Written Testimony by

Michael Stegman

Counselor to the Secretary for Housing Finance Policy
United States Department of the Treasury

House Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Monday, May 7, 2012

Chairman Garrett, Ranking Member Waters and members of the committee, thank you for the opportunity to testify this morning.

Prior to joining the Department of the Treasury as Counselor to Secretary Geithner for Housing Finance Policy, I worked on housing policy in various capacities over the course of my forty-five year career. Most recently, I was the Director of Housing and Policy at the John D. and Catherine T. MacArthur Foundation headquartered in Chicago and, before that, spent much of my career as a professor of city planning and public policy at the University of North Carolina at Chapel Hill (UNC). During my long career at UNC, I took leave twice to serve in the Carter and Clinton administrations as a senior official at the Department of Housing and Urban Development (HUD).

Throughout my career, I have been involved with affordable housing issues, with combating predatory lending, and with broadening access to safe, sustainable mortgage credit. At the MacArthur Foundation, we invested millions of dollars to revitalize low-income neighborhoods right here in Chicago – communities that have been ravaged by a flood of foreclosures, exacerbated by the loss of jobs and incomes due to the financial crisis.

And so I thank you for holding this hearing to discuss the Real Estate-Owned (REO) Initiative, because I think this emerging phenomenon has the potential to help stabilize communities while expanding affordable rental housing opportunities. The Administration believes that the REO Initiative can help bring stability to some of the hardest hit neighborhoods and attract much needed private capital back to our housing markets. It can provide financial institutions, including the Government Sponsored Enterprises (Enterprises), with an alternative, cost-effective, channel to sell their foreclosed REO properties at scale in ways that complement ongoing neighborhood stabilization initiatives. In the process, it can create a supply of much needed rental housing for those families looking to rent, either out of choice or necessity. At its best, it can also help stabilize local housing prices by removing surplus homes from the for sale market. With the right set of incentives and requirements for investors, this strategy can spur the kind of long term investment that our communities need today.

****

The REO Initiative is part of the Administration's broader efforts to help heal the housing market in the aftermath of the financial crisis. Our primary goal is to help prevent avoidable foreclosures and accelerate recovery in the housing market.

A core component of the Administration's housing policy is to help more Americans refinance their mortgages at today's low interest rates. Typically, when rates fall – as they have in recent years – homeowners refinance their mortgages. This helps put more money back in the pockets of American families, and, in turn, is one of the primary ways that lower interest rates can support an economic recovery. Since 2006, however, less refinancing has occurred than the fall in rates would suggest.

The Home Affordable Refinance Program (HARP*)* was designed to encourage more borrowers who are underwater on their mortgage, or have little equity in their home, to refinance at today's historically low rates. To date, HARP has helped more than one million homeowners refinance their mortgage– and we recently worked with the Federal Housing Finance Agency (FHFA) to expand and simplify the program's criteria so that we will be able to help even more borrowers.`

Difficult labor market conditions and other financial stresses in the wake of the crisis, however, have made it more challenging for many borrowers to continue to make their mortgage payments regardless of the level of interest rates. Today, one out of twelve homes with a mortgage is either in foreclosure or is seriously delinquent. We have seen this in Chicago, which has a foreclosure rate that is almost twice the national average.

The Home Affordable Modification Program, or HAMP, is a mortgage modification program created to help financially distressed borrowers avoid foreclosure. The Administration's programs, combined with private sector modifications spurred by our efforts, have helped approximately 5 million homeowners across the country receive assistance to avoid foreclosure. Here in Chicago, HAMP and other programs have led to more than 226,000 mortgage interventions since the program's launch in April 2009 – twice the number of foreclosures completed during this time.

In addition, given challenges with long-term unemployment, the Administration also announced last summer that unemployed borrowers with FHA loans could receive up to a year of forbearance on their mortgage payments, up from the previous maximum of four months. We also included the twelve months' forbearance requirement in HAMP. As a result, the Enterprises, as well as other major servicers, are now offering 12-months of forbearance for most unemployed homeowners, giving borrowers the breathing room they need to resume making their mortgage payment once they find new jobs.

We have also asked the FHFA to allow the Enterprises to participate in the principal reduction alternative of HAMP. Given the large percentage of outstanding mortgages that are currently backed by the Enterprises, it is important that they fully participate in this program. Principal reduction is an important tool to have at our disposal as we continue to repair the damage caused by the housing crisis. In many cases, principal reduction makes economic sense for both the homeowner and the lender – helping reduce investor losses and preventable foreclosures over the long term. That's the view of not only the Administration and others within government, but also many private market participants. The most recent quarterly survey from the Office of the Comptroller of the Currency showed that, of those mortgages held by private investors, nearly one in five that were modified reduced principal. Indeed, in the each of the last six months, more than 40 percent of non-GSE mortgages modified through HAMP included principal reduction.

