plan. This plan included both HAMP, the Home Affordable Modification Program, a loan modification program designed to help at-risk borrowers, and HARP, the Home Affordable Refinancing Program, a program designed to eliminate frictions to refinancing and allow existing GSE borrowers to take advantage of lower mortgage rates.

There have been a number of enhancements to HAMP. These enhancements have included programs for unemployed borrowers, the principal reduction alternative for "underwater" borrowers, the introduction of the 2nd lien modification program, and the introduction of the Home Affordable Foreclosure Alternatives Program (HAFA) which has streamlined the process for homeowners seeking a short sale or deed-in-lieu of foreclosure. The HARP program has seen no changes, although in his latest speech on Sept 8, President Obama announced that the HARP program would be retooled in order to make it more effective in allowing more borrowers to take advantage of lower rates.

In February 2010, the administration introduced the Hardest Hit Fund, a program, funded by TARP, designed to target aid to families hit by the economic and housing downturn. Twenty states that had been hit particularly hard were targeted for this program. The Neighborhood Stabilization Program was first established under HERA, the Housing and Economic Recovery Act of 2008. It was designed to stabilize communities through purchase and redevelopment of foreclosed and abandoned residential properties. Grants were provided to states and select local governments. Further funding from this program was authorized under The American Reinvestment Act of 2009 and the Dodd Frank Wall Street Reform Act of 2010. In his Sept 8, 2011 speech President Obama proposed "Project Rebuild," a part of the job creation bill, which, if enacted by Congress would create a $15 billion fund to get people to work rehabilitating homes.

Given my expertise, I will focus on an evaluation of the HAMP and HARP programs and what can be done to improve them.

HAMP and Other Foreclosure Prevention Initiatives

The HAMP program has originally estimated to reach 4 million borrowers. As of the end of July, the actually tally has been 1.89 million trial offers extended, 1.66 million trial modifications started. Out of these 1.66 million trial modifications, 675 thousand are active permanent modifications, and another 106 thousand are in active trials. So, even if all of these trial modifications were to become permanent and do not default, the performance rate of these modified loans would be less than 50% (781K/1.66 million) and the program overall would come in at less than 20% of the original stated goals. The HAMP program has done a good job reaching eligible borrowers. The Treasury Department estimates (as reported in the HAMP monthly report) that there are now 2.56 million eligible delinquent loans—loans that are 60 days or more delinquent, in foreclosure or bankruptcy, that have a loans size less than $729,750 on a one family property (higher limits on 2-4 family units), are owner occupied, are not FHA or VA loans, and the loan was origination prior to January 1, 2009. However, not all of the borrowers would be eligible—if you exclude loans on vacant properties, loans with borrower debt-to-income ratios below 31%, loans that fail the NPV (Net Present Value) test, properties where the borrower is unemployed, manufactured homes that are not eligible for HAMP, private label securitizations where the pooling and servicing agreement preclude modification, and loans that have already received trial/ permanent modifications—only 1.02 million eligible borrowers remain.

In fact, the problem with HAMP has not been the reach—that has been quite successful. Every HAMP servicer is required to test every borrower for a modification before proceeding with the foreclosure process. If the borrower is eligible for a modification, he must be offered one. To further encourage the program's reach, servicers are afforded a legal safe harbor for modifications done under HAMP. The problem with HAMP has been that the success rate has been lower than hoped. Less than 50% of the borrowers that were offered a HAMP trial modification have become permanent or are still in a trial modification.

The issue is the program design. When the program was first announced, we predicted that the program was apt to fall far short of expectations for 3 reasons:

First, the servicers were being asked to do a small amount of underwriting (including income verification). This is an origination activity, not a servicing or payment processing activity. The servicers were not geared up for this; it took them a long period of time to build the underwriting capability.

Second, the borrowers' total debt burden was ignored: the payments under the HAMP program were based totally on the so-called front end debt-to-income ratio (first mortgage + taxes + insurance as a percentage of pre-tax income). As a result, under HAMP, a borrower's front-end DTI went from 45.2% before the modification to 31% afterward, a drop of 31.4%. However, the median back-end DTI (the borrower's total debt burden, including the first mortgage payment + taxes + insurance + 2nd mortgage debt + credit card debt + auto loans + student loans) went from an unbelievably high 78.4% before the modification to a still unsustainable 61.6% afterwards. To put this into perspective, FHA guidelines suggest that the maximum back-end debt-to-income ratio be no higher than 43%. In our view, the emphasis on front-end DTI rather than the total debt burden was a legacy of having the largest servicers (who are also the largest banks) help design the original program. Remember, these entities own the credit card and auto debt, the second mortgage debt and often do not own the first mortgage, either because it is in a Fannie or Freddie pool or because it is in a private label security. As an interesting indicator of the conflicts at work during the design of the program, note that the only consumer loan being impaired at the government's direction was the 1st lien mortgage debt. A long-term sustainable debt restructuring requires that other debts be restructured as well, to make the total debt burden manageable..

Third, HAMP does not provide long term incentives to the borrower via a path to regaining equity. Early numbers indicated that the median mark-to-market loan-to-value ratio (LTV) under HAMP actually increased from 120 to 125 LTV (as more monies were capitalized than were forborne). And this was LTV of the first lien only—the combined LTV, which includes the second mortgage (and many of these borrowers have second mortgages), would have been even higher. Not surprisingly, borrowers that have very high LTVs, and the LTVs are not addressed by the modification, are very likely to fail on the modification. The solution to this is clear—greater use of principal reductions in modifications, larger write-downs on second mortgages.

Under HAMP, servicers are required to test the borrower to see if the net present value of the modification is positive using both the standard HAMP waterfall (involving interest rate reductions, term extension and, if necessary, principal forbearance) and a principal reduction alternative, in which some amount of principal forgiveness is the first step. However, even if the principal reduction alternative has a higher net present value, the servicer is not required to offer it. Our research indicates a significantly lower re-default rate when principal reduction, rather than just payment reduction, is used. We would ideally like to see the principal reduction alternative be mandatory if it has a higher net present value.

What about the moral hazard in principal reduction? Wouldn't borrowers deliberately default in order to get the principal reduction? The problem with this argument is that it doesn't recognize the incentives already in place for the borrower. We and others have documented that certain subsets of borrowers were more apt to default after HAMP was introduced than before. Moral hazard abounds, avoidance of such a risk would have been ideal, but we are well beyond the ideal and need to realize that borrowers can simply choose not to pay at all. When they do, the system needs to minimize the external damages and deal with situation on a least cost basis. Strictly awarded and earned principal forgiveness can meaningfully reduce both foreclosures and losses to investors. Moreover, if one chooses to do so, there are ways to partially mitigate the moral hazard issue. Adding a shared appreciation feature to accompany the principal reduction is one alternative. The design and implementation of a principal reduction program should not be done by those with large conflicts on the subject.

An additional obstacle for principal reduction—many servicers feel that it does not make sense to put a principal reduction program into place if it cannot be used for GSE loans. And the GSEs largely refuse to allow principal reduction because, even though it is net present value positive for the loan, it is NPV negative for the GSE. And, by definition, since the GSEs are in conservatorship, the directive is to conserve assets to the extent possible. How can a loan modification be NPV positive for the loan and NPV negative for the GSEs? It goes to the heart of the complex relationships between the GSEs, the mortgage insurers, and the originators. If a borrower, who would otherwise default, is offered a principal reduction, and the borrower does not re-default, the GSE bears the entire cost of the principal reduction. If there is mortgage insurance on the loan (a disproportionate number of defaulted loans have mortgage insurance), and the borrower makes his new modified payments, the mortgage insurer is not on the hook at all. In essence mortgage insurance only covers losses from foreclosures, not forgiveness. If Fannie and Freddie did principal reductions on loans with insurance, they would be absorbing losses that should legitimately belong to the mortgage insurers. Even if the loan does not have mortgage insurance, the GSEs are often able to avoid those losses by forcing the loan to be repurchased by the original owner. It appears that a substantial number of defaulted loans have material breaches of representations and warranties made at the time the loans were bound by GSE issued insurance. If the loan is granted a principal reduction and does not default, Fannie and Freddie have again absorbed losses that correctly belong to the mortgage originators. The correct solution is to work out a settlement between the GSEs, the mortgage insurers and the originators that allows for principal reduction modifications.