And this is why the Administration believes it would be valuable to expand the availability of this option to homeowners who happen to have their mortgages backed by the Enterprises. It would not only help stabilize communities, but also reduce losses to the Enterprises and the taxpayer. As Secretary Geithner has recently said, the number of families who would benefit is not overwhelmingly large, but is significant and "any time we think there's a way to help more people stay in their homes, help facilitate transitions to other forms of housing, help repair and heal the damage, we're going to keep doing that."

****

HARP, HAMP and other non-government programs have allowed millions of homeowners to stay in their homes. However, we know we cannot stop every foreclosure. As a result, we must work equally hard to find ways to reduce the impact foreclosures and distressed sales have on our neighborhoods and communities. There are a number of ongoing programs, including HUD's Neighborhood Stabilization Program (NSP), which helps support the rehabilitation of communities significantly impacted by foreclosed and abandoned homes. Because of these programs' success, the Administration proposed a $15 billion boost in broad-based neighborhood stabilization activities called Project Rebuild.

But these efforts won't be able to mitigate the impact of mass foreclosures on their own. As estimated by Amherst Securities, more than 3 million homes are currently in the foreclosure pipeline. Amherst Securities also projects that another 9 million homes are at risk of default over the next six years – what many call the "shadow inventory" – and to address this real and potential supply, 3.1 to 5 million units of housing demand would need to be created over the next six years. This rate of home buying activity will be difficult to generate given the continued headwinds facing economic growth, continuing credit access issues, and the fact that many would-be-homeowners do not have the wherewithal to buy a home. Enabling investors to acquire these foreclosed properties will prevent them from sitting vacant, will help stabilize home prices, and will prevent neighborhoods from suffering additional blight. By allowing investors to purchase pools of foreclosed properties owned by the Enterprises and requiring those investors to rent the properties, the REO Initiative provides an alternative approach to addressing this significant oversupply in the market. It also provides the Enterprises and other holders of REO with an additional market for selling foreclosed properties.

There are several conditions that make this scattered-site, single family rental model an attractive business investment today. First, the economics of an investor purchasing a home for the purposes of renting it have become more attractive. In fact, home prices nationally are down by over 30 percent relative to home prices in 2006, while rents are now up significantly in certain areas. Research from the Federal Reserve demonstrates that this increase in rental demand is partially driven by the fact that the majority of Americans who have recently lost their homes transition to single family-rentals after foreclosure. We see this trend here in Chicago, where home prices have fallen about 35 percent due in part to the recent wave of foreclosures in the wake of the crisis, while rental vacancy rates are at a recent low of less than 5 percent.

Second, the supply of homes for sale today and potentially in the future present investors with the opportunity to purchase properties at a scale and geographic concentration that has not been possible before. To effectively manage a large, scattered-site, single family rental housing portfolio, investors must be able to spread their fixed costs across a larger set of homes – and the large volume of real-estate owned property provides an opportunity to build to economies of scale. Additionally, building to scale in a specific market allows not only for the fixed asset management costs to be spread over a greater number of properties, but likely reduces the aggregate amount of fixed costs. Due to the large amount of foreclosed properties that could potentially come to market over the coming years, investors may be able to achieve this scale and geographic concentration.

While the emergence of this buy and rent business model is primarily driven by private capital and entrepreneurial initiative, there is a public policy interest in supporting this phenomenon for the reasons discussed earlier, and the REO Initiative can provide this support in a number of ways. First, through this initiative the Enterprises can facilitate the aggregation of foreclosed properties into larger pools that can be purchased in bulk. Second, they can increase the transparency and awareness of where foreclosed properties are located. Third, they can create policies and regulations that support financing for these types of transactions. And finally, they can facilitate communication and coordination among the wide range of market participants that are necessarily involved in the development of such a large and complex undertaking.

However, current broad-based enthusiasm for the REO Initiative must be tempered by an appreciation for the inherent challenges in this business model. Investors and their partners must be properly equipped to deal with the complexities associated with managing and maintaining dispersed properties in a cost-effective manner. Moreover, as the character and local dynamics of real estate markets vary, it is important for investors to understand the markets in which they are investing. For example, it may not be a smart business decision for an investor from California to buy a cluster of REO properties in the Chicago market without securing a local operating partner with experience managing rental housing in the neighborhoods in which these properties are located.

Additionally, it is important to note that owners of foreclosed properties have traditionally sold their properties on a one-off basis through conventional retail channels. This conventional disposition strategy makes it difficult for an investor to scale a scattered site, single family rental business in a timely and cost effective manner. Absent a regular and predictable flow of bulk sales, it will be important to develop ways for the scattered site, single family rental business to function profitably within the retail market.