Second liens are a large contributor to negative equity. The HAMP 2MP program, the second lien modification program, essentially requires that whatever modification is done to the first mortgage should be done to the second mortgage. If there is a rate reduction on the first lien, there is also a rate reduction on the second lien; if there is a principal write down on the first lien, there is also a principal write-down on the second line. This essentially makes the first and second lien pari passu when the first lien is modified; it ignores the concept of lien priority. This makes no sense, as the junior lien is, by definition, subordinate to the first lien, and logically should be written off entirely before the first lien suffers any loss. If a modification is done outside of HAMP (and there are more non-HAMP modifications than HAMP modifications) the servicer is not compelled to address second liens at all.

The negative equity position of many borrowers would be dramatically improved if the second lien were eliminated or reduced more in line with the seniority of the lien. Indeed modification programs would be markedly more successful if principal reduction were used on the first mortgage and the second lien were eliminated completely.

Bottom line: principal reductions are the most effective type of modification, and the HAMP program should make it mandatory. Second liens are a clear and present danger to the economy and the banking system and need to be addressed.

How Severe is the Housing Crisis?

Modification activity alone will not be sufficient to "solve" the housing crises, although it is certainly helpful. Our research results indicated that, if no further changes in policy are made 10.4 million additional borrowers are likely to default under our base "reasonable" scenario. (And even under our lower bound numbers, 8.3 million borrowers will default.) Since 55 million homes carry mortgages, that 10.4 million roughly equates to 1 borrower out of every 5. This includes 4.1 million of the 4.5 million borrowers who are already non-performing; those loans have been liquidating very slowly. The remaining (and the majority) of defaults will come from borrowers presently performing on their loans, but who are likely to eventually default. Our default estimates include 2.5 million of the 3.8 million re-performing loans that have been more than 60+ days delinquent in the past, but are now performing. History suggests these borrowers are very prone to another default. The final group includes the 46.7 million borrowers who have never missed 2 payments; many owe more than their home is worth. By studying the default behavior of that borrower base over time, we believe that 3.7 million of these borrowers will eventually default if home prices stay at current levels. So, of the 10.4 million units that we expect to eventually default, 4.1 million are already non-performing, 2.5 million are re-performing and 3.7 million have never missed two payments.

Supply—If we assume that 8.3-10.4 million homes will need to liquidate over the next 6 years, that equals 1.38-1.73 million units/year. We assume new 1-4 family construction continues at its low level of 0.5 million units/year, which gives us 1.88-2.23 million units of total supply.

Demand—The Joint Center for Housing Studies at Harvard University estimates a household formation rate of 1.2 million units/year for the next 10 years. This is much higher than the actual 2007-2010 household formation rate of 0.5 million/year, but in line with average numbers over the 1990-2010 period. We assumed a 50% demand from new households, giving us 0.6 million units of annual demand due to housing formation. We feel that is a generous number, as 70% of this will be from minorities who have historically had lower levels of home ownership. To that we add 0.4 million units needing to be replaced due to obsolescence, and 0.2 million units of second home purchases, for a total of 1.2 million units annual demand.

These demand numbers may prove to be high; they may be hampered by credit availability (which has tightened significantly). We estimate that 19% of borrowers who had a mortgage in 2007 would be unable to obtain a new mortgage due to credit history alone (they were >90 days late on their mortgage at some point, experienced foreclosure, or were otherwise liquidated). Still other potential borrowers would be unable to qualify at today's tighter credit standards. Recent GSE origination has an average FICO score of 762 and an average LTV of 67 (and recent bank portfolio origination is similar). FHA and VA have become the major supplier of purchase money to the housing market. And every single policy measure that has been discussed would tighten credit further. HUD is considering tightening DTI (debt-to-income ratio) requirements. FHFA is considering increasing loan level pricing adjustments. And the proposed Dodd-Frank rules implementing the Qualified Residential Mortgage (QRM) and Qualified Mortgage (QM) provisions are likely to compress credit availability further, particularly when the interplay between these two proposed rules and the lower HOEPA thresholds (which are also included in the legislation) is considered.

So we end up with a housing chasm. The housing gap consists of:

Supply = 1.88 – 2.23 million units

Less: Demand (1.2 million units)

= Gap of 0.68 – 1.03 units/year

This equates to a gap of 4.1 – 6.3 million units over the next 6 years.

Even if the modification program, a supply side measure were hugely successful, it would be insufficient to close this gap. Assume we can save 1.5 – 2.0 million additional units through more successful modification activity, an unrealistic upper bound. This still leaves a gap of 2 – 4 million units. We need to increase the demand for housing, and there are two ways to do it:

Alternative #1: We can make credit more available to borrowers who have recently defaulted on their mortgage, or who have otherwise compromised credit. And, as we have discussed earlier, government policy is moving in the direction of demanding higher credit standards.

Alternative #2: The government can aide in structuring bulk sales of REOs and non-performing loans to encourage investor participation. We were heartened by the recent Request for Information from FHFA, HUD and Treasury looking for suggestions on how to structure such a program. Comments on the RFI were due back on September 15; we hope this will result in bulk sales.

We strongly believe that investor participation is the key (actually, the only reasonable alternative) to increase the demand for housing. The benefit of this is that it will put a floor on housing prices, and stop the vicious cycle in which deteriorating housing prices cause borrowers to default, which in term causes more deterioration in home prices and more defaults. It would also introduce much needed supply into the rental market, keeping rents lower than more affordable than otherwise would have been the case. Remember, defaulting borrowers are apt to turn into renters, further increasing the demand in this space. And the current program of selling properties one-by-one is too slow, and excludes large scale investors as they are unable to accumulate a large enough block of properties in a given geographic area to build out a rental organization, including rental agents and property managers.

HARP

The Home Affordable Refinance Program was instituted in March of 2009, in order to facilitate the refinancing of Fannie and Freddie insured mortgages in which the new LTV would be >80%. More specifically, the guidelines allow mortgages with an original LTV≤80% and no mortgage insurance (MI) initially, but now has a current LTV>80 but ≤125%, to refinance without MI. If the borrower had an existing LTV of >80% with mortgage insurance, the level of MI coverage on the existing loan would remain in place and would not need to be increased. This program was originally supposed to reach 4-5 million borrowers with GSE mortgages, allowing them to refinance into lower rates. In fact, the number of HARP refinances is actually 838,400 through June 30, 2011.

HARP was a very well intentioned program, logically allowing borrowers with mark-to-market LTVs>80 to take advantage of lower mortgage rates, thereby lowering the default risk to the borrower, to the GSEs, to the MI companies, as well as providing a much needed stimulus to the economy. It is clearly not working as intended. The reason for the small reach of HARP again have to do with the frictions to refinance; most of these frictions stem from the fact that while these HARP-eligible loans are, by definition, all GSE-insured, the GSEs are not the only stakeholders. If the loan had an original LTV>80 and carries mortgage insurance, part of the risk is actually laid off on the mortgage insurers. Moreover, in order to obtain GSE coverage, the originator must make representations and warranties on the loans, covering items like property valuation and the borrower's income/assets/employment etc. If a loan goes into default, the originator can be asked to substantiate the claims made on the loan. If the originator cannot prove the loan was adequately underwritten, the GSE can force the servicer to buy back the loans. These representations and warranties are lost if the loan is refinanced with another originator. Does this sound familiar? It should, it is exactly the same set of frictions that we talked about in our earlier discussion on why the GSEs don't do principal reductions when it would be the most advantageous modification alternative.