Because of these and other challenges, the Administration has worked closely with FHFA to help design and execute a pilot program to test investor demand for portfolios of geographically-concentrated REO properties. The Administration and FHFA have sought to do this in a way that allows FHFA and others to assess both the impact on communities and the financial return to the Enterprises relative to the value realized from transacting through the retail channel. To inform the design of the inaugural pilot, FHFA convened an interagency group that included participants from HUD, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Treasury Department, as well as executives from Fannie Mae and Freddie Mac. This group has engaged with the public through a Request for Information that received over 4,000 comments. We have conducted ongoing outreach with nonprofit housing and community development groups, investors, local government officials and other stakeholders to ensure that these important constituencies provide direct input on how best to structure the program.

I would like to highlight the effort that has been taken to establish high standards that investors must meet if they wish to participate. To realize the desired stabilizing impact on communities, we have to get more than just a good price for the properties. Investors must be responsible property owners. We want to encourage investment for the longer term that will sustain the repair and restoration of the hardest hit communities.

Three controls built into the pilot will be important to addressing this concern. First, strict bidder qualification requirements have been established that are intended to disqualify any investors who lack the experience and expertise to successfully manage large numbers of scattered site properties, or who have a history of behavior that could lead to bad results. This review includes an assessment of an investor's ability to provide tenants with housing counseling services and to provide credit bureaus with documentation related to a tenant's timely payment of rent so that those hard hit by the financial crisis can rebuild their credit scores more quickly. Although the selection of winning bids will be conducted through an auction and based solely on the highest bid offered, only those investors that meet the high standards built into the qualification process will be permitted to bid on the Enterprises' portfolios.

Second, effective operating guidelines and compliance systems will be a part of the contractual agreement between the Enterprises and the investors. We are mindful that this is a transaction between a private seller and private investors, not a government program. Nevertheless, it is in the interest of the Enterprises, FHFA and the Administration that properties be well maintained and have a stabilizing effect on surrounding properties and communities.

Finally, certain usage restrictions, including limiting the sale of properties over the first few years of the investment, will create the right controls to ensure buyers invest and manage the properties for the long term and help attract a more stable base of investor capital.

Ultimately, we hope that if this pilot is successful, it can serve as a model for private market participants. While Fannie Mae and Freddie Mac own approximately 200,000 distressed loans, other financial institutions own over 400,000 nonperforming mortgages. A number of private sector firms are considering, and in some cases executing, pilots of their own. Responding to this demonstrated interest, the Federal Reserve Board issued clarifying guidance on effective policies and risk management processes for its regulated institutions and determined that prudently executed rental initiatives by covered financial institutions could receive favorable Community Reinvestment Act consideration.

Investors from across the country are actively pooling capital as a sign of increased demand for this business model. And lenders are beginning to develop products to provide investors with the necessary financing to invest in this space. We have heard anecdotally that the private sector is looking to Fannie Mae's initial pilot as a model, in the same way that servicers relied on HAMP when developing their own proprietary loan modifications. We hope that many of the same investor standards and usage restrictions will be replicated so that communities are properly protected, tenants are effectively served, and investors are appropriately rewarded for doing the right thing.

I would also be remiss if I did not note that I am particularly encouraged to hear that certain financial institutions are beginning to explore how deed-for-lease, deed-in-lieu and short sale programs, as well as nonperforming loan sales, can be aligned with the REO Initiative. Treasury's Home Affordable Foreclosure Alternative Program, or HAFA, set a new standard for short sale and deed-in-lieu execution by promoting pre-approved short sale transactions, requiring that borrowers with a genuine hardship be released from liability for the remaining mortgage debt upon sale, and establishing a reasonable industry standard for payments to extinguish junior liens. Most recently, the FHFA has also provided leadership in this area by directing the Enterprises to develop enhanced and aligned strategies for facilitating foreclosure alternatives. This includes the requirement that mortgage servicers review and respond to requests for short sales within 30 calendar days from receipt of a short sale offer. These foreclosure alternatives are an important complement to a scattered site single family rental business, as the leased or vacant properties that result from these actions can be purchased by investors as well as by homebuyers.

****

In closing, I want to emphasize that the problems that this REO Initiative seeks to help mitigate are of historic proportion. They didn't occur overnight, and they won't be fixed overnight. This is why the REO Initiative is not a silver bullet. Rather, it is an important component of our overall strategy to help communities by preventing avoidable foreclosure, expanding access to refinancing, and supporting areas hardest hit by this crisis. I look forward to continuing to work with all of you on assessing the merits of these pilot programs, and more broadly, stabilizing and reforming the nation's housing market.

Thank you.