When we make a list of the frictions to refinance, the top three obstacles all arise due to complex interrelationships between the GSEs, the mortgage insurers and the originators. This includes:

Rep and Warrant Issues: If the refinancing is done with a different originator/servicer, the servicer must take the rep and warrant risk on the high LTV loan, even one with a reasonably clean payment history. If the refi is done with the same servicer, you would think this is not an issue, as the servicer already has the risk. However, if the new loan goes delinquent in the first 6 months, Freddie and Fannie usually conduct a review of the loan file and find a reason to put the loan back. Many originators believe that they are better off with a 4 year old loan with a clean pay history than refinancing the borrower and taking the chance that the loan becomes delinquent in the first 6 months. This can be easily fixed by attaching the pay history of the original loan to the new loans, and consider the combined pay history. A second issue is that there were a lot of loans where the servicing was sold or transferred in the 2005-2007 period. Freddie and Fannie generally required the new servicer to absorb the rep and warrant risk on the loans, but the servicer usually mitigated the risk through a back-to-back rep and warrant policy with the originator. Under these circumstances, the new servicer will be much less eager to do a HARP refi on a mortgage they did not originate, as the servicer loses the back-to-back rep and warrant policy with the originator. The most fundamental problem—if the same servicer is the only one who can refinance the borrower, there is no incentive for that servicer to offer a competitive rate. If Fannie and Freddie were prepared to take the rep and warrant risk on the new loans, this problem would be eliminated, but it is inconsistent with the idea of conservatorship. The solution, while certainly not simple, is to encourage, in a way only the US government can, the transfer of the rep and warrant risk from the old provider to the new loan. The borrower is less likely to default so the old provider is better off than if the borrow did not refinance at all.

Mortgage Insurance: One of the major initiatives of the HARP program was to permit a borrower to refinance without adding or increasing mortgage insurance coverage, under the recognition that the GSE already owns the risk on the loan at its current value. In practice, in order to port the policy to the new loan, the MI company treats the refinance as a modification of the existing policy. In a same servicer refinance, the reps and warrants made by the originator of the original loan to the MI provider remain in effect. In a different servicer refinance, the risk to the MI provider is increased. Some MIs require a new certificate, charge higher rates or costs, or just require considerable increased documentation. Not surprisingly, only a tiny fraction of HARP loans with mortgage insurance are different servicer refinances. When the same servicer is the only refinancing alternative, the servicer has no incentive to be competitive. The result: loans with mortgage insurance generally refinance much more slowly than loans without mortgage insurance, even controlling for LTV. This friction can be partially overcome through a combination of carrot and stick type of discussions with MI providers. After all, their largest customers are the GSEs.

Bank Profits: Banks are capacity constrained, and are keeping primary rates artificially high. The spread between primary rates (the rates the bank charges borrowers) and secondary rates (the rate at which the agency MBS market will buy a par mortgage) is at a very elevated level. As a result, the amount banks make on a refinancing can be quite significant. Let's work through an example. Banks are generally posting rates in the area of 4% plus 1 point. This mortgage could be sold into a Fannie 3.5 pool, currently trading at 102.75. In addition, the mortgage originator obtains a 1% upfront fee, for an upfront profit of 3.75%. And this does not consider the value of the mortgage servicing rights. Assuming a 25 basis point guarantee fee, the originator would also be retaining about 25 bps of servicing (4.0% mortgage-3.5% on the pass-through-25 bps to the GSE= originator retains 25 bps servicing), this is worth about $1.25 (assuming a 5 multiple). Total profit on this representative transaction: 5 points! And, it can get even more profitable for the banks because, for some of the HARP loans, the market pays a specified pool premium because the borrowers have so few refinancing opportunities. Yes, banks have some costs of origination, which are not completely offset by the application fee, but mortgage origination is a very good business right now. Banks generally don't add capacity during refinance waves, as they are never sure how long the low rates will last, preferring instead to reap the benefits of larger margins. Moreover, the 4 largest banks, with a 62% origination share, are actually posting higher rates than smaller institutions, and a disproportionate amount of same servicer refis must go through these entities. To make HARP successful, it is important to introduce competition by reducing the frictions to different servicer refinances.

These are the 3 largest obstacles to refinance, and until these problems are tackled HARP is apt to dramatically underperform expectations. There are a number of simple actions that are being considered, and will help at the margin. This includes:

Loan level pricing adjustments for high LTV/low credit score borrowers: These loan level pricing adjustments are capped at 2%. We believe these adjustments should be eliminated. Fannie and Freddie already have the risk on the loans, it is unnecessary to charge a premium on a refinancing that will actually lower the risk to the GSEs. However, if the GSEs eliminated the LLPAs, it is important that the LLPA savings be passed through to the borrowers. Initially, when the program was first introduced, Freddie Mac had no LLPAs while Fannie had uncapped LLPAs; banks did not differentiate in the rate they charged borrowers, essentially capturing the benefit of the LLPAs that Freddie was not charging.

Eliminating the 125 LTV Ceiling: Currently loans with an LTV>125 are not eligible for an agency refi, as tax laws do not recognize mortgages in excess of 125% of property value as principally secured by real estate. Hence these loans are not eligible for inclusion in a REMIC. However, there is nothing preventing the GSEs from guaranteeing and pooling these loans into a new set of pool prefixes that are not REMIC –eligible. This should be done, but it won't help much.

Eliminating all appraisals on HARP refis: There is no reason not to rely on Fannie's Automated Valuation Model or Freddie's Home Value Explorer for a loan in which the GSEs already have the risk. An appraisal is an unnecessary hassle. Remember, the GSE already has the risk on the loan. Moreover, the FHA is ahead in its thinking on this point: streamlined refis of FHA insured loans are permitted without an appraisal.

Some of the possible changes to the HARP program do involve tradeoffs. Is it more important to prevent defaults or to provide a stimulus to the economy? We know originators are very capacity constrained. If the HARP cutoff date is extended or re-HARPing is permitted, more borrowers will be eligible for the program. Banks will refinance these borrowers first—most of whom are in 4.75-5.50% mortgages, tend to be less credit-constrained, and easier to refinance. However, this would make it less likely that a borrower in a higher coupon mortgage (paying a 6.5-7.0% coupon), who is credit constrained and has a high LTV, is able to refinance, as that loan will likely be more time consuming to process. And credit constrained borrowers with high LTVs are precisely the borrowers for whom refinancing might prevent default.

We strongly believe that the benefit of lower rates should be passed through to borrowers who already have a GSE loan. Ultimately, the only way HARP can come closer to meeting its goals is to reduce the frictions to encourage different servicer refinances. This requires that the three largest frictions in the refinancing process need to be confronted: reps and warrants, mortgage insurance and bank profitability (or profiteering) in a capacity constrained environment.

It is clear that a better-functioning HARP program is a win for the borrower, the GSEs, the MIs and for the housing market as a whole, as the borrower is less likely to default. It is a win for the economy as it provides much needed stimulus. The loser is the investor who is going to see the value of their premium mortgages decline quite sharply. The Freddie and Fannie portfolios, while smaller than several years ago, are still large investors in MBS. We would hope that the decline in the value of the pass-throughs held in the Freddie and Fannie portfolio, as well as those held at the Treasury and the Fed, is not a deciding factor in the HARP discussion.

Again, thank you for the opportunity to appear before the Subcommittee. We look forward to working with you on practical solutions to ease the housing crisis, promote housing market stability, and allow homeowners to take advantage of lower rates to refinance.

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United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Laurie S. Goodman	Amherst Securities Group, LP

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Laurie S Goodman

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